MSE's Academy of Money

About this free course

This free course is an adapted extract from the Open University course .

This version of the content may include video, images and interactive content that may not be optimised for your device.

You can experience this free course as it was originally designed on OpenLearn, the home of free learning from The Open University –

There you'll also be able to track your progress via your activity record, which you can use to demonstrate your learning.

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Introduction and guidance

The Open University has joined forces with MoneySavingExpert (MSE) to produce this new free badged course to give you the skills and knowledge to master your finances. The course was written by The OU, with MSE providing support and guidance.

Packed with videos, audios, quizzes and activities, the course covers all the key aspects of personal finance.

The course starts by looking at how to be savvy when spending money and at the behavioural and marketing pressures that try to influence what consumers buy. It then looks at budgeting and the impact of tax on household finances. Borrowing money is something virtually all households are familiar with but it can cause financial problems. The course explains how to borrow money sensibly if necessary, whether it's a loan to buy a car or a mortgage to buy your home. Do you want to save or invest money? The course looks at simple savings accounts but also investments such as shares, commodities or property. It explains what is involved and the risks you expose yourself to as you look for a higher return on your money. The course finishes by getting to grips with the complexities of pensions. It will help you to think about your options when retiring, such as how much your state pension will amount to, supplementing this with an occupational or personal pension, and what you can do if your pension provision falls short of what you need.

This free course lasts 12 hours and is comprised of six sessions. You can work through the course at your own pace. The six sessions are linked to ensure a logical flow through the course. They are:

1. Making good spending decisions
2. Budgeting and taxation
3. Borrowing money
4. Understanding mortgages
5. Saving and investing
6. Planning for retirement

Each session should take you around 2 hours to complete. At the middle and end of each session there is a quiz to help you check your understanding. And, if you want to receive a badge and formal statement of participation, at the end of Session 6 there is a quiz which you need to pass.

After completing this course, you should be able to:

- budget effectively and know how to make good spending decisions
- understand how income is taxed
- understand how and when to borrow money responsibly
- understand savings and investment products – including their different risks

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- plan for retirement and know what to do if a projected pension is insufficient.

Moving around the course

In the 'Summary' at the end of each session, you will find a link to the next session. If at any time you want to return to the start of the course, click on 'Full course description'. From here you can navigate to any part of the course.

It's also good practice, if you access a link from within a course page (including links to the quizzes), to open it in a new window or tab. That way you can easily return to where you've come from without having to use the back button on your browser.

You will find that some words are highlighted. You can hover over the highlighted word to see the definition, or if you click on the link, it will go to the glossary page at the end of the session. A definition of all the key terms highlighted throughout the session are in the glossary.

The Open University would really appreciate a few minutes of your time to tell us about yourself and your expectations for the course before you begin, in our optional start-of-course survey. Participation will be completely confidential and we will not pass on your details to others.

MoneySavingExpert's Forum

MoneySavingExpert.com have created a thread on their Forum to provide you with a community to discuss your progress, and chat to other students as you work through the course.

Open the link in a new tab or window and come back here when you've finished.

> This resource is part of the 'Wellbeing and Mental Health Collection' collated by The Open University in Wales. You can find out more and discover other courses, articles and interactives on the collection homepage.

What is a badged course?

While studying *MSE's Academy of Money* you have the option to work towards gaining a digital badge.

Badged courses are a key part of The Open University's *mission to promote the educational well-being of the community*. The courses also provide another way of helping you to progress from informal to formal learning.

Completing this course will require about 12 hours of study time. However, you can study the course at any time and at a pace to suit you.

Badged courses are available on The Open University's OpenLearn website and do not cost anything to study. They differ from Open University courses because you do not receive support from a tutor, but you do get useful feedback from the interactive quizzes.

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What is a badge?

Digital badges are a new way of demonstrating online that you have gained a skill. Colleges and universities are working with employers and other organisations to develop open badges that help learners gain recognition for their skills, and support employers to identify the right candidate for a job.

Badges demonstrate your work and achievement on the course. You can share your achievement with friends, family and employers, and on social media. Badges are a great motivation, helping you to reach the end of the course. Gaining a badge often boosts confidence in the skills and abilities that underpin successful study. So, completing this course could encourage you to think about taking other courses.

How to get a badge

Getting a badge is straightforward! Here’s what you have to do:

- read each session of the course
- score 50% or more in the Session 6 badged quiz.

For all the quizzes, you can have three attempts at most of the questions (for true or false type questions you usually only get one attempt). If you get the answer right first time you will get more marks than for a correct answer the second or third time. Therefore, please be aware that for the badge quiz it is possible to get all the questions right but not score 50% and be eligible for the badge on that attempt. If one of your answers is incorrect you will often receive helpful feedback and suggestions about how to work out the correct answer.

For the badge quizzes, if you’re not successful in getting 50% the first time, after 24 hours you can attempt the whole quiz, and come back as many times as you like.

Introduction and guidance

We hope that as many people as possible will gain an Open University badge – so you should see getting a badge as an opportunity to reflect on what you have learned rather than as a test.

If you need more guidance on getting a badge and what you can do with it, take a look at the OpenLearn FAQs. When you gain your badge you will receive an email to notify you and you will be able to view and manage all your badges in My OpenLearn within 24 hours of completing the criteria to gain a badge.

Get started with Session 1: Making good spending decisions.

Introduction and guidance

Session 1: Making good spending decisions

Introduction

Video content is not available in this format.

Video 1 Introduction to Session 1

Welcome to the first session of MoneySavingExpert's Academy of Money.

In this session the focus is on spending.

Spending money is something we do virtually every day, whether that's buying a sandwich at lunchtime, a trip to buy clothes for yourself or the family, or shopping online. A lot of us enjoy this, whether that's the shopping experience itself, or the anticipation of using or consuming the item we're buying.

We are, however, subjected to an array of influences when it comes to how we spend our money.

Some of these influences come directly from our personalities and habits. Some are socially driven – for example, spending money to impress others, or as a manifestation of a certain type of lifestyle. Or, we might be directly influenced, whether consciously or not, by the retailer marketing certain products to us

You'll start this session by looking at these influences. Then, you'll look at how a simple decision-making model can help you ensure that you make rational decisions when choosing to buy something, rather than falling foul of these internal and external pressures.

You'll then be taken through how to apply this model to one category of spending that nearly all households engage in – buying insurance products. The range of different types of insurance, the multitude of insurance providers and the complexities in the terms of the products make this an ideal area for the help that the four-step model can provide.

Next, you'll look at online shopping and at how to make good decisions online. You will also find out how to identify the clues to the scams that are found on the internet and the action you can take to minimise the chances of being scammed online.

To ease you into the course you'll start by examining your financial personality. What are your financial traits? Are any of these bad habits? Understanding the ways you currently approach money management will help not only with this session but the entire course.

After studying this session, you should be able to:

- understand some of the behavioural, social and marketing pressures that affect spending
- use a four-step approach to make effective spending decisions
- understand the factors affecting the cost of insurance products
- apply the four-step model to the selection of insurance products
- identify scams when shopping online
- be a savvy internet shopper.

The Open University would really appreciate a few minutes of your time to tell us about yourself and your expectations for the course before you begin, in our optional start-of-course survey. Participation will be completely confidential and we will not pass on your details to others.

> This Session is one of a suite comprising the course *MSE's Academy of Money* and has been made possible by financial and content contributions by MoneySavingExpert.com.

1 What is your financial personality?

Before you start this course on money management it will be very useful for you to identify and understand your current attitude and experience when it comes to your personal finances. This review will allow you to reflect on your financial ‘personality’. It will also help you understand where you need to develop your financial skills and perhaps change your behaviour when it comes to money management.

Figure 1 What is your personality when it comes to money matters?

Try this activity and then select ‘Reveal answer’ to get some feedback on each of the questions and direction to where in the other sessions in the course further information and guidance are provided.

Activity 1 What is your financial personality?

Allow approximately 10 minutes for this activity

In the blank boxes in the table, add your answers to the questions.

Question	Answer
When it comes to money do you consider yourself a risk-taker or risk averse?	Risk-taker or risk averse? *Provide your answer...*
Are you more of a spender or a saver?	Spender or saver? *Provide your answer...*

Do you currently actively budget for you and/ or your household?	Yes or no? *Provide your answer...*
Do you check your bank and credit card accounts – either online or the paper statements?	Yes or no? *Provide your answer...*
When it comes to suppliers (e.g. gas, electricity, internet) do you consider yourself a 'switcher' or a 'stayer'?	Switcher or stayer? *Provide your answer...*
Are you always looking for a better deal?	Yes or no? *Provide your answer...*
How far ahead do you plan your finances?	Up to 1 month, up to 1 year or beyond 1 year? *Provide your answer...*
Do you solely manage your own money or do you manage your money jointly with other people?	Solely, jointly or a mixture of the 2? *Provide your answer...*

Answer

Question	Answer
When it comes to money do you consider yourself a risk-taker or risk averse?	Feedback from previous Open University courses shows the majority of people consider themselves to be risk averse. Perhaps this is because people would rather keep what they have than risk losing it all in the search for higher gain. You can see, though, in the sessions on borrowing and on saving and investing that taking some risks in money management can be sensible if considered carefully.
Are you more of a spender or a saver?	The selection here may say much about your financial circumstances rather than your aspirations. Many people who would like to save more simply do not have the spare income to do so. Those who have more money will find it easier to save. In the session on savings and investments you can look at the options for saving money for the future and which options suit your circumstances.

Do you currently actively budget for you and/or your household?	Running even a basic budget makes huge financial sense as you really need a good idea of your spending versus income to avoid getting into financial difficulties. In Session 2 you will learn how easy it is to budget effectively.
Do you check your bank and credit card accounts – either online or the paper statements?	If you don't, you should! You need to do this to make sure there are no wrong or fraudulent transactions, know when you're close to your credit limit and when you need to repay. Managing your accounts supports your budgeting too – letting you know how much money you have in the bank and when you have to pay bills.
When it comes to suppliers (e.g. gas, electricity, internet) do you consider yourself a 'switcher' or a 'stayer'?	The general rule is the 'switchers' are much more likely to end up on the best deals than 'stayers'. If you have stayed with the same supplier for years you could well be paying too much for the service they provide. You will look at the benefits of switching at various points in this course.
Are you always looking for a better deal?	Scanning the markets and switching to cheaper deals is usually good news for your finances. You'll find out how to search for the best deals in this course.
How far ahead do you plan your finances?	Always plan ahead as far as possible – even if this involves some estimations about spending and income. You should plan for up to a year ahead if you can. Working from month to month may lead to the situation where you are always worrying about money. At the very least month-to-month management may encourage inefficient decision-making – for example by the selection of the monthly payments option for services bought once a year (e.g. car insurance).
Do you solely manage your own money or do you manage your money jointly with other people?	This will depend on your circumstances. If you are living alone then you are very likely to be a 'solo' money manager. If you are in a relationship or co-habiting then at least some financial matters may be managed jointly even if you keep separate bank accounts. Living in shared accommodation may also mean some pooling of finances with others. Whatever the arrangements though, if you live with someone else, it's best to coordinate finances to some degree so everyone's able to pay their way towards shared bills.

2 The social influences on spending

When you buy products – particularly when you're buying something expensive – several different sources of pressure may apply to the decisions you make.

Clearly there are economic pressures. Do you have enough money to buy the item you want? What is the item worth? Do you need to borrow money or can you pay for the whole item upfront?

But there are social pressures too. Our choices of products and brands can be affected by these, particularly when the products are seen and used publicly – for example cars, smartphones and clothing.

Listen to Audio 1 and learn about these social pressures which may consciously or subconsciously affect what we buy. Then try the activity below.

Audio content is not available in this format.

Audio 1 The modern way to shop

Activity 2 Why we buy what we buy

Allow approximately 5 minutes for this activity

Identify the main social influences on what we buy according to:

- Veblen
- Bourdieu

Provide your answer...

Answer

Veblen refers to the concept of **conspicuous consumption** where products are bought as a manifestation of prosperity or to seek recognition and approval from others.

Bourdieu's approach is that what people buy is influenced by the social class they believe they belong to or aspire to belong to. So, the purchases made are symbolic of this class and are intended to be distinguishable from the tastes and preferences of other **social classes**.

Do you recognise these influences within your own social group?

3 Your habits could impair your spending choices

In addition to the social factors that affect the way we make financial decisions there are several bad habits that can impact adversely on our decision-making. Now you will look at some of these behaviours.

Figure 2 Are your spending habits causing problems?

3.1 The preference for bringing forward financial rewards and for delaying outlays

Evidence suggests that, given a choice, around a fifth of us would prefer to accept less money now as opposed to more money later. This was shown in a survey by the Money Advice Service (This Money, 2013), which found that one person in five would prefer to be given £200 today rather than £400 in four months' time!

Figure 3

This preference also means that people prefer to delay payments rather than make them straight away. This behavioural trait to delay payments may lead to poor decision-making when paying for goods – for example, paying for car insurance in monthly payments over a year rather than in full at the point of purchase. If you pay in instalments over a year you are entering into a loan arrangement with the insurance provider. Given that the interest rate charged is commonly very high, choosing to pay in this way is usually a poor financial decision.

3.2 The preference for simplicity over best value

Do you look closely at the details when comparing the cost of alternative products? Try this activity.

Activity 3 Choosing the low-cost loan

Allow approximately 5 minutes for this activity

You are buying a vacuum cleaner costing £100. But you need to borrow the money to buy it. You are offered a series of choices to borrow the money. Which loan would you choose?

> Loan 1: pay back £120 at the end of the year.
>
> Loan 2: pay back £115 at the end of the year.
>
> Loan 3: pay a £10 arrangement fee and then equal monthly repayments; the interest rate is 5% per annum.
>
> Loan 4: pay a £5 arrangement fee and then equal monthly repayments; the interest rate is 8% per annum.
>
> Loan 5: pay equal monthly instalments at an interest rate of 7% per annum, plus a final charge of £3.

Provide your answer...

Answer

Which loan did you choose? You may be surprised to discover the cheapest loans are Loans 4 and 5. The issue is that people do not like complexity and so often opt for higher-priced products where the pricing is simpler. For comparison, here are the total costs of each loan option:

> Loan 1 costs £120
>
> Loan 2 costs £115
>
> Loan 3 costs £112.70
>
> Loan 4 costs £109.40
>
> Loan 5 costs £106.80

As options become more complex, the reliability of our decision-making quickly deteriorates and we become more inclined to go for the simplest options.

Plus, we also don't get a lot of practice doing this. Our big financial decisions – like buying a home or car – don't happen very often. So, there's not much opportunity for practice, and consequently there's a lot of scope to forget what we learned the last time we made a big financial decision.

Technical note

To clarify how the answers to Loans 3, 4 and 5 are obtained, a detailed calculation for Loan 3 is shown below.

You can use the same methodology to derive the answers for Loans 4 and 5.

In each case, the £100 loan is repaid in 12 equal instalments, with these being made at the end of each of the twelve months of the year.

The fee needs to be added to the interest costs – with both then added to the original £100 borrowed to get the total repayment.

Note that the process does involve some 'roundings', so your answers may be different to those above by a few pence.

Loan 3

Month	Loan o/s	Monthly interest @ 5%pa
1	£100.00	£0.42
2	£91.67	£0.35
3	£83.34	£0.35
4	£75.01	£0.31
5	£66.68	£0.28
6	£58.35	£0.24
7	£50.02	£0.21
8	£41.69	£0.18
9	£33.36	£0.14
10	£25.03	£0.11
11	£16.70	£0.07
12	£8.37	£0.04
Total Interest		**£2.70**
Upfront fee		**£10.00**
Total repayments (including the original £100 loan)		**£112.70**

3.3 Not evaluating the evidence properly when buying things

When buying household goods you might look very closely at the reviews of their performance, but how much do you factor this into your decision-making? Try this activity.

Activity 4 Which is the better washing machine deal?

Allow approximately 5 minutes for this activity

You are buying a new washing machine. The machine from shop A costs £600 and comes with a 5-year guarantee for replacement if it breaks down. Shop B sells the same machine for £500 but offers no guarantee.

Tests done by a consumer group show that this machine has a 25% chance of breaking down and needing replacement per year.

Assume you have the money to buy either deal and that you are only interested in the financial impact over the next 5 years. Which shop would you buy at?

Provide your answer...

Answer

The better option is to buy the machine from shop A, as the probability is that your washing machine will break down and need replacement within 5 years.

The probability that the washing machine will be OK in year 1 is 75% (100% minus the 25% chance of a breakdown).

This probability applies in each subsequent year.

So, the probability that the machine does **not** break down over 5 years is:

75% x 75% x 75% x 75% x 75% = 24%

So over 5 years it is likely that this particular brand of washing machine will need replacement. The chance of this is 76% (100% minus 24%). Therefore, the wiser choice given what you know is to pay more and go for the deal from shop A, as it will replace the washing machine without charge if it broke down before five years are out.

Though, if we are honest, it'd be better to find a different washing machine that's a lot less likely to break down than the one in the example here! In fact, these days washing machines are generally much more reliable that the one in this activity.

We're very good at not expecting 'the unexpected'. In fact, we really don't like unpredictability at all. Financial decision-making involves projecting ourselves into situations we don't want to think about. So, we may be tempted not to make financial provisions for unexpected events – like major repairs to our cars, having to replace our boilers, or finding that the roof needs retiling. But, it's always best to expect the unexpected – and plan for it!

3.4 Putting off the decision can be a (bad) decision

Finally, a common weakness when making decisions is inertia – meaning it's always easier not to make a decision rather than make one and find out you chose wrongly. Try this activity.

Activity 5 Inheriting money

Allow approximately 5 minutes for this activity

Imagine you inherit £20,000. The inheritance comes to you in the form of £5,000 in cash and £15,000 in shares. Would you:

- Use the cash to buy more shares?
- Make no changes?
- Sell some shares to increase the amount of cash?

Provide your answer...

Answer

Did you select 'no changes'? If you did, it's not unusual. That's because we all have a tendency towards inertia. That means we tend to feel uncomfortable making changes and so often stick with existing arrangements even when they might not be the best option.

To help people deal with the problem of inertia when it comes to financial decisions, policymakers have become very interested in the idea of giving us a 'nudge'. This is a way of structuring financial choices so that people, while still free to choose, are steered in a direction that's likely to be best for them. A recent example has been the introduction of workplace pension schemes. Here employees are automatically enrolled onto pension schemes unless they take action to opt out. So here inertia – taking no action – means employees become pension scheme members and start to build up their own savings for their retirement.

If you did select 'no changes' you may also have been manifesting your risk appetite too, preferring to keep the portfolio as it is rather than taking on more risk by investing more in shares.

As you've learned in this section, we have to be aware of, and try to overcome, certain biases when we're trying to make the best financial decision. But it's not just about being rational – we all have emotional pressures that may influence us to spend, or to choose one particular product over another. In the next section, you'll look more closely at these emotional pressures.

4 Your personality can seriously affect your spending

Have you ever thought about how much your personality and approach to risk-taking affect your spending and other financial decisions?

In Video 2 Mark Fenton-O'Creevy, Professor of Organisational Psychology at The Open University Business School and an expert in behavioural finance, introduces the way behavioural biases affect personal financial decisions.

A warning before you watch the video: the content does include details of someone receiving a serious head injury.

Video content is not available in this format.

Video 2 Mark Fenton-O'Creevy

Activity 6 Impulse buying

Allow approximately 5 minutes for this activity

As you heard from Mark Fenton-O'Creevy, there are good reasons why we sometimes make bad decisions about spending money, even if we're smart about most other things in life.

Do you consider yourself to be an impulse shopper?

What do you think are the factors driving this behaviour? If you're not an impulse shopper, think back to Video 2 and what you may have learned about the reasons for impulse shopping in it.

Provide your answer...

Answer

Most of us have bought on impulse at some point in our lives.

Those of us who routinely spend money on impulse may be doing this to try and regulate their emotions. The driving forces may be coming from within the mind rather than just being the result of people succumbing to the (external) forces of marketing by retailers.

5 Understanding the marketing forces that can affect our spending

Figure 4 What influences your choice of products?

One reason why people sometimes pay higher prices for certain goods and services is that they think a higher price equates to higher quality. The price of a product is often used as a mental shortcut to assess quality. Such shortcuts (sometimes called **heuristics**) are used to help assess situations when there's limited information available. Marketing departments employ these market beliefs to influence people's spending.

Of course, a link between price and quality may or may not be accurate; or at least the differences in price may not reflect differences in quality, especially when it comes to more expensive branded items.

Here's a list of some common decision-making shortcuts people use when shopping. Think about what each shortcut is suggesting to you to do, and who wants you to believe it.

- Supermarkets' 'own' brand products are just national brands sold under a different label at a lower price.
- Larger-sized containers are cheaper per unit than smaller sizes.
- When in doubt, a big brand is always a safe bet.
- Items tied to 'give-aways' are not good value.
- Stores that have just opened usually offer attractive prices.
- Larger stores offer lower prices than smaller stores.
- Small shops give you better service than large stores.
- Higher prices indicate higher quality.
- When buying heavily advertised goods, you are paying for the label not the quality.
- More recent products are likely to incorporate newer and better technology.
- It's best to buy well-established products which have been tested by the market for some time.
- If companies advertise heavily they must believe that their products will sell well.
- Don't buy 'fresh' fish on Mondays.

Some of these shortcuts are suggesting that you should buy from large stores; some from small stores. Some are telling you that you should search out bargains; others that it's not worth it. Some suggest that buying named brands is a protection; others that they're a waste of money.

In each case, there are some particular groups, producers or retailers, who would like you to believe in what is being said so that you spend your money on their products rather than their competitors.

Activity 7 Mental shortcuts: which do you believe and use?

Allow approximately 5 minutes for this activity

How many of the above 'shortcuts' do you believe and use when you are shopping? Have you got any other ones you use?

Provide your answer...

Answer

The answer will obviously vary from person to person but most of us deploy at least one of these shortcuts, whether consciously or unconsciously.

Some are usually reliable – for example the cost per unit of goods in large containers is usually lower than in smaller containers. But not always. Check this out when you are next at a supermarket. Other shortcuts are, at best, a figment of the imagination.

Some shortcuts, while you might even believe both of them, are contradictory – see the first and third shortcuts about 'brands'.

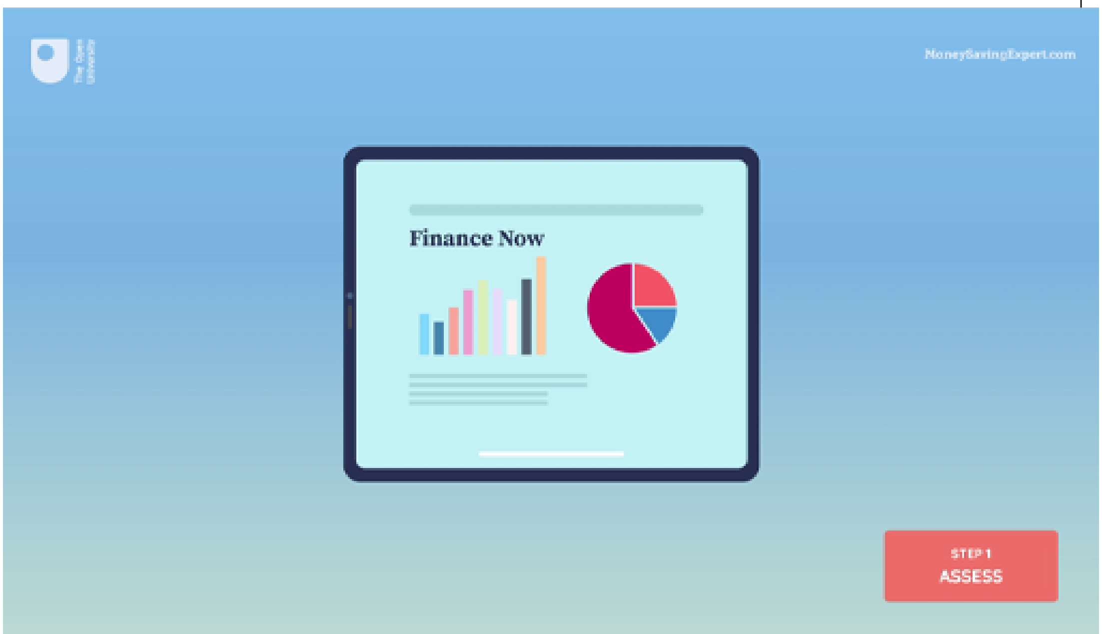
6 A decision-making model to take control of spending decisions

Having examined the various internal and external influences on spending decisions, it's time to take control of how you go about spending money. There are a few simple steps that can help you make good (or at least better) choices of products and services.

Watch Video 3 on the four-step decision-making model.

Video content is not available in this format.

Video 3 A decision-making model to take control of spending decisions



Activity 8 Making spending decisions

Allow approximately 5 minutes for this activity

Think back to a recent major purchase you made – perhaps a car, a household appliance, a new computer. Having watched the video, if you were now to make a similar spending decision would you approach it differently?

Provide your answer...

Answer

Clearly the answers are personal to you. The key questions are:

- Did you do some market research before buying?
- Did you take time to locate the best deal?
- Did you then act promptly to buy the product?

- Did you negotiate the terms of the deal, including the price?
- Were you prepared to switch services when buying such products as insurance products, and utility, internet and mobile phone services?
- Are you using the outcome to guide you when making your next major purchase?

All this may seem like a bit of a chore – but you may be amazed how much you can save each year by applying this four-step model.

Next you have a short quiz before examining how the four-step model can help when it comes to buying insurance products.

7 Half-time quiz

Now it's time to complete a short quiz to see how much you've learned so far.

Half-time quiz

Open the quiz in a new tab or window then come back here when you've finished.

8 Why do we buy insurance?

You should now be familiar with the four-step decision-making model. You are now going to test out the model by applying it to one category of household spending – the purchase of insurance products.

There are several reasons for testing the model on insurance:

- Purchasing insurance products is an activity regularly undertaken by virtually all households.
- There are different types of insurance – motor, home, pet, health, travel and others – each with different features. There are many providers of insurance products too. This means that there is an array of information that needs to be digested by consumers. The four-step model provides the means to assess these different insurance products rigorously and facilitate appropriate choices.
- Each year most households spend large sums on insurance. So, if applying the model can improve product selection the savings generated could be substantial.

Figure 5 Check the small print on insurance policies before you need to make a claim

First let's look at the basics of insurance.

Insurance is a method whereby individuals or households (or organisations) can protect themselves against the unexpected. To do this, they pay a sum of money called a premium to an insurer in exchange for being indemnified (protected) against the losses that result from specific perils, under conditions specified in a contract. This contract is called an insurance policy.

When you take out an insurance policy you're transferring to the insurer the risk of the financial loss arising from the peril, and so you're reducing the potential consequences to yourself.

Actuaries provide statistics to insurers to help quantify the risks that insurers are taking on. Insurers need data on the probabilities of the perils for which they offer insurance – death, illness, disease, burglary, accidents and so forth – and data on people of different ages, genders, locations, postcodes and households, so that they can estimate their risks of paying out.

Actuarial data will give an approximation of the future claims that the insurer might face across the range of perils they insure. Insurers will then aim to set premiums so that, on average, total premium income will cover the cost of paying out for claims, building up reserves and making a profit.

Insurers spread their risk by insuring many individuals and households against various risks. By insuring a large number of risks, the average number of times that insurers have to pay out will be more predictable, and so will be the total amount that they have to pay out in any given year. In taking on the risks of many and aggregating them, the insurer faces a more predictable future than individual policy holders would if they had to face their risks themselves.

What are the different strategies people could apply for managing risk and uncertainty themselves?

One approach is to ignore the risk. If the peril then materialises, there could be major negative financial ramifications, and so this would be a high-risk strategy.

Another approach is to try to eliminate or reduce risk. Strategies here could include fitting house alarms (to reduce the risk of burglary or fire) or eating healthily and exercising (to reduce the risk of premature death). These might be beneficial in themselves – although they may have costs attached too – but they cannot eliminate all of life's risks and uncertainties.

A different strategy is 'risk assumption'. This involves accepting and taking on the potential financial impact of the peril materialising. It could also be called 'self-insurance': putting savings aside to cover the costs of any potential financial loss.

This can be a strategy adopted by choice by people who are risk-takers or who have enough income or savings to cover possible losses. It can also be adopted by default when other types of insurance are not available or are too expensive.

Yet where the financial impact of something happening may be large, for example, redecorating your home and buying new furniture and personal items after a home fire, people who can afford to buy insurance tend to do so to transfer the financial risk to the insurance company.

The reality is that certain insurance products are compulsory – certainly motor insurance if you have a vehicle and home insurance if you have a mortgage (lenders generally require this).

With other insurance products purchase is optional – for example home contents insurance and travel insurance. But you might want to consider whether you really want to self-insure against some of the more extreme costs that could fall to you (e.g. hospitalisation during a holiday in the USA which can easily run in to tens of thousands of dollars).

Elsewhere you may feel that the social fabric of the UK negates the need to buy insurance – the best example here being the existence of the **NHS** which, arguably, make the purchase of health insurance illogical (unless perhaps it's offered for free or heavily discounted through your employer).

Either way each insurance category is different and making effective choices between the products – or, indeed, deciding whether you need to buy insurance in the first place – is a good place to use the four-step model.

Activity 9 Estimating an insurer's potential liability

Allow approximately 5 minutes for this activity

What are the two categories of information an insurer needs to forecast the amount of money they will have to pay out under the insurance contracts they have sold?

Provide your answer...

Answer

The two categories are:

- the probability of claims being made by those who are insured
- the cost of meeting those claims (provided the claims are covered by the terms of the insurance)

This can alternatively be expressed as:

Total cost to the insurer = expected number of claims x expected average cost of a claim

The data compiled by insurers from previous claims can provide a very good guide to the *average* expectation of future claims, and how much they may need to pay out per claim.

But, the risk to the insurer is that they get a high number of claims one year that means the total amount they pay out is (well) above average. For example, claims under home and contents insurance policies are huge when the country gets hit by exceptional weather conditions like the Great Storm of October 1987, or the more recent floods.

9 Applying Steps 1 and 2 of the decision-making model to insurance

Now you'll look again at the four-step model and see how we can apply it to insurance.

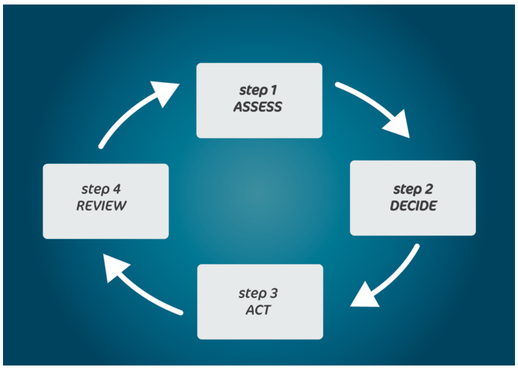


Figure 6 The four-step model for decision-making

For Step 1, where you assess the situation, it's worth stressing the significance of the perils that can be insured against, as related insurance policies vary according to individual circumstances. **Life insurance**, for example, is likely to be especially important in a family with children and with one income earner but may be regarded as irrelevant to a single person with no dependants.

An important factor to consider is what other protection is available. State benefits are part of this equation, as are any benefits available from an employer (if you're employed).

With large employers, benefits may include sick pay above the statutory minimum, 'death in service' benefits (a form of life insurance that usually covers three or four times your salary) and private medical insurance (PMI).

As part of your Step 1 planning you need to find out what you are entitled to. Your entitlements may not completely replace the need for additional private insurance, but it's important to know what they are, as they may reduce the amount of additional cover needed.

A further factor to assess at Step 1 is your attitude towards risk. Your aversion (or otherwise) to risk will be affected by several factors, including age, tastes and preferences. The more risk averse you are, the more likely you are to consider additional insurances.

Step 2 is when you decide which additional insurance policies to buy. As a rule, the greater the potential financial impact of a peril, the more likely it is that you will consider insuring against it. The key thing to consider is whether you could bear the cost if the worst were to happen – even if the risk is very low.

The obvious example of this is insuring your home – rebuilding costs would be far beyond most people's means, and so most owners decide that risk shifting makes sense (or must do so as a condition of their mortgage).

But where the costs would be smaller, self-insurance may be considered a better alternative. To illustrate, it may be cheaper to buy a new mobile phone rather than paying for the insurance for it over several years.

Another thing you need to think about is the cost of the insurance policy. Normally, the higher the premium, the less likely someone is to take out the policy.

However, while it’s theoretically possible for you to calculate the expected benefit from an insurance policy, it’s difficult to do in practice. You might be able to calculate the financial loss you’d suffer, but it’s unlikely you’d be able to calculate an accurate figure for how likely it is for your car to be stolen, or for you to drop and break your mobile phone.

Your decisions about whether to take out insurance policies will have a direct impact on your household budget: the more policies you take out, the more you have to pay for them.

But it’s worth looking at ways you can bring premiums back down. For example, fitting window locks or a burglar alarm may bring your home insurance premiums down.

One way to think about the impact of insurance premiums on your household budget is to realise that the current expense aims to protect you and your household from greater expense in the future.

10 Applying Steps 3 and 4 of the decision-making model to insurance

Now continue the process of applying the four-step model to insurance with Steps 3 and 4.

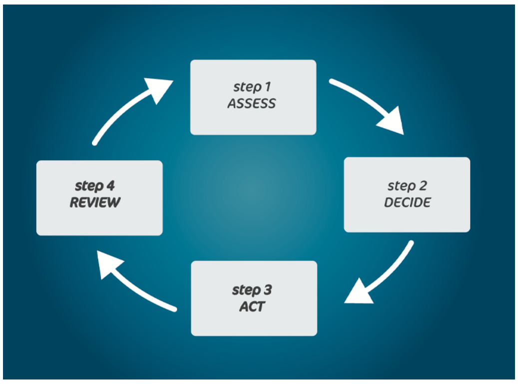


Figure 7 The four-step model for decision-making

Step 3 is about acting to put the insurance plan into effect. This involves looking at the details of policies and comparing quotes to make sure you get the best deal.

As the UK's insurance market is so developed, taking out most types of insurance is relatively easy. Insurance policies can be bought either:

- directly from an insurance company
- online, through price comparison websites
- via a third party, such as mobile phone shops that sell mobile insurance, or electrical retailers that sell 'service and repair' packages on their goods. Another example is travel agents or airlines that sell holiday insurance when you book with them, or
- through an intermediary (usually called a 'broker') who can use their knowledge of the insurance market to select the best policy for you from the ones offered by the companies it works with. Generally, the more complicated the insurance, the more an intermediary can help you in assessing your situation and needs, recommending and explaining policies, and in assisting in the event of a claim.

Whatever route you take to buy your policy, do take time to check closely the terms of the contract with your chosen insurer. Insurance policies are not identical. You need to ensure that the policy is right for you.

Step 4 is to ensure that you regularly review your decisions. When you review, check you still need the insurance – for example, if you're unlikely to go on holiday in the next year, there's no point in paying for travel insurance.

Always review your insurance needs when policies come up for renewal and when personal circumstances change (for example, if you have your first child, or when all your children are grown up and financially independent).

One of the worst things you can do in insurance is just renew with the same insurance provider year after year, rather than comparing every time your renewal comes up to see if you can get a cheaper deal with another provider.

As with any financial plan, check how things have worked out in the light of experience. This gives you the chance to remove 'double insuring' – to check that the same risk is not insured twice (for example, whether you are covered for legal expenses on both your car and home insurance), which would be unnecessary expenditure.

Activity 10 Applying the four-step model to insurance products

Allow approximately 5 minutes for this activity

Having looked at how the four-step model can be applied to purchasing insurance – and reflecting on how you have done things in the past – are there any changes you will now make to the way you buy insurance cover?

Provide your answer...

Answer

Clearly your response is a personal one. For many people the main lesson learnt is to do the research necessary at the 'assess' step.

But many people do the assessment of the options available but then fail to decide what to do – perhaps because of the perceived complexities of choosing between alternative products.

A clear failing for many is to allow inertia to prevail and just accept the existing insurer's renewal quote – which can be a costly option. Sometimes people find a better quote but simply fail to 'act' on it. Make every effort to avoid these pitfalls.

11 Mobile phones and insurance

There's a huge market for phone contracts and with these comes the question of whether you need phone insurance.

So, using the four-step approach, you can now consider whether it makes sense to insure your phone.

Figure 8 How did we manage without mobile phones?

Buying insurance for a phone is not cheap. The cost typically varies from £5 to £15 per month.

So, when assessing whether you need to insure your phone, think about these questions:

- What exactly are you getting cover for?
- Does the cover you get justify the cost?

Cover will include your phone being lost, stolen or broken. It might also include cover for unauthorised calls, accidents and phone accessories such as linked headphones/ earphones if stolen along with the phone.

But policies will exclude several situations where you will not be covered. These are called 'exclusions to the cover'. They could include damage resulting from carelessness, theft of the phone when it was left unattended or water damage. Exclusions might also apply if there's delay in reporting your phone lost or stolen.

So, before you 'decide' and 'act' on this question of whether to insure, make sure you check what's in the cover and what's not.

One thing to note is that the cost of mobile phone insurance, unlike most other forms of insurance, is not risk-based. The cost does not reflect your characteristics or record of claims. This is something else to bear in mind when deciding whether you need to insure your phone.

Activity 11 Should you buy phone insurance cover?

Allow approximately 5 minutes for this activity

What should you think about when deciding whether to sign up for cover?

Provide your answer...

Answer

First, check whether you already have protection through a home contents insurance policy for the family home. If you have a bank account, check there too. Some banks and building societies offer phone insurance to their customers with a paid-for bank account.

Next, if neither of those solutions covers your phone, run through these statements to see if any apply to you:

- You have a history of lost or broken phones.
- You are very reliant on the phone – and would need to be able to replace it quickly (in this case make sure the insurance contract offers speedy replacement).
- You have a very expensive smartphone.
- You could not afford to replace the phone yourself.

Are you any closer to deciding whether or not to take out insurance cover? The greater the number of statements that apply to you, the more insurance cover would make sense.

Given that the cost of phone insurance is not risk-based, you do need to consider closely your own record when it comes to mishaps with your phone. If you are a regular loser of your phone or prone to mishaps causing it to damage, buying insurance is likely to make good financial sense. If, by contrast, you never lose or damage your phone, insurance is likely to be a waste of money.

12 Shopping online

Online shopping lets you buy the things you need (or want) from companies around the globe.

Shopping this way lets you compare deals (like insurance) more easily, increasing the chances you'll be able to find a decent offer that suits your needs at a price you can afford.

However, the convenience of online shopping may lead people to spend more than they can afford. Consumers can shop around the clock without the need to leave the comfort of their own home and may be more likely to make impulse purchases. An aspect of this risk was highlighted by research published in 2016 which showed that some people with compromised mental health can struggle to control their spending when they are acutely unwell (MMHPI, 2016). So for some people, during a vulnerable time, the availability of online shopping increases the risk of getting into financial difficulties.

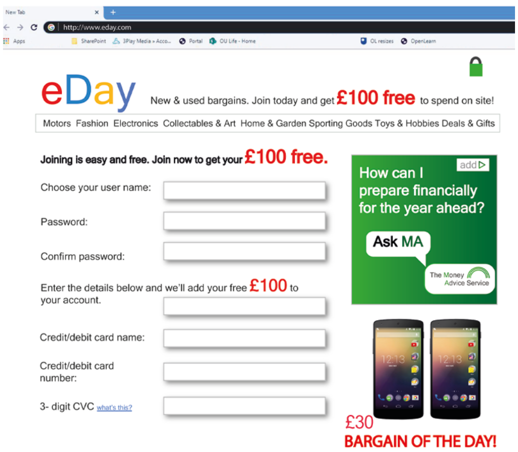
The transformation the internet brings to our shopping habits is demonstrated by the financial performance of the major retailers. Those with huge and highly effective web shops tend to deliver better financial results at a time that conventional high-street shopping is under a growing cloud.

But, be careful, as there are some risks when you transact online. Shopping online can expose us to the risk of being defrauded by rogue sites posing as genuine online retailers. Try this activity.

Activity 12 Spotting a dodgy website

Allow approximately 5 minutes for this activity

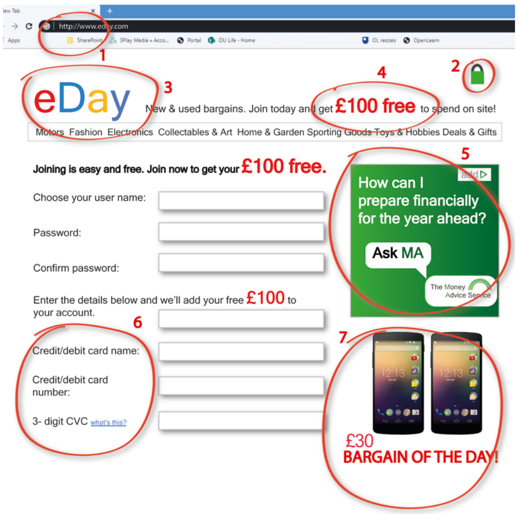
Does anything strike you as suspicious about this website?



Which features would make you suspicious of this online retailer?

Provide your answer...

Answer



Well, what aroused your suspicions? You may have spotted some, or all, of the following:

1. This site is asking for details, like a password, that should be gathered only over a secure site. But the site address (URL) starts with 'http://'. A secure site's address will start with 'https://'.
2. Another sign of a secure site is a padlock symbol. It should appear just before the website address or sometimes in the bar at the bottom of your computer screen. If, as here, it appears only in the body of the website, this is an indication that it could be fake.
3. A name and logo that are very similar to a real website. It's designed to trick you into thinking you're on the real website or an associated company's site.
4. Inducements to sign up right now, so you don't have time to think carefully about what you're being asked to do.
5. Genuine ads from real organisations designed to reassure you that the site is a trusted one.
6. Collecting card or bank details over an unsecure site and unrelated to any purchase. This is the whole purpose of the fraudsters: to steal your card details and then go shopping at your expense.
7. Smartphones are just not sold for £30. If an offer sounds too good to be true, then it usually is.

You might also notice that there are no contact details on the site, so there's no way to find out more or to complain if things go wrong.

13 Being a smarter online shopper

Figure 9 Take care when providing your credit card details

Here are some useful tips for consumers buying online, although many tips on buying online are the same as for buying from a shop.

- Make sure you don't just visit one site before you buy. That great deal might be on offer somewhere else – and cheaper.
- Use retailers and services you know about – or ones that have been recommended to you by a trusted source like MoneySavingExpert. If it's a site you've not used before, check out reviews online on sites like Trustpilot and Feefo. Have other customers reported good experiences using the site?
- A company might have a great website, but that doesn't mean it's law-abiding.
- Make sure you know the trader's full address – especially if the company is based outside the UK. The internet makes buying from abroad easy so it's important you know your rights.
- Don't assume an internet company is based in the UK just because its web address has 'UK' in it – check out the physical address and phone number.
- Take into account the shipping, postage and packing costs. Weigh them up against the parking and travelling costs you would have to pay if you went to the high street.
- Although shopping from overseas websites is relatively safe, it may be difficult to enforce your contract if things go wrong. Consider paying by credit card, especially if the item you're buying costs more than £100, as you then get Section 75 protection, meaning you can claim from the credit card company if anything goes wrong. Buying for under £100? You'll still get **chargeback protection**.
- If you are thinking of buying from an overseas website, check the costs you would incur if there is a reason to return the goods. These costs may be very high.
- Look for websites that have a secure way of paying (known as an encryption facility) – these show a padlock, as noted in the previous activity, before the web address or at the bottom of the screen when you're filling in the payment details. Also check the web address starts with 'https' rather than just 'http'.
- Check whether the company has the privacy statement that tells you what it will do with your personal information if this is collected. This is required under the **GDPR**.

- If buying from an auction site, check the seller's reputation. Be careful, some traders will make up accounts and post good comments about themselves. Look to see how many transactions the person giving feedback has carried out online; a number next to their name will indicate this.
- Be wary: if the price is too good to be true, it usually is.

(Adapted from Callaghan et al., 2012, pp. 109–10)

14 End-of-session quiz

Now it's time to complete the end-of-session quiz. It is like the previous quiz but this time instead of answering three questions there will be five.

End-of-session quiz

Open the quiz in a new tab or window and come back here when you've finished.

15 Summary of Session 1

Decisions about spending money – particularly on major purchases – may put you under various influences and pressures, whether from society or from yourself. Some of these emanate from our personality and our behavioural traits. Some influences come from social pressures and the marketing tactics of those wanting to sell to us.

All these influences can result in poor spending decisions being made.

To take control requires having an unbiased methodology to help us. The four-step model provides this by setting out what needs to be done when making major purchases.

You examined the way the model can help make good decisions when buying insurance products – something most households do several times a year.

You also looked at internet shopping and tips to spot and avoid the scams that are found online, and ways to shop more safely on the web.

So, this session should have made you more self-aware about how and why you spend your money and more skilled at making considered decisions about what to buy.

Further reading links

Read the MoneySavingExpert.com Scam blog.

Learn more about copycat websites.

Get started with Session 2: Budgeting and taxation.

Session 2: Budgeting and taxation

Introduction

Video content is not available in this format.

Video 1 Introduction to Session 2

This is the second session of a course on money management produced by The Open University in collaboration with MoneySavingExpert.com.

In this session on budgeting and taxation you will learn how the income you receive – your **net income** – is affected by the deductions of **income tax** and **National Insurance Contributions (NICs)** from your **gross income**.

You'll then explore the characteristics of your spending before you start building your **budget**.

Understanding how to manage your budget provides the foundation of good financial management and in this session you will learn how to go about this.

After studying this session, you should be able to:

- understand how income tax and National Insurance impact on earnings

- understand household spending
- compile a budget
- understand the key aspects of budget management.

This Session is one of a suite comprising the course *MSE's Academy of Money* and has been made possible by financial and content contributions by MoneySavingExpert.com.

1 Income and taxation

There are two sides to budgeting – calculating income and forecasting spending.

The income side is usually easier as for many of us it's what we get from our employer(s) or from government benefits.

Being self-employed or having several sources of income can make budgeting tricky as there are likely to be some uncertainties about how much you will earn in the course of the year ahead, meaning that there will a bit more guesswork in your budget.

Figure 1 Getting to grips with those household finances

When building income into your budget you need to focus on net income. This is the income you actually receive after tax and other deductions are made from your salary (known as your gross income).

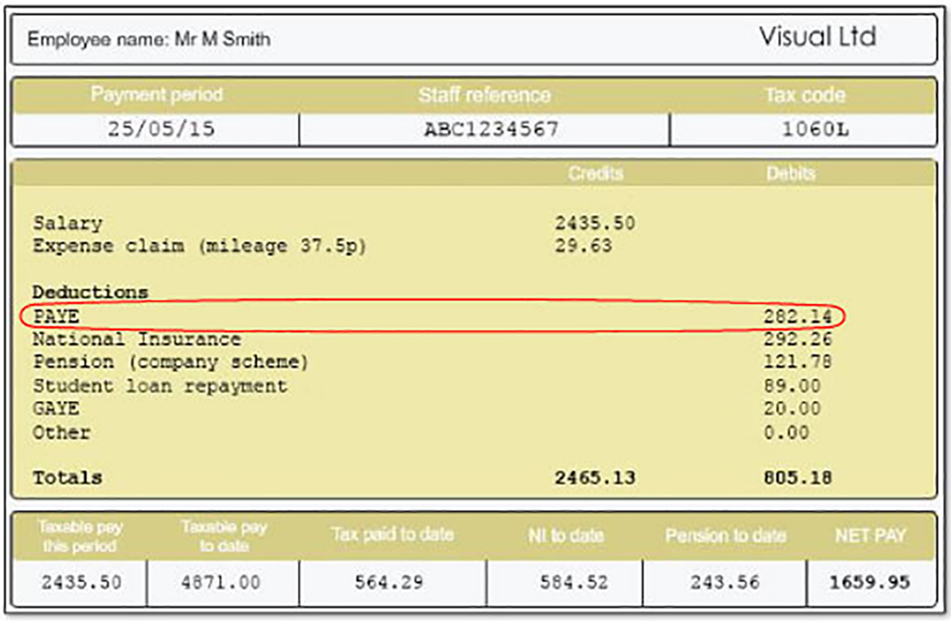
If you're employed, these deductions are made for you and set out in your monthly payslip. If you're self-employed or a contractor, you'll need to factor in tax and other deductions yourself or employ an accountant to do it.

But even if these deductions are made for you, it is important that you understand them to ensure that they are correct. So next you'll look at the two main deductions made from gross incomes – income tax and National Insurance contributions.

2 Understanding income tax

Employees

When you earn money by working for an employer you don't normally receive the whole of your wage (your 'gross' income). Instead, you get your gross income minus certain payments such as tax and National Insurance. What's left is your 'net' income – and this is the amount you actually receive.



Employee name: Mr M Smith

Visual Ltd

Payment period	Staff reference	Tax code
25/05/15	ABC1234567	1060L

	Credits	Debits
Salary	2435.50	
Expense claim (mileage 37.5p)	29.63	
Deductions		
PAYE		282.14
National Insurance		292.26
Pension (company scheme)		121.78
Student loan repayment		89.00
GAYE		20.00
Other		0.00
Totals	**2465.13**	**805.18**

Taxable pay this period	Taxable pay to date	Tax paid to date	NI to date	Pension to date	NET PAY
2435.50	4871.00	564.29	584.52	243.56	**1659.95**

Figure 2 The tax authorities take their cut

Self-employed

If you are self-employed your earnings are not automatically taxed. Payments for the work you undertake are made without tax deductions. So the onus is on you to set aside the money that you will have to pay after you have made your annual tax return.

One way to help ensure you retain the money that is due to be paid in tax is to open a new bank account and place into it one-third of all the money you receive for your work. Having this separate account will help ensure that you do not spend the money before you have to pay it to the taxman. Setting aside one-third of your earnings is not a precise estimate of your tax bill but it is a good enough approximation that will avoid you getting into a panic when the tax is due.

If you employ an accountant then they will help you with your tax planning.

Deductions from your gross earnings

In the UK the top two payments that come out of your gross income are income tax and National Insurance Contributions (NICs), which are covered in the next section. Other deductions may be made too, like contributions to a pension scheme – but here you'll focus on what for most people are these main two payments.

Income tax is imposed – levied – on almost all types of income including pensions (but it's not payable on gifts, lottery winnings, **Premium Bond** winnings and **ISA** earnings). When it's collected by **HMRC** through an employer (when the worker is employed rather than self-employed) it's often referred to as a 'pay as you earn' (PAYE) tax.

Income tax is paid on income that is received by you within a given tax year (6 April in one year to 5 April of the following year).

You are allowed to earn up to a certain amount of money before having to pay income tax. This is called receiving the 'personal allowance', which was £12,500 for the 2019/20 tax year.

The allowance is higher for certain groups of people, such as those who are registered blind. From 2021/22 the current plan is for this personal allowance to increase each year in line with the rate of price inflation measured by the **Consumer Price Index (CPI)**.

The personal allowance has an income limit of £100,000. If you earn above this limit the allowance tapers away, and those earning more than £125,000 a year (in 2020/21) don't get any personal allowance.

Income tax in England, Wales and Northern Ireland

If you earn more than your personal allowance in any tax year, you will need to pay on the amount you earn above it. In England, Wales and Northern Ireland, there were three different tax bands in 2019/20:

- the first £37,500 above the personal allowance was taxed at 20%, known as basic-rate tax
- between £50,000 and £150,000 of taxable income, the rate was 40%, known as higher-rate tax
- there was a rate of 45% on taxable incomes over £150,000, known as additional-rate tax.

The same tax bands and rates were retained for the 2020/21 tax year.

While Wales and Northern Ireland currently have the same income tax bands as England, there are plans for these nations to set their own tax bands, so this could change in the future.

Income tax in Scotland

Since 1999 Scotland has had some discretion in respect of taxes and now has a slightly different income tax structure. In 2020/21:

- the first £2,085 above the personal allowance was taxed at 19%
- the next £10,573 was taxed at 20%
- the next £18,272 was taxed at 21%
- between £43,430 and £150,000 of taxable income, a 41% tax rate applied
- there was a rate of 46% on taxable incomes over £150,000.

The economic impact of income tax

Income tax is the largest source of tax revenue – contributing nearly a third of the government's tax receipts. This income is then used to pay for government spending, on things like the police, the NHS and the civil service.

Income tax is a form of **progressive tax**. This means that the proportion of income paid in income tax rises as earnings rise. For example in 2019/20 someone earning £25,000 would pay 10% of their earnings in income tax. Someone earning £100,000 would pay 27.5% of their earnings in income tax.

In setting income tax rates, the government does need to take into account the impact on the incentive to work. High rates of income tax can deter people from taking on extra work or seeking jobs with greater responsibilities paying higher incomes. People making such decisions will often focus on what extra *net* income they get – the money in their pocket each month. High tax rates mean they'll only see small increases, and may mean they're less likely to do the additional work.

At the end of this session, you will find a link to MoneySavingExpert's income tax calculator to help you check if you are paying the right amount of tax.

3 National Insurance Contributions (NICs)

The second important deduction from your gross income is National Insurance Contributions (NICs). National Insurance is paid by both you as an employee and by your employer(s).

Historically, National Insurance formed the basis for paying social security benefits related to unemployment, illness and retirement. It was first introduced in 1911 and gradually expanded, especially in the 1940s with the launch of the National Health Service and the expansion to state benefit schemes.

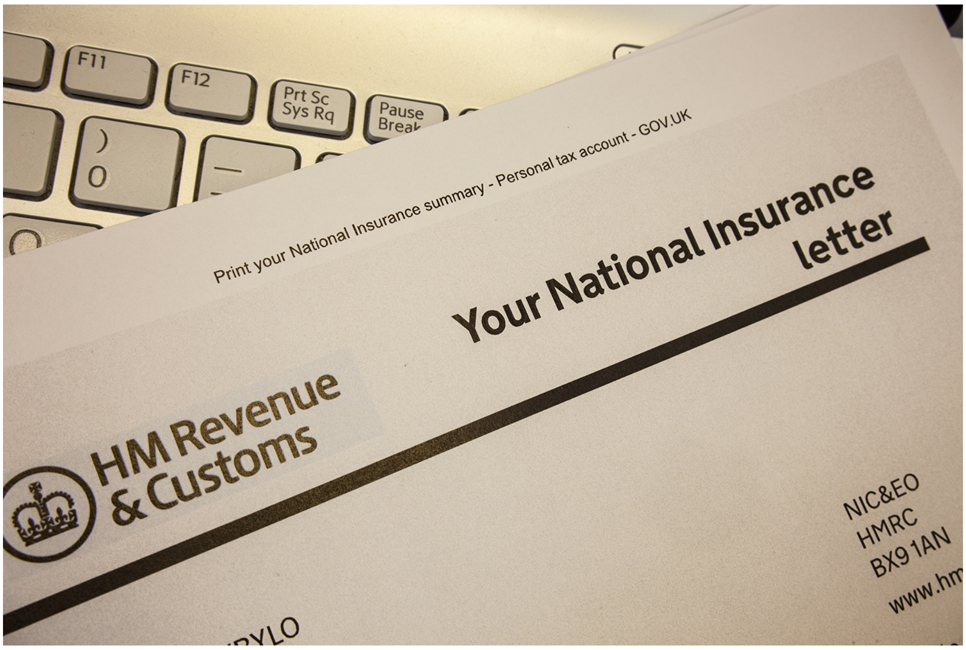


Figure 3 National Insurance Contributions(NICs) are like another tax

NICs from employers and employees make up the second largest single contribution to UK government receipts – close to a quarter of the total. Recent decades have seen this proportion rise as governments have preferred to use NICs rather than income tax to raise additional revenue – perhaps because NICs are not perceived as being a tax!

The way NI works is that HMRC issues each person in the UK with a National Insurance account number when they turn 16. Your contributions to NI each year are recorded under this number.

Your level of contributions and the number of years you've been paying NI influences entitlement to, and in some cases the level of, certain benefits. The state pension is a good case in point as it now requires you to have 35 years of NICs to get the full amount of state pension.

As with income tax, the rules and regulations surrounding National Insurance change regularly. In 2019/20 there was a lower income threshold of £8,632 per year and an upper earnings limit of £50,000. On income between these limits, employees' National Insurance was generally levied at 12%. If you earned more than £50,000, you paid NICs at 2% above that.

These rates and bands were retained for 2020/21 except for the lower income threshold which was raised to £9,500.

Table 1 Bands for Class 1 NICs in 2019/20 and 2020/21

Rate	2019/20	2020/21
0%	£0–£8,632	£0–£9,500
12%	£8,632–£50,000	£9,500–£50,000
2%	£50,000+	£50,000+

If you are self-employed you pay different NICs. Here the NICs paid are based on the annual profits made. In 2019/20 ‘Class 4’ NICs were levied at a rate of 9% on profits between £8,632 and £50,000. Above £50,000 the rate was 2%. Also, those earning profits of more than £6,365 paid ‘Class 2’ NICs at a rate of £3 per week.

The rates for Class 4 contributions remained the same for 2020/21 but with the threshold for payments rising to £9,500. Class 2 contributions were raised to £3.05 per week on profits above £6,475.

Next, have a go at using what you’ve learned about income tax and NICs by trying some calculations.

4 Half-time quiz

How much in income tax and National Insurance Contributions (NICs) would be paid by someone earning £56,000 in 2019/20?

The tax-free personal allowance for the year was £12,500 and the rate of tax on incomes above this (and up to £50,000) was 20%. Above this level the higher rate of tax of 40% started to apply.

NICs were payable at 12% on earnings over £8,632 and at 2% on earnings above £50,000.

Information about income tax is provided in Section 2 and details about NICs are given in Section 3.

If you find it helpful, work out your answer using the following process.

Half-time quiz

Income from employment or pension		£56,000
Minus personal allowance		£
Leaves taxable pay of		£
Basic rate %	on	£
Provide your answer...	£	
Higher rate %	on	£
Provide your answer...	£	
Tax to be paid in the year 2019/20		£

Income from employment		£56,000
Threshold for paying National Insurance contributions (NICs)		£
NICs %	on	£
Provide your answer...	£	
NICs %	on	£

Provide your answer...	£	
NICs to be paid in the year 2019/20		£

Answer

Income from employment or pension		£56,000
Minus personal allowance		£12,500
Leaves taxable pay of		£43,500
Basic rate 20%	on £37,500	£7,500
Higher rate 40%	on £6,000	£2,400
Tax to be paid in the year 2019/20		£9,900

Income from employment	£56,000

Threshold for paying National Insurance contributions (NICs)		£8,632
NICs 12%	on £41,368	£4,964.16
NICs 2%	on £6,000	£120
NICs to be paid in the year 2019/20		£5,084.16

Note that NICs are not paid on pensions.

5 Understanding tax codes

Understanding how income tax is deducted is important, but you also need to keep an eye on your tax code. This code tells your employer or pension provider how much income tax to deduct from your salary or pension. You can find your tax code on every payslip.

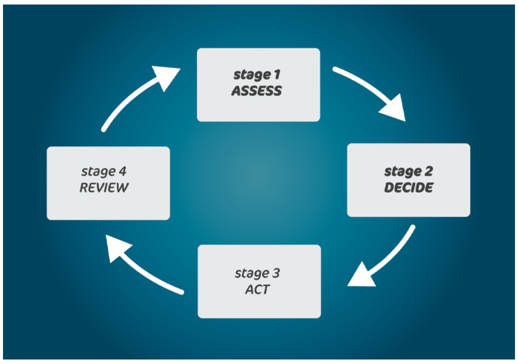


Figure 4 Always read any communications from HMRC carefully

The code usually comprises four numbers and one or two letters – for example, 1250L. In Scotland, you'd see an S before it, and in Wales a C, so S1250L or C1250L.

The numbers define your tax-free personal allowance. You simply add a zero (0) to the end of the number, so in the example above your personal allowance would be £12,500 for the tax year.

The letter in the code defines the nature of your income. L is the most common letter in tax codes as it applies to most people who have just one job – be it full-time or part-time.

There are two tax forms that you will become familiar with in your working life:

- P60: the annual statement of how much you've earned that tax year and how much you have paid in income tax and other deductions. You will normally receive this from your employer within two months of the end of each tax year (5 April).
- P45: the statement of income paid and tax deducted so far for the year when you leave a job (called the 'prevailing tax year'). This form needs to be passed to your new employer so that they know what your tax code is, and how much tax you have already paid in the tax year.

The table below sets out the main alternative letters used by HMRC in their tax coding.

Table 2 The different tax codes

Code	Explanation
L	You are entitled to the standard tax-free personal allowance
M and N	These relate to additional marriage allowances some people are eligible for
K	For someone whose income is not taxed another way and which is worth more than the tax-free allowances
T	This code applies when the computation of tax due is made more complicated – for example by earning a very high income
0T	Either your personal allowance has been used up (e.g. by being applied against another source of income) or you have started a new job and you don't have a P45 form (see above) or your employer has insufficient details to give you your tax code

BR	All your income is taxed at the basic rate of tax – normally applies if you have more than one job or pension
D0	All your income is taxed at the higher rate of income tax – normally applies if you have more than one job or pension
D1	All your income is taxed at the additional rate of tax – normally applies if you have more than one job or pension
NT	This code applies if you are paying no tax on your income. It applies to those in some categories of self-employment
W1 and M1	These are emergency tax codes (M1 if you are paid monthly, W1 if you are paid weekly). This means the tax is calculated only on the income earned in the current pay period, rather than an assessment of what you will earn on a full year.

Emergency tax codes are usually updated automatically after you have given your employer your P45 (see above). If you're on an emergency tax code for more than a month or two after starting a new job, it's best to contact HMRC and ask them to send your employer an updated tax code. You will always start a new tax year with a normal tax code, not an emergency one.

Activity 1 What's your tax code?

Allow approximately 5 minutes for this activity

Take a look at your most recent payslip and check your income tax code.

Does the code look right given the information in Table 2 above?

Provide your answer...

Answer

If the code looks right there are no issues for you to address.

If it looks wrong you might want to first double check your understanding with your organisation's payroll department. The payroll department cannot, though, change the code if it is wrong. Only HMRC can do this and so if there is an error you need to contact them

At the end of this session you'll be provided with links to MoneySavingExpert's tax code checker if you need further help.

5.1 Do I need to make income tax returns?

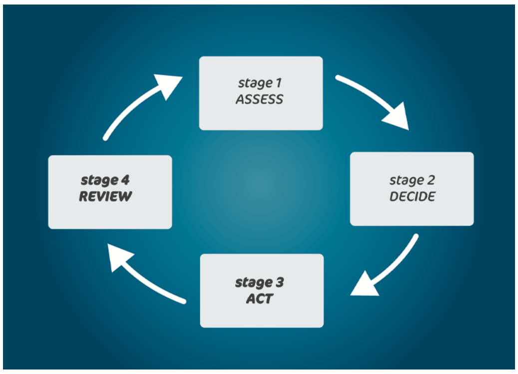


Figure 5 Compiling the figures needed for the tax return

If you have to make a tax return, the form you complete enables you to assess how much income tax is due – hence the use of the term 'self-assessment' when talking about income tax returns. HMRC will, though, check the details. These days you can complete the form online which makes the assessment process quite easy.

If your only income comes from being employed, and from no other source, and if your taxable income is less than £100,000 a year then you don't need to fill in a self-assessment form.

Common reasons for being in self-assessment for tax include:

- making money from freelance or self-employed work
- getting income from abroad
- letting out property or rooms in your home
- making profits from selling property or investments.

A link to the full list of circumstances that call for a tax return is provided at the end of this session, as well as some guidance on completing a self-assessed tax return.

If you have to complete a self-assessment form, make sure you do so even if you think there's no outstanding tax for you to pay.

If you're completing the return online you have until 31 January after the end of the tax year (paper forms must be submitted by 31 October). You need to register for online submission in advance by going to HMRC. A link for this is provided at the end of the session. If you don't fill in your self-assessment form and submit it on time, HMRC will charge you a penalty.

Any outstanding tax also has to be paid and reach the HMRC's account by 31 January after the end of the tax year – so amounts due for the 2019/20 tax year would need to be paid by 31 January 2021. Failure to pay on time means that your tax account starts to accrue interest at a penalty rate – currently 3% per annum.

If your tax-paying arrangements indicate that there will, on an ongoing basis, be tax outstanding after each tax year, the HMRC will set up a tax account for you and you'll pay your tax in two instalments – the first by 31 January in the tax year and the second by the following 31 July. This reduces the time that the HMRC has to wait for receipt of outstanding tax revenues.

If your annual return shows that you're due a refund as a result of the overpayment of tax, then you will receive this once HMRC has processed your return.

One final point on tax: tax calculations are formulaic, not personal. You only have to pay the tax that is mathematically due. If you're owed a refund you will get it.

Next, now that you have covered how incomes are taxed, you will move on to how to build your own budget.

6 Why do I need to budget?

So how does setting a budget help you manage your household finances?

- It helps you control spending by comparing your income with your spending.
- It helps you check that you have enough income to pay current and future bills without having to borrow.
- It shows how much ‘spare’ income you have for saving or spending on treats (like new trainers or an extra holiday).
- It gets you to focus on whether you could make better decisions in the way you spend your money.
- It lets you plan how to meet your spending goals and other financial targets, like saving.

Carrying out a budgeting exercise once is useful to help you to work out if your spending is under control, but budgeting is most effective when you use it as part of an ongoing process.

Now you understand the impact of income tax and NICs on your earnings, you can start the process of budgeting.

To draw up a budget you start by looking at your cash flows. This involves measuring your income and expenditure on a regular basis. You’ll look at the income side first.

7 The income side of the budget

There are four issues to be considered in measuring the income side of a budget.

Figure 6 'Look after the pennies and the pounds will look after themselves'

First, the budget should record income in the relevant time period, such as a month or a year. For most people this will represent their net income (with income tax, NICs and pension contributions taken off). If you have income that hasn't been taxed, you will need to include tax, NICs and any pension contributions in your expenses when you do the 'outgoings' side of the budget.

Next, make sure you include all your sources of income, which could be any or all of: income from paid employment, self-employment, savings and investments, pensions and social security benefits. Any additional income – for example the cash received from selling items – should be recorded under the 'other' category.

Next, you need to know when you are getting these different sources of income. For example, a household may receive a combination of weekly benefits and monthly pay. In order to standardise these different frequencies of income for a monthly budget, the technique is to calculate an equivalent annual income first (for example, by multiplying a weekly income by 52) and then estimate a monthly income equivalent by dividing this figure by 12.

Finally, are you budgeting for just you, or for the whole family? If it's for more than one person, make sure you include any income other members of the household get that they contribute to the family budget.

Activity 2 What is income and what is not?

Allow approximately 5 minutes for this activity

Sometimes people can confuse income and wealth. The former provides a cash inflow that you can spend. This is what you enter into your budget as income.

Your wealth, often referred to as ‘assets’, has value – perhaps substantial value – but does not provide a flow of cash to spend unless it is sold.

Look at the list below and identify those that are incomes and those that are assets in the form of wealth.

Interactive content is not available in this format.

The key thing when identifying income is whether it comes in the form of cash that you spend. Wealth or assets can produce cash only after they are sold.

From a budgeting viewpoint it is essential to distinguish between regular and virtually certain income – like your monthly pay – and irregular and uncertain sources of income (for example, from selling unwanted possessions online for cash). The latter will be difficult to forecast and may not materialise, for example if you can’t sell an item.

8 Turning to the spending side of the budget

Now you'll look at the spending side of your budget. There are different categories of spending – some expenses will be things like bills, where we have to pay them, but there are also those items of spending where we have complete discretion, like choosing whether we buy a book or leave it on the shelf.

Understanding the difference lets us make good spending decisions and, when necessary, rein our spending in.

Figure 7 Did we really spend that much?

Activity 3 Can't live without?

Allow approximately 10 minutes for this activity

For most of us, our spending is sometimes on essential things and sometimes on fun items. But what about the things that are neither of these?

How would you classify the items of expenditure listed below? Which of these categories best describes each item for you?

- an essential
- a desirable (not absolutely essential but you'd be hard pressed to go without).
- a non-essential

Clearly when prioritising spending, essential items come first before desirable and then non-essential expenditure.

Keep a record of the categories you've chosen. You might find it interesting to take a look back at these at the end of the session.

Category	Essential, non-essential or desirable?
Mobile phone	*Provide your answer...*
iPad/tablet	*Provide your answer...*
Gym membership	*Provide your answer...*
Meal out with friends each week	*Provide your answer...*
Sky TV	*Provide your answer...*
A holiday or break away	*Provide your answer...*
Christmas presents for friends	*Provide your answer...*
Insurance for your phone	*Provide your answer...*
Daily coffee from a coffee shop	*Provide your answer...*

Answer

Some suggested answers are given below, but really classifying the items of spending is a personal matter.

Most people view a mobile phone as an essential. Insuring your phone could be an essential cost too – but you might find that this is already covered by your house contents insurance, or you might want to just put money aside to buy a new one if yours is lost or stolen.

Most people would view having a break away, even if not a full holiday, as being close to an essential, though your opinion is likely to depend on whether your income makes a holiday possible.

The other choices will vary from one person to another depending on what's important to them.

What's the reason for linking your spending to what is essential, and what is important to you but not essential? It's so that you develop clear thinking about what's important to you, and what you can cut out of your spending if your income isn't high enough to afford everything you'd like it to.

When you have to make cutbacks to your spending, start with the clear non-essentials. And then, if necessary, target those things that are not really essential – even though it's difficult for you to do without them. Sometimes managing money means making tough choices.

You may have come up with something like the following:

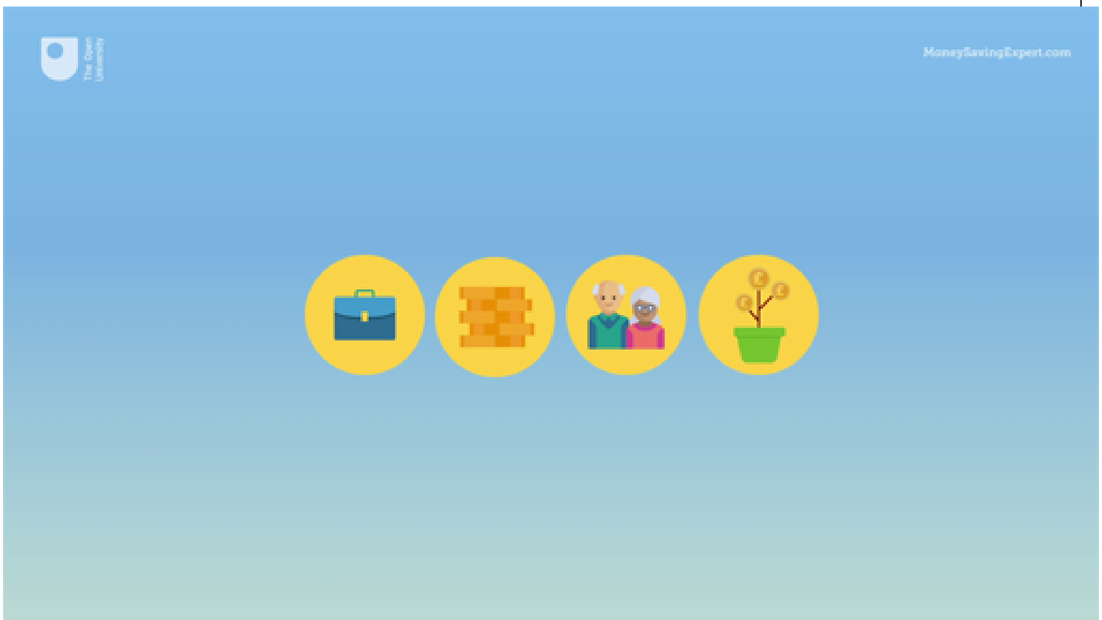
Category	Essential, non-essential or desirable?
Mobile phone	Essential!
iPad/tablet	Non-essential
Gym membership	Non-essential or perhaps desirable
Meal out with friends each week	Non-essential
Sky TV	Non-essential – although sports addicts and film buffs may disagree!
A holiday or break away	Desirable? Perhaps even essential given the relaxation and enjoyment these can offer.
Christmas presents for friends	Desirable?
Insurance for your phone	Essential? Perhaps not! You looked at this in Session 1.
Daily coffee from a coffee shop	Non-essential or perhaps desirable.

9 Building your budget

It's time to start building your budget. Before you do so, watch this short video which sets out the simple steps involved.

Video content is not available in this format.

Video 2 Building your budget



While you need to make a budget that works for you, there are some key rules you should think about before starting.

- Make sure the time horizon is long enough to capture all your income and spending. Working to just a weekly or monthly budget may miss spending on holidays, gifts or annual insurances.
- Start your budget with your income before moving on to your expenditure. Only include income that is certain or at least likely. This way, anything on top is a pleasant surprise.
- Break down your spending as far as possible. This will help you see exactly where your cash is going if you find you need to rein in your spending.
- If you're not sure how much something will cost (e.g. your phone bill) it's best to overestimate and have cash to spare, rather than underestimate and not have enough.
- Divide your spending between 'essential', 'desirable' and non-essential' – as per the activity you completed in the previous section. This really helps if you need to cut back on what you spend as you can start by trimming non-essentials.
- Add in an amount for unexpected spending, e.g. to cover replacing household goods that break down. Having this emergency fund for unexpected expenses means you don't have to resort to panic measures (like borrowing on a credit card).

It makes sense to have an annual budget, but also to break it down month by month.

The annual budget will present you with that high-level picture of your finances and whether over the course of the year you are spending beyond your means (bad news!), or living within your means and potentially able to save up (good news!).

The monthly budget will help you manage your day-to-day money, indicating if this is a month of heavy spending (e.g. December, with its Christmas spending for most people) or a month of light spending (e.g. February, which is a short month when people do not tend to go away on holiday, when Council Tax is not normally payable and when the Christmas bills have been paid). These monthly snapshots will also highlight when you might have to draw on savings to cover a month of heavy spending or place money in savings when the monthly spending is relatively low.

10 Your own budget

You've looked at how to build a budget. Now start to have a go for yourself. You can either add your answers into the table below or download and complete a Word version of the budget grid. You can complete and refine this after you have finished this course, particularly as you may have to spend time looking through your financial documents to get the details you need.

A link is provided at the end of the session if you need further guidance on building your own budget.

Figure 8 Are you paying too much for energy supplies?

Pay close attention to the income and spending categories.

One of the key benefits of a budget is the insights you can gain from it. When you've compiled your budget complete the activity below.

Activity 4 Reflecting on and reviewing your budget

Allow approximately 20 minutes for this activity

Part 1 Reflecting on your budget

	Current Month	**Full Year**
Balance from previous period	*Provide your answer...*	*Provide your answer...*
Income		

Income (after all deductions like tax)	*Provide your answer...*	*Provide your answer...*
Pension income (after tax)	*Provide your answer...*	*Provide your answer...*
Investment income (interest etc.)	*Provide your answer...*	*Provide your answer...*
Other income	*Provide your answer...*	*Provide your answer...*
Money from sale of assets	*Provide your answer...*	*Provide your answer...*
Total Income (A)	*Provide your answer...*	*Provide your answer...*
Essential Expenditure		
Mortgage or rental costs	*Provide your answer...*	*Provide your answer...*
Council Tax	*Provide your answer...*	*Provide your answer...*
Water charges	*Provide your answer...*	*Provide your answer...*
Utilities (gas, electricity, other fuels)	*Provide your answer...*	*Provide your answer...*
Groceries (food and drink)	*Provide your answer...*	*Provide your answer...*
Day-to-day spending (lunch at work etc.)	*Provide your answer...*	*Provide your answer...*
Essential travel & car expenditure	*Provide your answer...*	*Provide your answer...*
Insurance premiums	*Provide your answer...*	*Provide your answer...*
Phone & Internet costs (including mobiles)	*Provide your answer...*	*Provide your answer...*
TV costs (including TV licence)	*Provide your answer...*	*Provide your answer...*
Clothing	*Provide your answer...*	*Provide your answer...*
Hairdresser costs	*Provide your answer...*	*Provide your answer...*

Medical costs (dentist & other)	*Provide your answer...*	*Provide your answer...*
Home and garden maintenance	*Provide your answer...*	*Provide your answer...*
Total Essential Expenditure (B)	*Provide your answer...*	*Provide your answer...*
Other Expenditure (Desirable/non-essential)		
Holidays/optional travel	*Provide your answer...*	*Provide your answer...*
Socialising & eating out	*Provide your answer...*	*Provide your answer...*
Club memberships	*Provide your answer...*	*Provide your answer...*
Presents	*Provide your answer...*	*Provide your answer...*
Other spending (not classified above)	*Provide your answer...*	*Provide your answer...*
Money set aside for savings & contingencies	*Provide your answer...*	*Provide your answer...*
Total Other Expenditure (C)	*Provide your answer...*	*Provide your answer...*
Outturn (= balance for start of next period)	*Provide your answer...*	*Provide your answer...*
= Total of A minus (B+C)		

Part 2 Reviewing your budget

Answer the following questions:

- Have you got a surplus of income over spending, or do you spend more than you earn?
- Are all months similar when it comes to budgeting?
- What's the reason for having a contribution to a savings account or for 'contingencies' as an item of monthly spending?

Provide your answer...

Answer

- If you've ended up with a surplus of income over spending this is good news. It enables you to save to cover periods where spending exceeds income. If you have an excess of spending over income you will have to cut your spending down, or find a way to cover the shortfall (your savings account?).
- No, each month is different. Spending should be expected to peak at key points of the year – at an annual festival that you celebrate with your community, like Christmas, or when you go on holiday. Income is often flat, but may increase if you get a bonus, or your work is seasonal and you get overtime in some months of the year.
- This is a good way to embed a savings activity habit into your everyday financial life. It makes sure that you have extra resources to draw on when you make major purchases, or at other times when your finances are under pressure.

11 Trimming your spending

Whether you've done a budget or not, it's a common situation for many households to have more going out in spending than they have coming in on the income side.

There are, though, many steps you can take to trim spending and get you back in balance with your income. Many of these are 'pain-free' ways of saving money through simply paying less for the same goods or services.

Figure 9 Time for a catch-up over lunch – and maybe exchange some money saving tips?

Here are some simple ways to cut your spending without radically changing your lifestyle.

- Paying some bills by direct debit may save you money, for example utility bills. But check this carefully as some bills – such as household and car insurance – may cost more if paid monthly by direct debit.
- Think about remortgaging if you're currently on your lender's standard variable rate, or your current deal is about to end. Saving 1% on a £100,000 mortgage saves around £80 a month (you will look at remortgaging in the session on mortgages later in this course).
- Check the market when it's time to renew insurance premiums. They are often increased each year, relying on customers not bothering to switch to another company. Also check that you're not paying for any 'extras' you didn't ask for or want.
- If you're paying high interest on your credit cards, look to see if you can transfer your balance to a new card at 0% – you can usually do this for a small fee.
- Switch suppliers of gas, electricity, phone and broadband. There are major savings to be had in these areas. OFGEM have created a website to help you find the best deal on your energy suppliers. A link is provided at the end of the session to help you select and switch energy suppliers.
- Consider getting a water meter, especially if you use low amounts, or there are fewer people living in your house than the number of bedrooms you have.

- If you're paying for a gym and don't go very often, see if you can do pay as you go instead. Alternatively, can you work out at home or go for a run in your local area?
- Think about whether a branded item is really value for money or if you can live with buying a store's own brand, or a non-branded item.
- Cut down on the number of takeaway meals you have – cutting from two to one a week would typically save over £250 a year and probably be healthier for you too.
- See if you can get a cheaper mobile tariff. Check the market to see what's out there and be prepared to switch. If you don't want to move, call your mobile supplier and ask if they'll match the deal you've found.
- Buying in bulk for items such as contact lenses saves a lot of money.
- Ditch your morning coffee from the local coffee shop. It's much cheaper to make it at home.
- Taking packed lunches to work can save £100s a year on lunch costs.
- Buy fresh fruit and vegetables in season. Check whether a local market is cheaper than the supermarket.
- Turn off lights, don't leave appliances on stand-by and turn down the thermostat to save large amounts on energy bills (and help the environment).
- Make a shopping list and stick to it rather than being tempted by items on the supermarket shelves. Try to use money-off coupons from papers and magazines where possible.
- Think carefully about buying extended warranties. They are usually poor value for money so it's usually better simply to put aside some money in case of a problem.

And if you are struggling to keep a lid on different aspects of your spending you can enforce more discipline through the 'piggybanking' technique. This is where you set up a series of savings or bank accounts for each major category of spending – for example holidays, socialising, clothing etc. You then assign your income to each account in accordance with your budget plan. If you keep to the discipline of never spending more on each spending category than is in its assigned account, then your overall budget will stay in balance. It's just like the well-known method of using jam jars to share your income between spending categories – except your money is safer in accounts and you could earn some interest too!

Next it's time for the end-of-session quiz – best wishes for this.

After the quiz it's time to round up what has been learned in this session, and where to go for further information on budgeting and taxation.

12 End-of-session quiz

Now it's time to complete the end-of-session quiz.

End-of-session quiz

Open the quiz in a new tab or window then come back here when you've finished.

13 Summary of Session 2

You've covered a lot of ground in this session and have explored:

- how income tax and National Insurance Contributions (NICs) are calculated
- how to distinguish between essential, desirable and non-essential spending
- how to build your own budget, taking into account all your sources of income and your spending
- how to manage your budget – particularly if spending exceeds income.

Effective budget management skills are critically important in ensuring you maintain good control of your finances. Other key financial decisions – about borrowing money, getting a mortgage, saving for the future and for a pension – are best taken when you have built this secure foundation for your finances.

You can now apply these skills in the rest of this course produced by The Open University in collaboration with MoneySavingExpert.com.

Learning more about budgeting and taxation

The following links can help you learn more about the subjects you have covered in this session.

Learn more about calculating the tax deductions on your income using the MoneySavingExpert tax calculator.

Learn more about tax codes using the MoneySavingExpert guide.

To find out more about making a tax return check out MoneySavingExpert's guidance on self-assessment

You may find these two HMRC sites useful. They provide guidance on who needs to complete a tax return and on how to register for online submission of income tax returns.

Check out the MoneySavingExpert website to learn more about budgeting and finance planning.

Go to the MoneySavingExpert website if you want help in comparing and switching your gas and electricity supplier.

Get started with Session 3: Borrowing money.

Session 3: Borrowing money

Introduction

Martin Lewis introduces Session 3 on borrowing, exploring the good and bad reasons people may have for getting into debt.

Video content is not available in this format.

Video 1 Introduction to Session 3

While borrowing should never be done lightly, and should always be for something affordable and budgeted for, if people are able to manage their debts sensibly and repay money at least on time or, better still, as quickly as possible, then there is no need to panic. After all, most people cannot afford to buy a home or car up front so need to borrow cash, which in turn helps to fuel the various markets.

In the UK in 2019 **personal debt** amounted to an astonishing total of £1.7 **trillion**. That is £1,700 billion pounds of borrowed money that is owed by households in the UK.

The good news is that for many people, borrowing doesn't cause them financial problems. But for some people repaying borrowed money is a problem.

Yet, some people cannot borrow at a reasonable cost due to their poor credit status. Their circumstances, often related to being on low incomes, may force them to use expensive sources of borrowing such as high-cost short-term credit – and the cost of borrowing in this way may mean their financial difficulties worsen.

This session of the course focuses on what you need to know to be able to borrow effectively on the best terms, and on what you need to do to make sure borrowing money is helpful, rather than the source of financial nightmares.

You will also see that the ability to borrow and the cost of borrowing are determined both by things you have some control over (such as your financial position and credit history, which affect your attractiveness as a borrowing customer) and things which you cannot control (like the prevailing level of **interest rates**).

After studying this session, you should be able to:

- understand who you can borrow from and what products are available
- understand what affects your credit score and what you can do to manage it
- know when borrowing is sensible and when it is reckless
- understand what determines the cost of borrowing money
- understand the relative cost of different ways of borrowing.

This Session is one of a suite comprising the course *MSE's Academy of Money* and has been made possible by financial and content contributions by MoneySavingExpert.com.

1 The boom of borrowing in the UK

There are many forms of borrowing – including credit card **debt**, overdrafts, loans, student loans and **mortgages**.

Borrowing can be used to finance everything from day-to-day spending, to holidays and to items you use over several years, such as furniture, cars, property and home improvements.

Figure 1 Most people borrow money at various stages of their life

Since 1993 in the UK, the aggregate (total) value of personal debt has risen over 3.5 times to a total of £1.7 trillion. The majority – *c.* 85% – is **secured debt** (like **mortgages**). This is money lent against the security of property or other assets. The lenders can take possession of these assets if the borrower fails to repay the money. So, it is the lender rather than the borrower who can benefit from a debt being secured. The rest is **unsecured debt** (like overdrafts) where the lender has no direct recourse to a borrower's possessions – like their house – in the event of failure to repay. This is usually more expensive than secured debt.

This debt total grew quickly in the 1990s and until the late 2000s. The financial crisis of 2007/8 and the subsequent recession in the UK economy brought this period of fast growth in debt to an abrupt end with lenders – the **banks** and **building societies** – adopting a more cautious approach to lending money. Additionally, the financial services regulator, the **Financial Conduct Authority (FCA)**, has introduced tighter regulations on the lending practices of financial institutions. Recent years have, though, seen renewed growth in personal debt – particularly unsecured debt.

Activity 1 Why has personal debt in the UK risen so much?

Allow approximately 5 minutes for this activity

Can you think of any factors that have contributed to the huge rise in personal debt in recent decades? If you can come up with more than one factor, which one do you think has had the greatest impact?

Provide your answer...

Answer

There are several reasons, although economists will disagree with each other as to the key reason.

One factor has been the fast rise in house prices over the same period. Most lending is via mortgages to buy property. With prices rising, people need to borrow more.

Yet what has arguably fuelled the growth in mortgages and other forms of debt is laxer lending standards, particularly in the early 2000s before the financial crisis that began in 2007/8. Some mortgage lenders allowed people to borrow 125% of a property's value, for instance, back then.

Credit cards and loans were also arguably handed out readily to some people who could not afford them.

Other factors have been influential such as growing incomes (at least until 2007/8) that have helped make borrowing affordable, as has the low levels of interest rates seen in the UK from the 2000s.

2 Good debt vs bad debt

Debt isn't bad, but bad debt is bad. Borrowing money to have something now, that you'd otherwise need to wait for, isn't automatically wrong.

Figure 2 Making the right decisions on borrowing is essential

Of course, it requires some major precautions. It's important that borrowers:

- do a budget and plan for it
- can comfortably afford the repayments
- ensure it's at the cheapest possible rate.

Having gone through all that, provided it's a rational, controlled, planned decision, it is a question of personal choice. Real problem debts tend to stem from three main things:

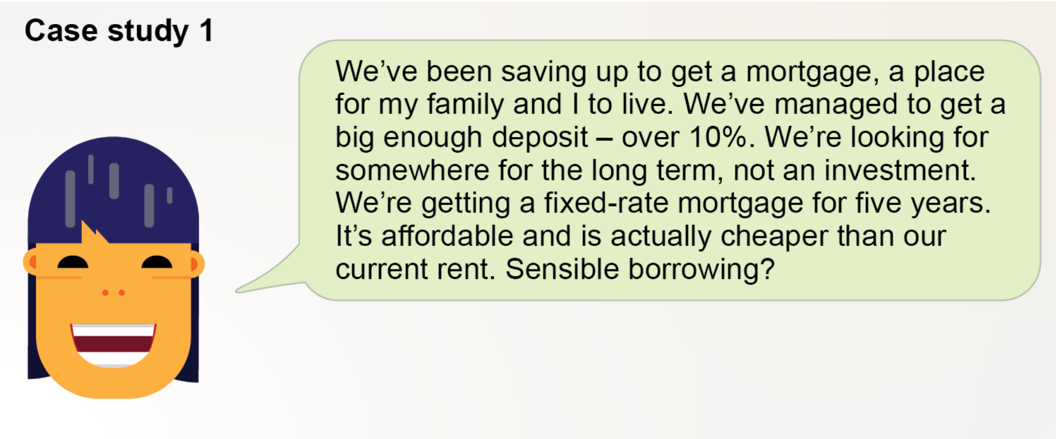
- unexpected changes of circumstance
- habitual overspending
- ignorance – people who borrow without understanding the true impact of it, and the fact that if you owe money you have to repay it.

Debt is like fire: use it correctly and it can be a useful tool, but make one tiny mistake and you can be burned.

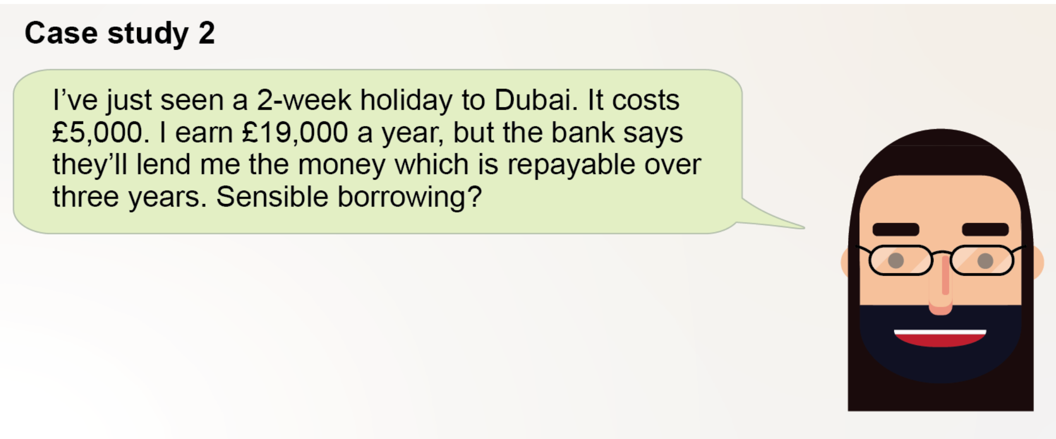
Activity 2 Case studies on debt

Allow approximately 10 minutes for this activity

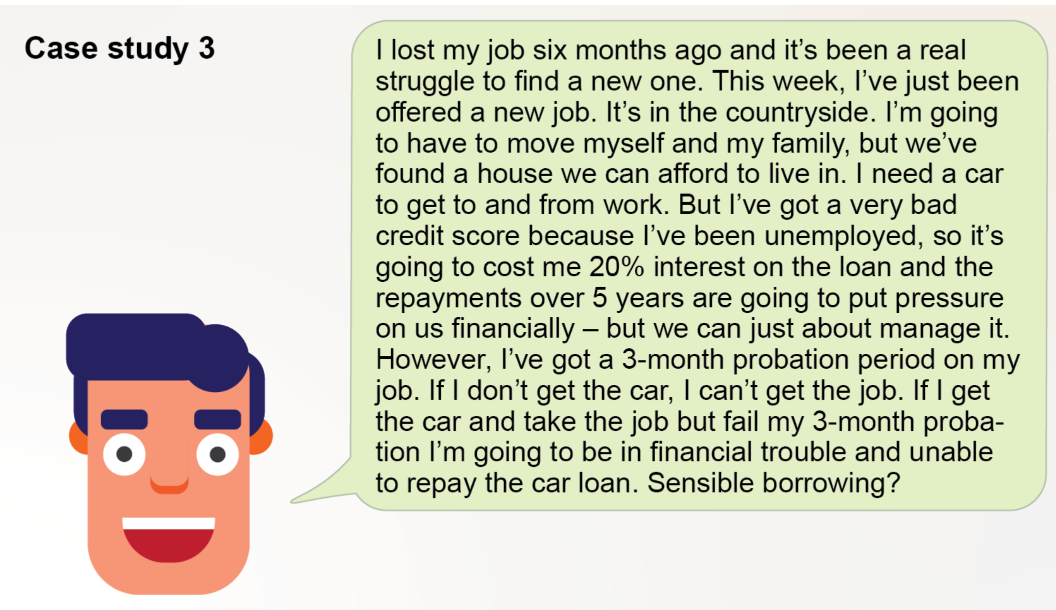
Here are four case studies of debt, some of which Martin Lewis referred to in the introductory video for this session. Some are good debts (sensible borrowing) and some are bad debts (ill-advised borrowing). Work out which category each case study falls into, and why. As you'll see, it's not always straightforward.



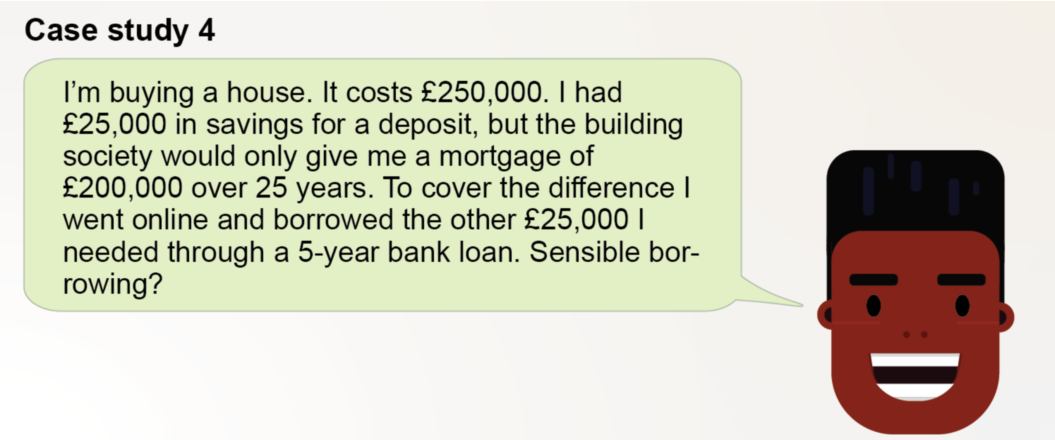
Case study 1



Case study 2



Case study 3



Case study 4

Answer

Case study 1: This is clearly sensible borrowing. The cost of borrowing is less than renting and the couple are paying an affordable mortgage to enable them to buy their own home. So it's a good debt.

Case study 2: This is ill-considered borrowing. The loan is for a holiday costing more than a quarter of gross income. Repaying the loan will take three years for a holiday lasting a fortnight. How is next year's holiday going to be funded? So this is a bad debt.

Case study 3: A trickier one – but arguably this is sensible borrowing. Most people get through the probation period when starting a job, so borrowing money to buy the car to get the job is rational behaviour. If repayments are made when due, there is likely to be an improvement in the borrower's credit score, making future borrowing cheaper. If things go wrong, the car could be sold to help repay the outstanding loan. Overall though, we could call this a 'grey' debt.

Case study 4: Not sensible at all. It is self-defeating. The building society will want to know how the 'other £25,000' is being covered. When they find that it is borrowed money, they will feed the cost of this to the borrower into their assessment of the size of the mortgage they are prepared to advance – with the likely outcome being that they will lend less than the original offer of £200,000. So clearly it is a bad debt.

So, whether borrowing is sensible depends on the circumstances. Certainly borrowing is not always a 'bad thing'. In most cases it provides the means to buy key assets like property and cars. And in most cases borrowers are able to repay their debts without financial stress to themselves or their families.

You now need to turn to the factors that will affect your ability to borrow money and the terms on which money will be lent to you.

This brings you to the credit reference agencies and their scoring of your credit worthiness.

3 Credit reference agencies and your credit history

Your credit history, which is collated by credit reference agencies, is a key factor in your ability to borrow money.

Figure 3 Do you know your credit scores?

As soon as you take out credit – be that a credit card loan, mortgage, or even a mobile phone contract – your credit history is recorded and a profile of you starts to build.

Lenders then use that profile when you apply for credit, to help them predict your future behaviour based on what you've done in the past – i.e. if a bank lends you cash, are you the sort of person who is likely to pay it back on time?

To do it, they look at lots of different data – much of which is on your credit file, though they may also hold that data too if you've been a customer of theirs. This may include how many applications you've made recently, how much you owe, what credit products you've had and whether you paid them all off on time.

Note that if you don't have a credit history – say you've only just left school and have never taken out credit – then it makes it harder to borrow money as lenders have nothing to go on.

The UK credit reference agencies that store this data are:

- Experian
- Equifax
- TransUnion

These agencies will give you a credit score (e.g. 900 out of 999) with each agency having its own way of scoring. You can, though, take these scores with a pinch of salt as it's the agencies' view of you, when what matters is a lender's view of you when you apply for credit, and every lender is different.

Where do they get the information about you?

This is provided by your bank or credit card provider and other organisations that have extended credit to you. These can include your mobile phone provider if you have a contract with it, utility companies, broadband suppliers and insurance companies. This may seem surprising but if you are paying for these services by month, your contracts constitute loans and hence are relevant for credit checks.

The information includes the amount of credit granted to you, whether you make repayments on time and the proportion of your bill that you repay each month.

Have you looked at your own credit reports? You should keep a close eye on them to help keep on top of your finances but also to check for errors – after all, a wrongly registered missed credit card payment could mean you are declined for a mortgage. The good news is that you can correct any errors, so don't panic if you see one.

You can access your reports from the three major agencies for free either directly or via a number of third parties that have agreements with them.

Next you look further at what information is gathered by the credit reference agencies and what information is not considered.

3.1 How your credit history is compiled

Now you will look at how the reference agencies compile credit scores.

Figure 4 What could be stopping you getting a top credit score?

The agencies don't have access to, or explore, all your personal information but they do examine the following:

- Have you a **county court judgment (CCJ)** (in Scotland, a **decree**) or other court orders indicating that you have a history of debt problems?
- Have you ever been convicted of a fraud?

- Have you ever been the victim of identity theft or fraud?
- Have you ever defaulted on a payment (when the information shows you didn't pay but should have done)? Defaults normally stay on your reports for 6 years. Are you still in default?
- How do you operate your bank and credit card accounts? For example, do you pay off your credit card bill in full each month? This makes it clear to the agencies that you are in control of your finances.
- How many recent applications for credit have you made? Note, though, that the agencies cannot find out whether you were accepted or rejected when you made these applications. However, they may be able to work out the result by the products you subequently have.
- Are you on the electoral register? This is one vital piece of non-financial information that will affect your ability to borrow money.

By contrast these are some of the financial and other matters that are **not** recorded by the reference agencies:

- your income or pension (although they may check that the income you disclose to lenders matches with the income on your bank statement)
- declined applications (the application will be recorded but not the result of it)
- criminal records
- details about your savings and investments
- your medical records or time taken off work for sickness
- your race, religion, ethnicity or any political affiliations (like membership of a political party)
- student loans – although defaults on payments may be taken into account (this is because, as you will see later, student loans are unlike conventional loans)
- your record in making **Council Tax** payments on time (unless failure to make payments has resulted in a CCJ being recorded)
- the timely payment of fines for driving and parking offences.

Additionally, on any application form, the lender will normally require the following details:

- Your age.
- Your type of employment. This might include confirmation of whether the job is permanent or a fixed-term contract. You may also have to disclose whether you have completed the probationary period that commonly applies when you start a new job.
- Your salary.
- Your marital status.
- Any financial dependents you have, e.g. children.
- Your address.
- Whether your home is owner-occupied or rented, or whether you're living in someone else's home – for example, your parent's house.

As noted earlier, the lenders will not make their lending decisions on the basis of your credit scores, although they may be interested if your scores materially change – particularly if they fall. The focus will be on your credit history and, provided this is satisfactory, on your capability to repay the money you are seeking to borrow. The latter involves 'affordability testing' – something you will look at in detail in Session 4. The result of affordability testing may mean that even if applications, say for a loan or credit card, are accepted the amount of the loan or credit granted may be less than hoped for by the applicant.

Activity 3 Creating a good credit history: credit rebuild cards

Allow approximately 5 minutes for this activity

If you hardly have any credit history, it's worth getting a specialist credit rebuild card and using it correctly. Why do you think this is?

Provide your answer...

Answer

You need to build a decent recent history to show that you can be responsible with credit and use it well. The catch-22 is that if you hardly have any credit history, getting credit is difficult.

The solution is to get a credit (re)build card, but you must use it properly to make it work or you'll get hit with hideous charges.

The providers of these cards charge a very high interest rate but do accept people with a poor credit history or little history at all. Yet provided you just do the normal spending you'd do on a debit card and repay the card in full each month, preferably by direct debit, and never withdraw cash, you won't be charged interest so it's no problem.

Provided you have no other issues after six months or so, things should start to improve. After a year, it should make quite a difference to your credit history.

3.2 How to boost your credit worthiness

There are a huge number of ways for you to take control of your credit file and therefore your ability to get credit in the future.

Figure 5 Take action to manage your credit score

First – as mentioned earlier – check your credit reports at least once a year.

This is a vital step. If information held on the reports is incorrect, you could end up having applications for credit declined as a result of errors. Ideally access the information on the reports of the 'Big 3' agencies – Experian, Equifax and TransUnion. You might be surprised to find the variations in the information held about you between these agencies. If there are errors, get them corrected.

In particular, do check your credit reports before any major applications (for example, before applying for a mortgage) and if you have an application for credit rejected.

Of course, having a rejection means you've applied, and each application puts a mark on your file. The odd one isn't usually a problem, but lots of applications can make you seem less attractive to lenders as it may make it appear that you're reliant on credit. So, get errors corrected immediately as they may mean you get continuously rejected, and you want to stop that spiral.

As well as checking your reports, make sure that you're registered on the electoral roll or, if you're not eligible to vote in the UK, that you have proof of residency. The electoral roll is updated annually. Staying registered is vital because if you're not on the roll, it's unlikely that any institution will want to lend to you.

Next, check whether you're linked to someone financially, as their credit score can affect yours.

Being 'linked' is not about whether you live together or are married, it's simply whether you have a joint financial product such as a joint bank account or mortgage (but not a 'joint' credit card as there's no such thing – if someone else has a card on your account it's still a sole account).

If you are financially linked to someone on any product, that means their history is considered as part of assessing whether to accept you. Even just a joint bills account with flatmates can mean you are co-scored.

Therefore, if your partner or flatmate has a poor history, keep your finances completely separate.

If you split up with someone you've had joint finances with (or just moved out from your flat-share), once your finances are no longer linked, write to the credit reference agencies and ask for a notice of disassociation. You can also find the forms online.

If you have never been linked to someone financially, you still need to be alive to these risks since you may become linked in the future.

3.3 Good tips to help your credit worthiness

Most of the key tips for managing and improving your credit score come down to 'good financial habits':

- Make sure you're not late on any repayments as they can end up on your credit report, as already mentioned – even some rental agreements are registered.
- Don't apply for lots of accounts in a short time, and try to avoid any applications before something major, such as a mortgage application.
- Consider closing *unused* credit card accounts and cut up the cards. Even though you're not using them, the credit limits for these cards might limit your ability to borrow elsewhere. But to complicate things, dispensing with cards you have *used responsibly* for a long period of time might lower your credit score so they're often best left open, though it's not an exact science. To strike a happy medium – if you've *lots* of unused credit, close some cards down, but don't close them all. And above all, don't max out your limits.
- Try to manage down your debts, focusing on the most expensive first, as this can help your credit score.
- Avoid payday loans. Not only are they hideously expensive, but the presence of one on your file can be a knock-out blow for other applications.

Also, remember never to lie when making any applications for credit as, if detected, this could come back to haunt you.

4 Half-time quiz

A lot of ground has been covered. It's now time for a short quiz to see how much you've learned.

Half-time quiz

Open the quiz in a new tab or window then come back here when you've finished.

5 Who are the lenders?

There are many institutions in the UK that are engaged in lending money to people and to households. This is good news to borrowers who can – subject to their credit record – check the market for the best deals.

Listen to Audio 1 which provides a tour of the lending industry in the UK.

Audio content is not available in this format.

Audio 1 Who are the lenders and how do they differ?

6 The debt supermarket: get to know the products

Here's a run-down of the most common forms of borrowing.

Figure 6 Sign here and here to get your loan

Overdrafts: People often don't think of this as a debt, but it is a debt. An **overdraft** is money a bank lends you on your current account up to an agreed limit when you run out of your own money, so it takes your balance into negative territory. So, if you're £500 overdrawn it means you've a balance on your current account of minus £500 which at some point must be paid back. The cost of overdrafts has risen sharply from 2020 with interest rates up to 40% being charged on the amounts overdrawn. If you need to borrow money you should seek alternative sources of credit.

Credit cards: You use a card to spend on up to a certain credit limit set by the lenders, but it's a debt you must pay back, and you're billed monthly with the balance. Unless you're on a limited-time 0% interest promotion, if you fail to pay the debt off each month, you are charged interest, which varies by provider. Even if you pay it off each month, there are some circumstances where you may be charged interest.

Store cards are a form of credit card used for buying from specified outlets. They tend to have much higher interest rates than credit cards.

Charge cards: can be used like credit cards to make purchases and obtain up to two months' free credit between purchase and paying off the outstanding amount. Charge cards differ from a credit card in that a borrower is required to pay off the entire balance each month. A fee might be payable for the card.

Loans: loans made to individuals, typically with terms of between 1 and 10 years. They may be either unsecured or secured against an asset. Unsecured personal loans are not contractually linked to any assets the borrower buys. These are available from credit unions, banks, building societies, direct lenders and finance companies.

Hire purchase (HP): a form of secured debt where repayments are made over a period, normally of up to 10 years, to purchase specific goods.

Mortgages: loans to purchase property or land, which are secured against these assets. Debt terms for mortgages are normally up to 25 or 30 years (though a few go to 40 years), though as you pay interest, the longer you borrow for, the more interest you pay. These are covered in more detail in Session 4 on understanding mortgages. There are many types of mortgages including equity release mortgage products. The latter are where you can borrow money if there is a sufficient difference between your property's market value and any existing mortgage on it.

Other (and very expensive) types of credit: these include doorstep lending and 'payday lending' and should only be seen as loans of last resort as the charge can be huge. Another form of alternative credit is '**rent-to-own**' which is like hire purchase (see above) but is also very expensive as it's a high cost means to buy household goods. These types of loans tend to be marketed at people on lower incomes or with poorer credit histories and have been subject to a number of clampdowns by the authorities over poor sales tactics. A link is provided at the end of this session to the Financial Conduct Authority's guide on alternatives to these forms of borrowing.

Peer-to-peer (Peer2Peer) loans: this is an emerging form of lending where special websites link people who have money to invest with individuals or companies wanting to borrow, so you're effectively borrowing from other individuals rather than a bank. The sites, such as Zopa and Ratesetter, profit by taking a fee.

Personal contract purchase (PCP): an increasingly popular form of car finance. These normally involve making a monthly payment for 2 or 3 years, at which point the residual sum left to be paid off on the car purchase is the same as its trade-in value. At this point, consumers can either make a one-off payment to complete the purchase, trade the car in for a new one (and a new PCP deal) or simply give the car back (subject to the 'wear-and-tear' provisions in the contract).

Student loans: these are used to finance further and higher education studies. These are, though, not like ordinary loans or other forms of credit. The debts are only repayable when (and if) the income threshold for repayments is exceeded when former students are in employment. Student loan repayments are, in effect, another form of income tax.

Table 1 provides a summary of the key figures of debt products.

Table 1 Debt products: key features

Product	Secured/ Unsecured	Interest type (typical)	Interest charged (typical)
Overdraft	Unsecured	Variable	Very high
Credit card	Unsecured	Variable	High
Store card	Unsecured	Variable	High
Charge card	Unsecured	Variable – charged only if full monthly amount due is not paid	High (if charged)
Loans	Usually unsecured	Fixed	Quite low
Hire purchase	Secured	Fixed	Quite high
Mortgage	Secured	Fixed or Variable	Usually the lowest for all forms of debt

High-cost credit (e.g. payday loans)	Unsecured	Variable		Extremely high
Peer-to-peer loans	Unsecured	Variable		From quite low to very high
Personal contract purchase (PCP)	Secured	Fixed		From quite low to quite high

7 How much does it cost to borrow money?

When someone borrows money, the amount they have to repay to the lender consists of three elements.

1. The amount originally borrowed. This is often referred to as the principal sum, or sometimes the capital sum. You usually pay this back in stages (usually monthly) over the life of the loan, but it is possible to pay it all back at the end and just pay the interest monthly – but this only really happens on mortgages, and even then, you need to satisfy tougher criteria to get these 'interest-only' mortgages than a standard mortgage.

2. The interest that has to be paid on the debt. This is the key price you pay to be able to borrow, and how banks etc. make their money. It is normally expressed as a percentage per year – for example 7% per annum.

In simple terms, on a constant £10,000 debt the cost at 7% is £700 per year. However, the reality is that it will be less over the year as you are likely to be paying back some of the loan. Working out precise interest costs is complex even for the most skilled mathematician, given the debt is constantly reducing and most loans charge interest on a daily basis based on the balance that day, but there are online calculators that can help.

3. Charges. There might be charges associated with taking out, having or repaying debt, which is very common on mortgages. These will be explored in more detail later in this session and in Session 4 on understanding mortgages.

Figure 7 Interest impacts on the total amount needed to repay a loan

7.1 Annual Percentage Rate (APR): the key comparator for borrowing decisions

You've seen that borrowers must repay to the lender both the principal sum and the interest. On top of this there are often extra costs. Some come from 'arrangement' fees and intermediary (**broker**) fees when you get a loan in the first place and others, in certain circumstances, arise if you repay the loan before the end of the term.

Figure 8 APRs are important when considering different ways of borrowing

Given these different potential charges, and the possible differences in the timing of repayments of borrowed money, it's important to have a good means of comparing the total cost of debt on different debt products. Fortunately, there is a way to create like-for-like comparisons and assess which debt product is most appropriate. This is known as the Annual Percentage Rate (APR) of interest. This takes into account not only the interest rate charged on money borrowed but also when, and how often, interest is paid during each year. The APR also takes into account any other compulsory charges that are contractually part of a loan agreement.

While useful with loans and credit cards, an APR as a comparator is not infallible. On mortgages, for instance, it assumes you stick with that mortgage provider for the full term and pay the standard variable rate when an introductory rate ends. The reality is many people never pay that standard rate – as they tend to switch mortgage before it's charged - so there is little to be gained from comparing a mortgage cost over 20 years or more.

Note that APR does not include:

- optional charges, such as buildings insurance, that is not required as part of a mortgage package (though you don't need to get it from your mortgage provider).
- 'contingent' charges, such as **early repayment charges**, that depend on certain circumstances and that would become payable only in situations that are not applicable to all lenders.

Generally, a low APR means lower costs for the borrower. You will see the APR set out in posters and other advertisements for debt products, helping consumers to make comparisons between them.

7.2 Setting interest rates and the role of the Bank of England

To understand what determines the level of interest rates charged when you borrow money, you first need to understand how 'official' interest rates are set. In Video 2 Andy Haldane, Chief Economist at the Bank of England, talks about the factors that are considered when official interest rates are set. The setting of interest rates is a key facet of **monetary policy** – and this is used to help manage the economy.

Video content is not available in this format.
Video 2 The Bank of England and interest rates

The rate set by the Bank's Monetary Policy Committee (MPC), also known as 'Bank Rate', is the rate at which the Bank of England will lend to the financial institutions. This, in turn, determines the level of bank 'base rates' – the minimum level at which the banks will normally lend money. The result is that the Bank Rate (also known as the 'official rate') effectively sets the general level of interest rates for the economy as a whole.

The Bank of England's MPC meets eight times a year to consider policy and set its Bank Rate in the light of economic conditions – in particular the prospects for **price inflation** (the rate of increase in the price of consumer products like groceries, clothing, household goods and fuel).

The prime objective is for the MPC to set interest rates at a level consistent with keeping price inflation at around 2% p.a. For example, if the MPC believes inflation will go above 2% p.a. it might increase interest rates in order to discourage people from taking on debt – because if people spend less, it could reduce the upward pressure on prices. Conversely, if the MPC believes inflation will be much below 2% p.a. it might lower interest rates (also known as ‘easing monetary policy’), and people might then borrow and spend more.

However, after 2013 this approach to setting Bank Rate was modified to one where the MPC takes greater account of other measures of economic activity, like the level of unemployment. The video explores this change of emphasis.

Official rates of interest tend to move in cycles, rising to peaks and then falling to troughs. Since 1989 the trend in the UK has been for the peaks in interest rates to be successively lower. The official rate of interest (or Bank Rate) set by the Bank of England fell to 3.5% in 2003. In 2009 it hit a then-record low of 0.5% and was reduced further to 0.25% in August 2016. In December 2019, Bank Rate was back up to 0.75%, only to be cut again to 0.1% in 2020 to help combat the economic consequences of the coronavirus (Covid-19) pandemic.

Note, though, that for individuals the rate paid on debt products will be ‘at a margin’ – sometimes a very high margin – over Bank Rate and bank base rates. In other words, the rate that is actually paid by individuals will be higher. The margin added by lenders will take into account the product (particularly if the loan is secured or not) and the risks associated with the lending, including the credit worthiness of the borrower. So, while there is usually a small margin of around 2–3% between Bank Rate and mortgage rates, there is a huge margin between Bank Rate and, say, the rates on credit card debts and payday loans.

One other factor to consider is the difference between price inflation and interest rates – the difference is referred to as the ‘**real**’ interest rate. When interest rates are higher than price inflation, then real interest rates are positive. This is good news for savers who will see the purchasing power of their savings rising. When price inflation exceeds interest rates, then real interest rates are negative. This is bad news for savers who will see the purchasing power of their savings falling.

For anyone who is borrowing, the reverse applies – positive real interest rates are bad news, but negative real interest rates are good news.

8 Low cost and high cost borrowing

You've looked at several different ways of borrowing in this session. Now see how much you have learned about these debt products.

Figure 9 The chip in the card makes it easy and quick to make payments

Activity 4 Match the debt product to its features

Allow approximately 5 minutes for this activity

Set out in the table below are six different ways of borrowing money.

Underneath the table are nine statements which apply to at least one of these ways of borrowing.

Applying what you have learned during this session select, for **each** way of borrowing, the **three** statements that apply to them.

In the boxes in the right-hand column, type in the letters (A–I) for the three comments that apply.

Ways to borrow	Features or consequences of this method of borrowing (A–I)
Mortgage	*Provide your answer...*
Bank Loan	*Provide your answer...*
Overdraft	*Provide your answer...*
Credit card	*Provide your answer...*

Store card	*Provide your answer...*
Payday loan	*Provide your answer...*

Features normally associated with the method of borrowing

A. Low cost interest rate (relative to the average cost of the six ways of borrowing listed)
B. High cost interest rate (relative to the average cost of the six ways of borrowing listed) if not on a promotional rate – e.g. 0% rate for an introductory period
C. You risk having an asset (e.g. your home) repossessed if you don't keep up repayments
D. Can be interest-free for a time (e.g. introductory 0% rates for balance transfers)
E. They can often get you price discount the first time you use them to buy goods in a shop
F. If this facility has been prior arranged, then you can use it to borrow immediately without having to notify your bank
G. The lender will need a valuation of the asset you are buying before lending money
H. You have discretion about what you spend the borrowed money on
I. Borrowing in this way might impair your credit score

Answer

Ways to borrow	Features or consequences of this method of borrowing
Mortgage	A, C, G
Bank Loan	A, F, H
Overdraft	B, F, H
Credit card	B, D, H
Store card	B, E, H
Payday loan	B, H, I

Well done – you have nearly completed the session.

It's now time for the end-of-session quiz. After that the session will be rounded off, and you'll be provided with some tips if you do experience problems managing the repayments of the money you have borrowed.

9 End-of-session quiz

Now it's time to complete the end-of-session quiz. It is like the previous quiz but this time instead of answering three questions there will be five.

End-of-session quiz

Open the quiz in a new tab or window and come back here when you've finished.

10 Summary of Session 3

In this session you have studied the different ways that money can be borrowed and the various organisations in the UK that are active in the lending business.

You have also examined the credit scoring process in some detail, and looked at the things you can do to maximise your credit score and open the door to the best deals to borrow money. Certainly, one thing you should do after completing this course is to check your credit records!

You have also explored how the levels of interest rates on debt products are set – and in so doing reviewed the wider economic considerations that affect the general level of interest rates, including the key role played here by the Bank of England.

You should also have learned that borrowing money is a routine activity for most households – how else would most of us buy property, make home improvements or buy a new car? You should also have learned how to make good borrowing decisions and avoid the ones you would probably regret.

But if you do find you are having difficulties with your debts and are struggling to meet the repayments due, there are some key tips that will help you.

- First and foremost, open a dialogue with your lender. They will not want you to default on (i.e. fail to repay) the money you have borrowed. The financial services regulators also require lenders to provide support when borrowers get into difficulties
- Be prepared to seek help from the agencies here in the UK that provide free debt advice – for example Citizens Advice and StepChange.
- Take charge of your overall finances by setting or reviewing your household budget. Some economies on non-essential spending could provide the scope to keep up with your loan repayments and avoid your credit score becoming impaired. Guidance on how to build and manage a household budget was provided in Session 2 on budgeting and taxation and is accessible via the MoneySavingExpert website.

Further help and guidance can be provided from the following sources. Open the links in a new tab or window and come back here when you've finished.

- Follow this link to learn more about how interest rates are set and at the key role played in the management of the economy by the Bank of England.
- If you want to know more about Experian's credit scoring and credit reports visit MoneySavingExpert's Credit Club.
- If interested, take a look at Equifax and TransUnion.
- If you want the latest news on the credit cards with the best 0% and credit transfer deals visit MoneySavingExpert.com.
- If you want to know more about the alternatives to expensive forms of borrowing, look at the Financial Conduct Authority (FCA) publication 'Alternatives to High Cost Credit'.

You are now halfway through the course. The Open University would really appreciate your feedback and suggestions for future improvement in our optional end-of-course survey, which you will also have an opportunity to complete at the end of the course. Participation will be completely confidential and we will not pass on your details to others.

Get started with Session 4: Understanding mortgages.

Session 4: Understanding mortgages

Introduction

Welcome to Session 4 of this free Open University course. This session you will focus on mortgages – loans used for buying homes.

Video content is not available in this format.

Video 1 Introduction to Session 4

The session explores the mortgage products available in the UK market – their interest rate and other characteristics – and examines the factors involved in making good choices from the product range. It explains why and how mortgages can be actively managed by borrowers through such options as overpaying, offsetting and remortgaging.

The session also examines the mortgages from the viewpoint of the lenders, including the factors that affect their decisions about making mortgage advances.

By completing the session you will not only become more knowledgeable about the mortgage market, but also more confident in making smart decisions about one of most important areas of personal finance.

By the end of this session, you should be able to:

- understand how banks and other lenders like building societies make decisions about providing mortgages
- know about the different types of mortgage products available and the interest rates that apply to them
- know about the benefits in proactively managing your mortgage – for example by periodically moving from one product to another
- understand the various costs involved in buying property
- know the risks involved in having a mortgage and how to manage these.

The first section will look at the factors that determine how much lenders will provide when you apply for a mortgage.

This Session is one of a suite comprising the course *MSE's Academy of Money* and has been made possible by financial and content contributions by MoneySavingExpert.com.

1 Getting a mortgage: how much can I borrow?

Before making an offer to buy a property you need to know how much your lender will be prepared to advance you and on what terms. Getting at least an indication of what you can borrow makes sense before you make an offer. Subsequently you can return with details of the specific property you want to buy.

Figure 1 Will your mortgage be enough to secure that property purchase?

Before making a mortgage offer your lender will:

- Check your credit report to ensure you're financially attractive. Lenders are very interested in your track record when paying back any money you have previously borrowed.
- Assess the amount of money they (not you!) think you can afford to pay back (the 'affordability test'). This involves the lender reviewing your income and spending – typically aided by studying your bank statements for the past three months. When it comes to your spending the focus will be on your regular and contractual expenditure (e.g. mobile phone contract, school fees and home insurance) rather than one-off discretionary spending. They will also take into account the number of dependents you have. This could include not only your children (depending on their age) but also your parents or partner, depending on their circumstances. The current norm is that you'll be limited to borrowing around four times your salary.
- Stress test your finances. This includes looking at the factors that could change the amount you spend each month, and seeing if your budget can cope with the interest rate on your mortgage rising sharply (normally by assessing the impact of a 3 percentage point hike in the mortgage rate you pay).

So ahead of talking to your lender, there are some things you should do to help present your best financial profile:

- Check your credit reports at each of the three credit rating agencies to make sure there is no incorrect information. A link is provided at the end of this session to help you do this.
- Make sure you provide both your income and your partner's income details (if you are getting a joint mortgage).
- Review your spending – ideally at least three months before approaching your lender and, perhaps, cut out some non-essential regular spending (for example gym

membership if you are not making use of this). This will improve the outcome of the affordability test.

- Consider using a mortgage advisor (also known as a broker) to help with your application for your choice of mortgage. The advisor's expertise can help – particularly if you are a first-time buyer. Do, though, check that their advice covers the whole mortgage market (as opposed to the products provided by a few lenders). And check the fee payable – typically this is around £500 or a small percentage (less than 1%) of the sum you want to borrow.
- Know your job status has an influence on a lender's decision. Some lenders are wary about lending to borrowers who are on a temporary contract or in a probationary period for a permanent contract. A mortgage broker will be able to help you find lenders who are more willing to lend in these circumstances.
- Think about the term of the mortgage. Typically, the first time people take out a mortgage they set a 25 year repayment term. You can borrow for longer though. This will mean your repayments are lower, as you're paying less each year, although the total amount you eventually pay in interest will be higher, as you're borrowing for a much longer period. Remember, though, that a longer term may stretch into your planned retirement at which point you are likely to have a lower income to cover mortgage repayments.
- Make sure you are aware of the costs involved in completing the purchase of your property – like legal and removal costs, as well as any fees payable to secure a mortgage. (This is covered in more detail later in the session.)

The next step is to present your chosen lender (either directly or through a broker) with details of the property you want to buy.

1.1 The property in question and the importance of 'loan-to-value'

In addition to undertaking the credit, affordability and stress tests, your lender will want details of the property you want to buy.

Figure 2 What's the LTV on your property?

This is because most mortgages are 'secured' on the value of the property or land they have been used to buy. This means that if the borrower fails to make the required mortgage repayments, the bank can repossess the property and sell it to recover the money originally lent.

Three things your lender will want to know about the property are:

- Are you buying a **freehold** or **leasehold** property? The difference between the two is that leaseholders do not own the land on which their property is built and only own the property for the term of the lease. Many lenders are unwilling to lend on leasehold properties, particularly where the residual term of the lease is short (80 years or less). This is because such properties may become difficult to sell unless the lease is extended. Note that owners of leasehold properties also incur certain property-related costs, including maintenance costs (to cover, for example, repairs to the exterior of buildings, particularly when living in a block of flats) and **ground rent** – a fee paid to the owner of the freehold land on which the leasehold property has been built.
- Are you buying a property to live in (your 'prime' residence) or to rent out ('buy-to-let')? For the latter, lenders will usually charge a higher mortgage rate.
- Is there anything about the property that could make it risky to provide a mortgage for? For example, is it a very old property, or does it have an unusual construction (e.g. built with straw rather than bricks)? Is the property in an unusual location (e.g. above a shop, which may result in issues about access and responsibilities for maintenance)?

Before agreeing to a mortgage, the lender will then get a valuation of the property you want to buy. For most lenders the maximum mortgage they will provide is 95% of the property's value – or 95% 'loan-to-value' (LTV). This is provided that the size of this mortgage does not exceed the maximum the lender is prepared to advance you under the affordability test.

So, for a property costing £200,000, a 95% LTV mortgage would enable you to borrow £190,000 (£200,000 x 95%) leaving you to provide the other £10,000.

The interest rate charged on your mortgage is usually linked to the loan-to-value (LTV). Lower LTVs attract (slightly) lower mortgage interest rates. So it may well make sense to take action to reduce the LTV of your mortgage.

Since lenders tend not to provide 100% LTV mortgages, there is usually a need to use other funds to supplement the mortgage in order to meet the agreed price for purchasing the property. For first-time buyers these could come from using the proceeds from a **Help-to-Buy ISA** or a **Lifetime ISA (LISA)**. These are specialist savings accounts designed to help first-time buyers onto the property ladder by giving them a boost to their savings. Note that Help-to-Buy ISAs are no longer available to new applicants, although existing account holders can still use them to help with the purchase of property.

Activity 1 Cutting the mortgage LTV

Allow approximately 5 minutes

What can I do to reduce the LTV on my mortgage?

Enter your comments in the box below and save to reveal the discussion.

Provide your answer...

Discussion

Pushing down the LTV – a particular challenge for first-time buyers – means finding other sources of money to help fund your purchase. This reduces the size of the mortgage you'll need. Some options include drawing on your savings or perhaps seeking help from your friends or family (for example the so-called 'Bank of Mum & Dad'). Your lender will, in any case, need details of the other funds that you use to supplement the mortgage to buy a property. If you do use the 'Bank of Mum & Dad' – or similar sources of funds – the providers will need confirmation in writing that such money is a gift. Without this, the lender may assume the money is a loan and include it in the affordability testing (with the risk that this will end up cutting the size of the mortgage they will advance to you).

Over time you may move on to a new home (and therefore a new mortgage). Keeping down the LTV will then become easier. This is because the general trend in house prices for decades has been upwards. So when you sell your first home – particularly if you have lived in it for several years – it is likely (but not definite) that you will receive more than you paid for it. This money or 'equity' that you extract from the property sale can then be used as the deposit on your next property, thereby helping to keep down the LTV of the new mortgage. In fact you may be able to lower your LTV without moving home by simply repaying your existing mortgage after a number of years and taking out a new mortgage (known as 'remortgaging').

Why do lenders charge lower mortgage interest rates on lower LTV mortgages?

Enter your comments in the box below and save to reveal the discussion.

Provide your answer...

Discussion

The banks charge lower interest rates on lower LTV mortgages because more of the house value has been paid for, thereby reducing the risk of the lender losing money on the mortgage provided. If they have to repossess a property and sell it during a period of falling house prices, there is less risk of losing money if the original LTV was, say, 60% than if it was 95%.

OK – you should now understand what a lender will be looking for when you apply for a mortgage. But there are different types of mortgage products – so which type should you go for?

1.2 Repayment or interest-only

The first major choice to be made about a mortgage is how to repay it. The options are a 'repayment' mortgage or an 'interest-only' mortgage. These days many lenders only offer the former, making the decision simple!

Figure 3 What's the interest cost on a mortgage?

With a repayment mortgage, the capital or principal sum (the original amount of debt) is paid off in stages throughout the life of the loan. Look at Table 1 below to see the pattern of payments on a repayment mortgage. The typical structure is a reducing balance loan with a set amount paid each month throughout the mortgage term unless the interest rate changes.

Table 1 Annual payments on a repayment mortgage (£)

In year	Interest paid	Capital repaid	Total mortgage payment
1	3957	2379	6336
5	3546	2790	6336
10	2930	3406	6336
15	2177	4159	6336
20	1412	4924	6336
25	142	6194	6336

As you can see from the table, initially the majority of annual mortgage repayments are made up of interest, as there's such a large sum to pay interest on. Only a small proportion of your repayments go towards paying off the capital. When you get closer to the end of the mortgage term, your repayments are mainly going towards paying off the capital, as there's then a much smaller loan, which accrues much less interest.

One consequence is that a borrower who wishes to repay early might be surprised at how much of the principal sum remains. Table 1 shows a £100,000 repayment mortgage payable over 25 years, at a mortgage rate of 4%. For this illustration it is assumed that the mortgage rate stays the same throughout the life of the mortgage.

With an interest-only mortgage, the principal sum outstanding is unchanged throughout the life of the loan and only interest payments are made to the lender until the end of the loan period. At the end of the period the borrower must have the means to repay the lender the principal sum (the amount outstanding).

With interest-only mortgages, repayment of the principal is typically achieved by putting money into a savings or an investment scheme (such as an **ISA** or **unit trusts**) throughout the life of the mortgage. To determine how much to save each month, the investment is projected to grow at an assumed rate in order to produce a lump sum large enough to repay the principal sum in full on the maturity of the mortgage.

Activity 2 Using investment schemes to repay a mortgage

Allow approximately 5 minutes

What could go wrong with using an investment scheme to build up the funds to repay a mortgage?

Enter your comments in the box below and save to reveal the discussion.

Provide your answer...

Discussion

The risk is that the investment scheme builds up insufficient funds to repay the mortgage. In such cases the borrower has to find other funds to complete repayment or borrow money for a further term. This risk means that interest-only mortgages are unpopular these days and indeed many lenders do not offer them. Lenders that do need to be convinced that a credible and robust scheme is in place to pay off the mortgage at the end of its term.

Those on interest-only mortgages are strongly advised by the **Financial Conduct Authority (FCA)** to check whether their investment schemes are on track to repay their mortgage. Those with such schemes set up years ago when interest-only mortgages were more prevalent are, in any case, very likely to be contacted by their lender to ask how they intend to repay their mortgage at the end of the interest-only term!

As mentioned above, you may not have any choice but a repayment mortgage. However, the next choice about your mortgage product is one you will certainly have to make: do you want a fixed-rate mortgage or one with a variable rate?

1.3 Fixed-rate or variable rate?

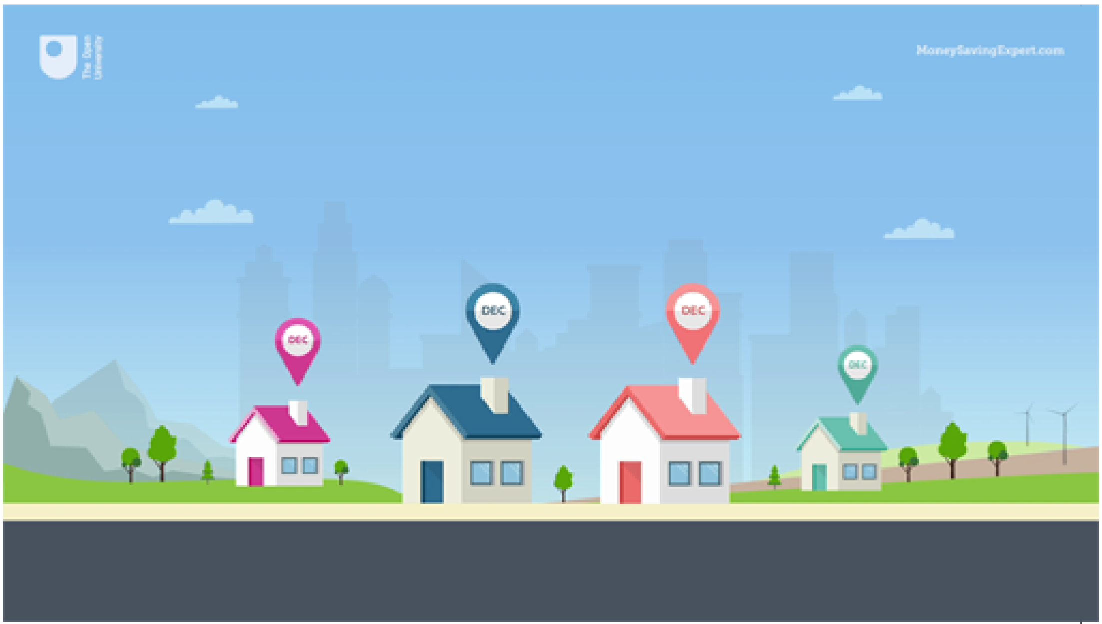
It is now time to make the decision about your mortgage – should you go for a fixed-rate or a variable rate mortgage product? Over the typical 25-year life of a mortgage this is a decision you may choose to make several times, switching from fixed-rate to variable or vice versa as you seek out the product that is best for you each time.

Watch Video 2 and explore the different interest rate features of mortgages, the fees that are associated with them and the pros and cons of different products. You will see that variable rate products take a number of slightly different forms.

Once you have watched the video, there are a couple of questions for you to answer below.

Video content is not available in this format.

Video 2 Understanding mortgages



Activity 3 Fixed-rate mortgages: benefits and risks

Allow approximately 5 minutes

What are the pros and cons of fixed-rate mortgages?

Enter your comments in the box below and save to reveal the discussion.

Provide your answer...

Discussion

Fixed-rate mortgages provide certainty about your monthly mortgage payments as these will not rise during the fixed-rate term. They are a sensible choice for households on tight budgets with only a limited capacity to afford an increase in the costs of a mortgage, or for those who simply prefer certainty about what their mortgage will cost.

Note that these fixed-rate products are commonly for 2 to 5 year terms, with a limited market for 10 year fixed-rate terms. Fixed-rate terms for longer periods have never caught on in the UK. So the likelihood is that any fixed-rate deal will only cover the first part of your mortgage term, and not the full term, unless you're in the final years of a mortgage and remortgaging for the last time.

Fixed-rate mortgages often come with the cost of an upfront 'arrangement' fee (though this is true of trackers and discount mortgages too). Those on fixed-rate mortgages do not benefit from falling interest rates. Also, usually you will have to pay an early repayment charge if you repay the mortgage before the end of its fixed-rate term. At the end of the fixed-rate term the mortgage will normally revert to the lender's standard variable rate unless action is taken to move to an alternative mortgage product.

What are the pros and cons of variable rate mortgages (including 'trackers' and 'discount mortgages')?

Enter your comments in the box below and save to reveal the discussion.

Provide your answer...

Discussion

Variable rate mortgages will move up or down as interest rates in the economy alter – specifically when the Bank of England moves its ‘Bank Rate’. Those with these mortgages benefit when interest rates fall and lose out when rates rise. This lack of certainty can cause problems with household budgets. On the other hand, there are normally no early repayment fees if you repay your mortgage early.

OK, it’s time for a short quiz to check how much you have learned so far. The section after that will look at the other options which may be available to you to customise your mortgage product.

2 Half-time quiz

A lot of ground has been covered and it’s now time for a short quiz to see how much you’ve learned.

Have a go at these three questions.

Half-time quiz

Open the quiz in a new tab or window then come back here when you’ve finished.

3 Mortgage choices: offset, flexible and portable mortgages

The pros and cons of fixed-rate and variable rate mortgages (including trackers) have been covered. But your lender is likely to offer some further choices about your mortgage product. These can, in a sense, customise your mortgage to meet your financial circumstances and even your lifestyle.

Listen to Audio 1 and learn more about these special mortgage features.

Audio content is not available in this format.

Audio 1 Mortgage choices

The next section looks further at how you can be proactive in managing the mortgage you have chosen.

4 Managing your mortgage: overpaying

The previous section covered how paying off your mortgage can be accelerated by using ‘offset’ and ‘flexible’ mortgage products. It was also noted how conventional mortgages can offer the ability to make overpayments, pushing down the balance left to pay off.

Figure 4 Should I make overpayments?

The maths behind this is quite simple if you have spare income each month – it comes down to a comparison between the mortgage rate and interest rate you could get if, instead of overpaying, you placed the money into a savings account. If the mortgage rate is higher than what you can get on a savings product the answer appears to be a ‘no brainer’: pay down the mortgage rather than save the money.

There are, though, a few things you need to be aware of before opting to overpay:

- Does your mortgage contract allow overpayments and, if so, by how much? 10% of the balance per year is a standard figure, but if you go beyond any limits for overpayments you could incur early repayment charges, particularly if you’re on a fixed-rate or discount mortgage.
- If you do use your savings to make an overpayment, check if there are any charges for withdrawing money from your account.
- Do you have other debts (e.g. a bank loan) with a higher interest rate than the mortgage rate you are paying? If so, using your savings to reduce or pay off these debts would make more sense than reducing your mortgage balance.

Activity 4 Should I overpay my mortgage?

Allow approximately 5 minutes

Imagine the following scenario. Your mortgage has three years left before you complete repayments. The mortgage rate is 3.2% per annum but you earn 1.8% per annum on your savings in a fixed-rate ISA account. If you withdraw money from the bond account before **maturity**, you pay a charge of 6 months interest. Leaving aside any other considerations, is it worth using money from your bond account to overpay your mortgage?

Enter your comments in the box below and save to reveal the discussion.

Provide your answer...

Discussion

Yes, it's still wise to overpay the mortgage. The loss of earnings on the fixed-rate ISA account is 1.8% interest. The one-off charge is 0.9% (= 6 months, or one half, of the annual interest of 1.8%). But this cost can be spread over the remaining 3-year life of the mortgage and so equates to 0.3% (0.9% ÷ 3) per year. That totals 2.1% (1.8% + 0.3%) of lost earnings per year against the 3.2% of interest that will be saved by reducing the mortgage balance.

Note that these calculations ignore the very small amounts of interest earned on previous interest paid (known as '**compounding**'). However this does not affect the conclusion that overpayment makes sense.

But remember that this is a mathematical exercise, where other considerations have been ignored. Ideally, you'll not have other debts, you'll have other savings you could fall back on if there was an emergency or you lost your job, and you've checked your mortgage allows overpayments.

While it can be the right decision to use savings to overpay your mortgage, be careful. It's often better to overpay each month with surplus income (if you have it) rather than cashing in your savings and putting them towards a mortgage when you probably won't be able to get the money back if you find you need it in the future.

Even if the maths points to overpaying your mortgage, should you use all your savings to reduce your mortgage balance?

Enter your comments in the box below and save to reveal the discussion.

Provide your answer...

Discussion

This would be unwise unless your mortgage has an easily accessible borrow back feature. Everyone should retain some savings to cover life's emergencies and uncertainties. One recommendation is that these savings should be equivalent to what you'd spend over six months.

If you've used all of your savings, you may have to borrow money at short notice if something unexpected happens – like if your car breaks down or if your washing machine needs replacing.

The next section looks at when and why it makes sense to change your mortgage product and maybe your mortgage provider too.

4.1 Moving to another deal

Around 4 in 10 mortgage transactions relate to people remortgaging their existing property without moving home at the same time. Moving home is very likely to trigger a new mortgage deal as well – certainly when the existing mortgage is not portable from one property to another. But it is the volume of remortgages which highlights the fact that periodically it makes sense to switch to a new mortgage deal, and maybe a new lender too.

Figure 5 Let's sign up to a new deal

One trigger point for remortgaging is when the initial mortgage deal comes to an end. It is normal for the mortgage rate to then default to the lender's Standard Variable Rate (SVR) unless action is taken by the borrower. And commonly, action should be taken, as SVR mortgages tend to be expensive – certainly when compared with fixed, discount or 'tracker' rate mortgages.

All borrowers on SVRs should really review whether they could find something better. A mortgage should not be seen as a product you have to stick with until its term is completed and the money repaid to the lender. Since it represents to many households the largest regular monthly outgoing, every opportunity should be made to switch to a new deal if it makes financial sense. Since interest rates do change over time, opportunities are likely to arise to cut the cost of your mortgage.

4.2 Ditching a fixed-rate mortgage

Another trigger for remortgaging that arises under certain interest rate conditions is when making an early repayment of an existing fixed-rate deal and moving to a new mortgage makes financial sense.

The calculations required to make good decisions are not daunting. Basically, you need to work out the costs of getting out of your current mortgage deal – there may be none if you are on a SVR or tracker product. Add on the costs of a new deal (possibly an arrangement fee and perhaps legal costs, although the new lender will sometimes cover these). Then compare these costs with the savings you expect to make by moving to a new product with a lower mortgage rate than you are currently on.

Figure 6 Is it time to get out of that fixed-rate deal?

In a period of falling interest rates, repaying a fixed-rate mortgage and moving to one with a lower rate can make sound financial sense.

Here is an example:

The Sharp family have 3 years left on a 5-year fixed-rate (interest-only) mortgage of £100,000.

The current mortgage rate is 6% per annum but they could move to a new 3-year fixed-rate mortgage at 4% per annum. To do this they have to pay an early repayment charge of 3% of the amount outstanding and also pay an arrangement fee of £500 for the new mortgage.

What should the Sharps do?

The costs of moving to the new product are:

- The early repayment charge: 3% × £100,000 = £3,000
- The arrangement fee: £500
- Total £3,500

But the benefits are the interest savings of 2% (that is, 6% less 4%) for three years:

That saves the Sharps £100,000 × 2% x 3 years = £6,000.

So, the net saving is £2,500.

The Sharps will have to dip into their savings to pay those upfront costs. But even if they are earning 2% per annum on their savings, the loss of interest earnings over the three years is only £3,500 × 2% × 3 = £210

So, the Sharps should move to the new fixed-rate deal.

Activity 5 Does ditching this fixed-rate mortgage make sense?

Allow approximately 10 minutes

Try the maths of moving to a new fixed-rate deal.

This time the existing fixed rate is running at 4% per annum and has two years left.

The interest-only mortgage is for £100,000.

A new 2-year fixed-rate mortgage can be secured at 2% per annum.

The arrangement fee is £750 and the early repayment charge is 2% of the amount outstanding.

Enter your comments in the box below and save to reveal the discussion.

Provide your answer...

Discussion

The costs of moving to the new product are:

- The prepayment fee: 2% × £100,000 = £2,000
- The arrangement fee: £750
- Total: £2,750

But the benefits are the interest savings of 2% (that is, 4% less 2%) for two years.

That saves £100,000 × 2% x 2 years = £4,000.

So the net saving is £1,250.

The costs have to be met up front out of savings (assuming these are available), but even if these are earning 2% per annum, the loss of interest earnings over the two years is only £2,750 × 2% × 2 years = £110.

For these reasons, it would make sense to move to the new fixed-rate deal.

If you struggled with the maths, you can access a link at the end of the session to guide you on whether it makes financial sense to pay off your fixed-rate deal.

The next section looks at how you have to cover several different costs when buying a property. Your financial outgoings will certainly start even before that first mortgage repayment.

5 The other costs of buying a property

It's not just about getting the mortgage and being able to pay it. There are a number of costs that you will additionally incur as you take ownership of your new home.

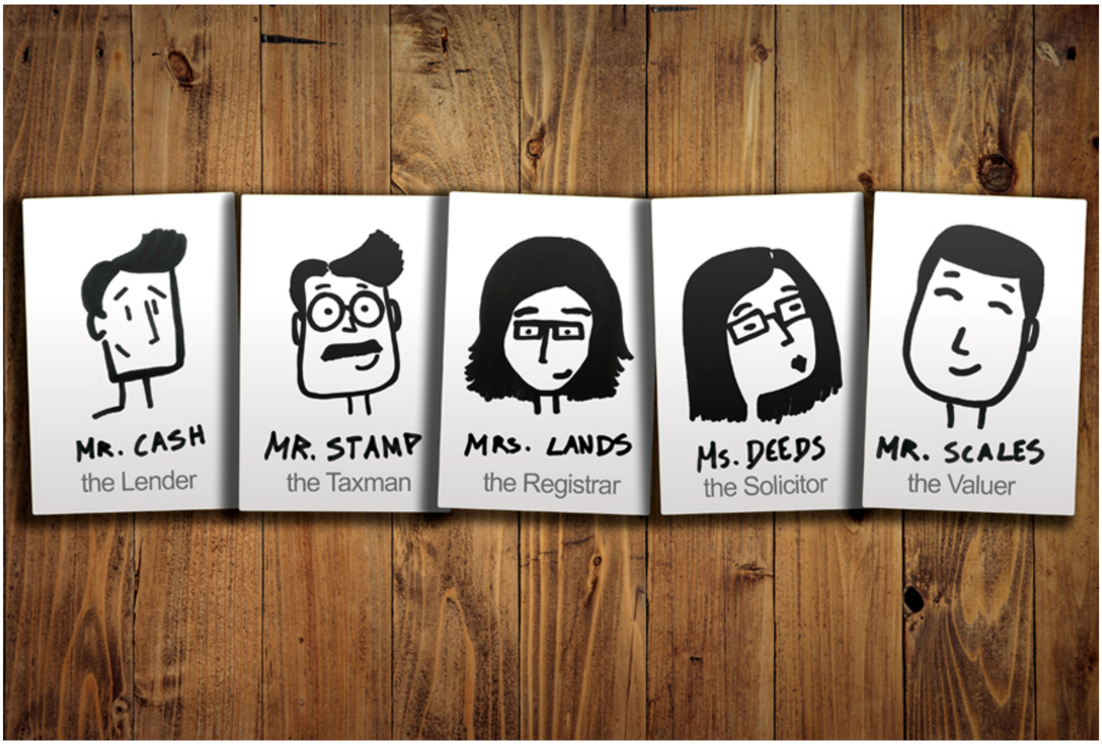


Figure 7 Meet the people involved in your property purchase

To show you how these costs may add up, let's suppose you're buying a property for £220,000 in England – which is close to the average cost of a property in the UK.

What costs do you incur if you are not a first-time buyer and the property is to be your home (your 'prime residence')?

- Mortgage arrangement fee (common with discount and fixed-rate mortgages and some other products): say, £500.
- Legal costs including local searches and Land Registry fee: £800.
- Survey and valuation: £350.
- Stamp Duty Land Tax (SDLT): £1,900.
- Removal costs: say, £700.
- GRAND TOTAL: £4,250.

There may also be a fee to the mortgage broker if you've used one to help choose and organise the mortgage. Some costs arising from getting a mortgage – specifically the arrangement fee – can, subject to the lender's approval, be added to the mortgage. The other costs will, though, have to be met up front.

Other transaction costs involved in property transactions are the fees payable to an estate agent (if one is used) and the charge for an Energy Performance Certificate in respect of the property. These costs are, though, met by the property seller rather than the buyer.

Box 1 explains Stamp Duty Land Tax in a little more detail.

Box 1 Stamp Duty Land Tax (SDLT)

The marginal rates of Stamp Duty Land Tax on residential property purchase in England and Northern Ireland in 2020/21 were:

- up to £125,000, 0%
- £125,001 to £250,000, 2%
- £250,001 to £925,000, 5%
- £925,001 to £1.5 million, 10%
- above £1.5 million, 12%.

Note that first-time buyers are exempt from SDLT for properties up to £300,000 and at a reduced rate of 5% for the amount in excess of £300,000 up to a maximum of £500,000. Purchases above £500,000 do not qualify for any SDLT relief. Also note that a surcharge of 3% applies if the property is not acquired as a 'prime residence'.

On 8 July 2020 the threshold for SDLT on property transactions was raised to £500,000. The introduction of this temporary measure, in place until 31 March 2021, was aimed at boosting the housing market and helping the wider economy recover from the impact of the Covid-19 pandemic.

In Scotland the equivalent tax to SDLT is Land and Buildings Transactions Tax (LBTT) and in Wales it is Land Transaction Tax (LTT). The Scottish Parliament and Welsh Assembly have the power to – and do – apply their own rates for these equivalents of SDLT.

The next section reviews the range of risks and challenges that come with a mortgage. It will look at how coping with the costs of a mortgage needs to be embedded into wider household financial management.

6 Mortgages: understanding and managing the risks

It is important to reflect on the risks that arise from home ownership and having a mortgage. Being alive to these risks means that even when you cannot take action to eliminate them, you are at least better prepared to handle the consequences of them.

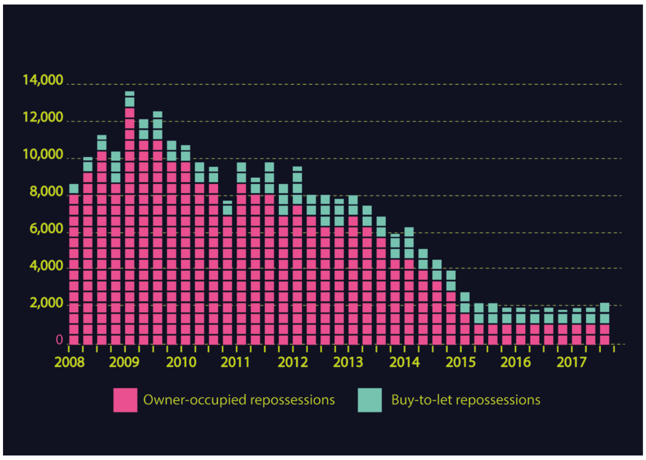


Figure 8 Repossessions, buy-to-let and owner-occupied markets. Source: CML (2017).

Mortgages are secured loans, so there is the risk of losing your home (via repossession by lender) if you default on repayments.

In recent years, mortgages have been very affordable due to the historic low levels of interest rates. But future years will virtually inevitably see higher interest rates return.

Mortgage lenders are required by their regulators to work with borrowers who get into financial trouble with their mortgages. But they could eventually repossess the property of a defaulter if it doesn't get resolved.

Then there is the reality that house prices do go up and down over periods of time – although admittedly the trend line since the 1970s has clearly remained upwards. The future is, though, uncertain. There is the risk of finding yourself in negative equity (where the market value of your property is less than the remaining mortgage on it) if you buy at times just prior to one of those periodic falls in property prices. Provided you can still afford to meet your mortgage repayments, being in negative equity by itself is not a problem, though, unless you have to move home. In these circumstances you may need to find the difference between the market value of your property and the mortgage amount you have to repay.

Another risk seen very recently is that those who obtained mortgages under old affordability testing rules cannot obtain the same size of mortgage under the rules that have applied since 2014. These people are at risk of being 'mortgage prisoners', unable to take advantage of better mortgage deals as it means submitting themselves for a re-appraisal of the size of mortgage they can afford.

Interest rate risk is pervasive for all mortgages – you may lose out by taking a fixed-rate deal only for interest rates to fall. Or you take out a variable rate deal and interest rates rise.

And there is always the risk of inertia – for example, not taking action (or at least reviewing the mortgage market) when your initial mortgage deal ends and you are placed on your lender's **reversion rate** (usually its unattractive SVR).

The other risk is not looking ahead and planning for life's uncertainties – those events which will affect your household budget and put pressure on your ability to make your mortgage repayments. These could include breaks in employment, marital breakdown, illness or simply unexpected repair bills on your property.

This may sound like home ownership brings doom and gloom – far from it, as most people repay their mortgages without issues. But being forewarned and planning accordingly can minimise the risk of these issues causing you a problem.

So now it's time for you to assess how you feel about the risks associated with mortgages and home ownership with this final activity.

Activity 6 Your perspective on the risks of home ownership and mortgages

Allow approximately 10 minutes

In Table 2 below are the risks relating to home ownership and having a mortgage.

In each case select whether you have no concern, some concern or great concern about these risks and what you think you can do to manage these risks.

If you don't have a mortgage right now, imagine you've bought a home and think how you'd feel in these scenarios.

Enter your comments in the boxes in the table and save to reveal the discussion.

Table 2 Home ownership risks

Risk	Concern and comments
Having my own home is likely to result in me having expenses – like repairs – that I may find difficult to afford.	None Some Great
My income could make it difficult to keep up with my mortgage repayments.	None Some Great
House prices could fall, pushing me into negative equity.	None Some Great
The rules on affordability may change making it difficult for me to remortgage to a new deal – leaving me on a bad mortgage deal.	None Some Great
I could make a poor choice of mortgage product, for example a fixed-rate deal when interest rates fall or a variable rate deal when interest rates rise.	None Some Great

After my existing mortgage deal ends the reversion rate is the SVR which is unattractively high.	None Some Great
I'm falling behind with my payments and I'm worried that my home will be repossessed by my lender.	None Some Great

Discussion

Table 2 Home ownership risks (with comments)

Risk	Comment
Having my own home forces me to have expenses – like repairs – that I may find difficult to afford.	Preparing for this means drawing up and managing a household budget and building in some financial room for manoeuvre to cover contingencies. Set up a 'rainy day' savings account too.
My income could make it difficult to keep up with my mortgage repayments.	Are there ways of increasing income (a part-time job, maybe?). Talk to your lender too to see if you can take steps to reduce your monthly mortgage payments – e.g. by extending the term of your mortgage or switching to a better deal. Note that there may be administration fees involved in doing this. This will depend on the policy of the lender.
House prices could fall, pushing me into negative equity.	If you can afford your mortgage payments, then you are OK unless you have to remortgage, for example if you have to move home due to a job move etc. If you do have to move, then you may need access to other funds to repay the mortgage outstanding after the proceeds from the sale of your home.
The rules on affordability may change making it difficult for me to remortgage to a new deal – leaving me on a bad mortgage deal.	A tricky one. Campaigning is taking place to help people caught by the affordability rules change. Maintaining an unimpaired repayment record with your current mortgage could help if you find that you do have to submit yourself to a new affordability test under the new rules.
I could choose the wrong mortgage option, for example a fixed-rate deal when interest rates fall or a variable rate deal when interest rates rise.	This happens to most people at some point in the years of having a mortgage. No one has a crystal ball when it comes to interest rates. Just be prepared to switch to a new mortgage deal if it looks as though it will save you money. Be proactive and keep an eye on the media and what is being said about the likely future direction of interest rates.
After my existing mortgage deal ends the reversion rate is the SVR which is unattractively high.	Don't just sit there, do something! Check out the market and move to a better deal, and if that is with a new lender then so be it! Again, there could be administration fees but your current mortgage paperwork will confirm this.

I'm falling behind with my payments and I'm worried that my home will be repossessed by my lender.	Start a dialogue with your lender – they are required to work with you at times like this to avoid matters getting worse. Be prepared to seek advice from organisations like Citizens Advice and StepChange.

It is now time to check what you have learned in the end-of-session quiz.

After that it is time to wrap up the session!

7 End-of-session quiz

Now it's time to complete the end-of-session quiz. It is similar to the previous quiz, but this time instead of answering three questions there will be five.

End-of-session quiz

Open the quiz in a new tab or window then come back here when you've finished.

8 Summary of Session 4

A lot of detail has been covered in this session. The information and skills provided will help you make good decisions when selecting and managing your mortgage.

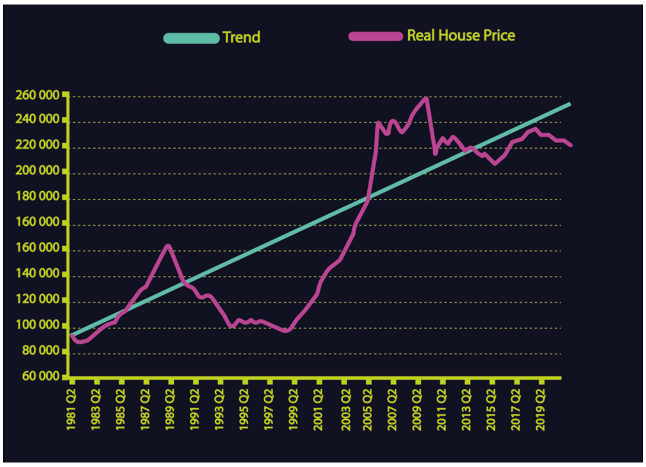


Figure 9 Average house prices in the UK (in real terms) 1981–2019. Source: Nationwide Building Society (2019).

To sum things up, here are five key tips:

- Always search for the best deal.
- Keep your eye on the market and monitor how mortgage rates are moving.
- Be prepared to remortgage – and not just once!
- Don't end up with a Standard Variable Rate (SVR) product. Other variable rate products (trackers and discount mortgages) are usually better. SVR products are the equivalent of energy companies' standard tariffs – expensive and designed to catch people who don't switch!
- Don't feel obliged to stay with the first mortgage provider just because they lent you money when you first needed a mortgage – it's a commercial relationship, not a marriage!

The good news is that the trend over many decades has been rising house prices in both cash and **real** terms (see the graph above) – so your mortgage not only provides a home, but a sound investment too!

Further reading

To learn more about certain of the issues covered in this course you can follow these links to the MoneySavingExpert site:

- Learn more about credit scoring
- Learn more about the early repayment of fixed rate mortgages
- Learn more about Stamp Duty Land Tax costs

The housing market is an important part of the economy. Understanding how it works can help you make better-informed decisions about your finances. To find out more, MoneySavingExpert recommends you visit the Bank of England's Knowledge Bank site, which includes sections on:

- What is the economy?
- What are interest rates?
- What is inflation?
- Who sets exchange rates?

Go now to Session 5: Saving and investing.

Session 5: Saving and investing

Introduction

Welcome to this session on savings and investments, produced by The Open University in collaboration with MoneySavingExpert.com.

Video content is not available in this format.
Video 1 Introduction to Session 5

The session covers the spectrum of savings accounts and investment products. It starts by looking at the importance of savings accounts and the many different products available.

You'll later explore the different types of investment products such as shares (or 'equities'), bonds, property and commodities (such as gold and silver). You'll also look at a relatively new type of investment: 'peer-to-peer' lending.

By the end of this session you should be able to:

- understand the key features of different savings products
- be able to identify the savings products that align with your reasons for saving up

- understand the different types of investments, such as funds, shares and bonds
- recognise the minor risks associated with savings accounts and the potentially substantial risks (but also possible rewards) associated with investing
- know where to go for help when considering investments.

Please note that this session covers one of the riskiest aspects of personal finance: investing. As such, the information here should be taken as educational guidance only. Before making investment decisions – certainly major ones – you should seek advice given the risk of potential financial loss you could be exposing yourself to.

This Session is one of a suite comprising the course *MSE's Academy of Money* and has been made possible by financial and content contributions by MoneySavingExpert.com.

1 Why should we save up for the future?

In Charles Dickens's book *David Copperfield*, Mr Micawber mused that an annual income of £20, coupled with an expenditure of £19, 19 shillings and sixpence (leaving sixpence over to save) was happiness itself. Whereas the result of spending £20 and sixpence (and having to borrow the difference) would be misery. Linking happiness or misery to having surplus income or surplus expenditure may be somewhat simplistic, but for many people having spare income, and thus an ability to put money away for the future, can indeed help make life easier and more rewarding.

Figure 1 W.C. Fields as Mr Micawber from the film *David Copperfield*, 1935. © Metro-Goldwyn-Mayer via Getty Images.

When thinking about the reasons for people to put money aside, we're really thinking about why they are deferring consumption rather than consuming now.

This can be for a number of specific or non-specific purposes.

Future purchases – both known and unknown

If you know what you want in future, you can put a certain amount aside each month (or week), based on a calculation of how much you need for a particular goal – such as buying your first home, a car or even to save for Christmas. It could simply be to have money put aside for items or services you don't yet know you need or want.

A safety net

Another reason is the 'precautionary motive' – perhaps more commonly known as 'saving for a rainy day'. This involves building up a buffer of funds to provide for unexpected events and bills, which can provide you with emotional and practical security because you know you have funds to call upon if you really needed them.

Supporting a change in lifestyle

Having sufficient savings could enable you to leave a job, to take a break for a few months. It could also enable you to do or buy things that you want, or to take advantage of opportunities that arise (such as being able to pay for education or start a business).

Planning for later life

One of the most significant purposes for saving is to help provide money for retirement. Another reason could be to have money set aside to pass to your dependents when you die.

As we are all different, you may have other motives not mentioned here.

The reasons above all underline an important overall aim of having savings – to ensure you do not overdo it now and leave yourself short for important future expenditure, and to create financial security and independence.

Activity 1 Your reasons for saving up for the future

Allow approximately 5 minutes for this activity

What plans do you have for the money you have currently saved or invested? Over what time period do you expect to use this money?

If you currently have no savings, consider the objectives you would have if you started to amass them.

Provide your answer...

Answer

While your response will reflect your personal circumstances, savings usually have multiple purposes – from a safety net to deal with immediate financial emergencies, to a pot of funds for future treats or necessities such as a new car or a world cruise, to a store of wealth for your family to benefit from in the future. The short-term use versus long-term use of savings needs to be reflected in where you save or invest your money – some ideally needs to be easily accessible while some can be put aside for many years.

1.1 The difference between saving and investing

Before you start to look at savings and investment products, there are some important definitions that need to be made clear.

People often use the terms ‘saving’ and ‘investing’ as well as ‘savings’ and ‘investments’ interchangeably. They may also use the term ‘saving up’ when talking about the way money is placed in a range of different products, albeit with the common objective of building up a sum of money over time.

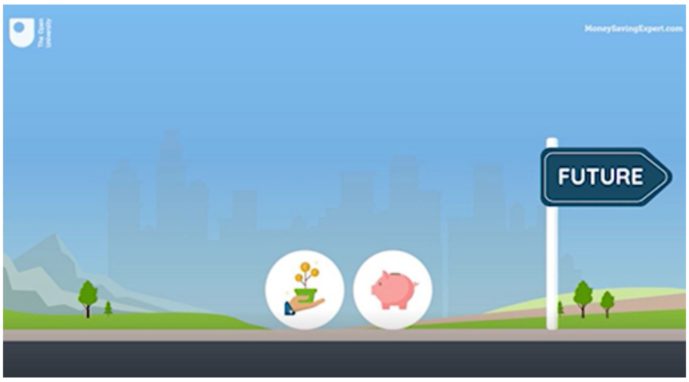
Yet there is a clear distinction between these terms.

- **Saving up.** This was covered in the previous section, and is the putting of money aside to use at a future date for an array of possible purposes.
- **Savings products or savings accounts.** These are simple products where you save money with a bank, building society or credit union, and you are paid **interest**. Crucially, other than for very large savers, the value of the capital (the amount you originally save) is not at risk if it is saved with a UK-regulated financial institution.
- **Investment products.** Here, there is risk but also possible greater rewards than with a savings account. With an investment, the value of your cash can subsequently go up and down depending on the performance of your investment. That is not necessarily a bad thing, but you need to understand that your capital is at risk.

Now watch the video to learn more about the differences between savings and investments and the various reasons for doing both.

Video content is not available in this format.

Video 2 The difference between saving and investing



2 The UK's savings problem

Figure 2 Are you building your savings up or running them down?

The video in the previous section talked about the various reasons for saving money.

Whatever your own reasons for saving money, the reality is that the UK is not very good at doing it! The data in the tables below make this very clear. The UK has a lower savings ratio than most other European countries (Table 1) and over the past twenty years it's been getting worse (Table 2).

Table 1 European Savings Ratios 2018. Savings as a % of disposable income.

Country	Savings Ratio (%)
Sweden	15.40
Germany	10.95
Netherlands	8.40
France	8.38
Ireland	5.78
European Union (average)	3.70
United Kingdom	0.37

Source: OECD (2020)

Table 2 UK Savings Ratio 2000-2018. Savings as a % of disposable income.

Year	Savings Ratio (%)
2000	4.97
2004	3.68
2008	3.79
2012	4.35
2016	1.74

2018	0.37

Source: OECD (2020)

Activity 2 Explaining the UK's poor savings rate

Allow approximately 5 minutes for this activity

What do you think are the reasons for the UK's poor savings record?

Provide your answer...

Answer

There are several likely reasons for the low savings ratio in the UK.

The past decade has seen the value of real income – that is, income after adjusting for price inflation – fall for many people. With less money spare after meeting household bills, savings perhaps inevitably suffer.

Another reason may be the availability of debt. Borrowing money rather than drawing on savings is what many do to cover for life's emergency spending or, say, the cost of a holiday. Yet this can be a very expensive way of covering such costs.

One reason for the decline in the UK's savings ratio is that interest rates in the UK have been at historically low levels since the financial crisis in the late 2000s – and reached a record low in March 2020 after the spread of the Covid-19 pandemic hit the UK. With the interest paid on savings accounts being so low, the incentive to save is less, and many may simply have opted to spend the money instead.

3 The savings supermarket: What type of accounts can I get?

Whether it be on the internet, in the print media or simply in the windows of banks and building societies (though they won't tell you about possible better rates elsewhere!) you'll find details of hundreds of different accounts, but which to pick depends on their features and your circumstances.

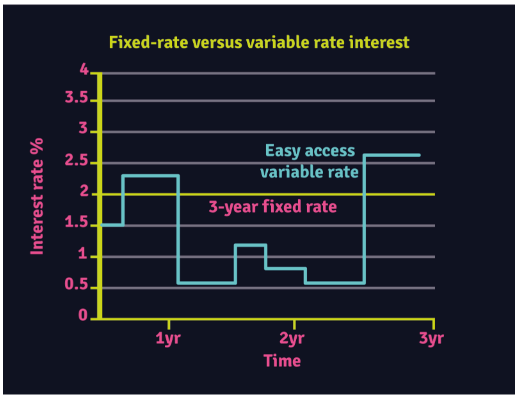


Figure 3 Fixed versus variable savings rates

When selecting your savings accounts, one key decision is whether to go for an easy access product where the rate will be variable or a fixed-rate product where the rate is, as the term clearly implies, fixed for the term of the product.

Fixed-rate products are commonly referred to as 'bonds', although you should try to get that term out of your head in the context of savings as it's a confusing term given lots of investments are also called bonds. They're just savings accounts that pay a fixed interest rate.

Another decision to make is whether to go for a cash ISA or a standard savings account. We explain later on what cash ISAs are in detail, and whether to go for one. Yet the basic premise of them is fairly simple in that they're just normal savings accounts where there is no tax on the interest, and as they're just like normal savings accounts, the descriptions below apply to both cash ISAs and standard accounts.

Let's look at the different types of accounts in some more detail.

Easy access (or 'instant access') accounts

These tend to give you easy access so you can make withdrawals at will (though some limit the total number you can make per year). They tend to pay lower rates than fixed-rate accounts, but are a good place to keep your money if you're going to need it soon (or frequently).

The interest rates on such accounts are variable so they can move up and down, either in line with the Bank of England's Bank Rate (you looked at Bank Rate in Session 3). But decisions about the exact timing and scale of the moves lie with the bank or building society and can happen at any time, so keep a close eye out.

Make sure you also keep an eye out for introductory 'bonus' rates. These are temporary interest boosts to attract new customers. They're actually a good thing for many, as they effectively act as a minimum rate guarantee during the introductory period, promising you at least some interest. But it is vital to remember the end date for the bonus and switch as soon as it ends, so you don't languish on a rubbish rate.

Fixed-rate accounts

These often give a better return than their easy access counterparts and you get certainty about the interest you'll receive. A fixed-rate account is just a savings account where the amount you earn is set in stone over a fixed time period, usually anything from 1 to 5 years.

Usually fixed rates are a little higher than rates on easy access accounts – although sometimes they can be lower. If current savings rates were to increase during that time, you would not benefit from rate rises. On the flip side, they provide protection in case rates drop in that time given their fixed nature.

You can't usually access the cash during the term (unless it's held within a cash ISA, though there are penalties to withdraw early from those).

The phrase 'usually' is important as there are some exceptions, even outside a cash ISA. A few banks occasionally allow early withdrawals for an additional fee but this is very rare. Plus, immediately after the Covid-19 pandemic hit the UK, many banks relaxed withdrawal rules for people in financial difficulty. Yet if you get a fixed-rate account, unless the terms clearly allow for early withdrawals, do not count on it.

Notice accounts

There is another, less common type of account called a notice account that is a hybrid of the two. Here, you have to give notice when you want to take money out, of say, 60 or 90 days. Rates tend to be variable and you tend to get better rates than on easy access, but they do not tend to be as high as fixed-rate accounts.

Limited access accounts

These are accounts where you can withdraw money but only on specific terms – for example one withdrawal per year or, say, up to two or three withdrawals. More withdrawals will result in a charge being incurred by the saver, usually by a deduction in the interest paid to them.

Regular savings accounts

Most regular savings accounts require you to put money away each month with interest paid yearly. They offer higher interest rates than traditional fixed or easy access savings accounts, but tend to impose rigid terms and conditions, such as limiting the withdrawals you can make, or forcing you to make a deposit every month. After a year, your cash usually sweeps into a bog-standard account – so be prepared to 'ditch 'n' switch' to a better deal.

Activity 3 Accounts with restrictions on withdrawals

Allow approximately 5 minutes for this activity

Why would you want to save in an account that restricts withdrawals?

Provide your answer...

Answer

The simple answer is that accounts with controlled access usually offer (slightly) higher interest rates than instant or easy access accounts. That's the incentive for you.

For the bank or building society, there is more certainty that you will leave your savings untouched if you place your money into accounts with controls on access, which gives them greater predictability about their cash flows. Remember the money you save is used by the bank to help finance its lending activities – such as loans and mortgages.

3.1 What about Premium Bonds?

The nation's most popular way of saving is through buying **Premium Bonds**, operated by **National Savings and Investments (NS&I)** – which is backed by the government. Because of this, your money is protected in full.

Figure 4 The then-Chancellor, Harold Macmillan, introduced Premium Bonds in 1956 – then with a top prize of £1000

Despite the term 'bond', they are a form of savings. But instead of earning interest, your bonds are entered into a prize draw each month where you can win up to £1 million. Each bond costs £1 and the minimum you can put in is £25, while the maximum is £50,000.

The prize money paid each year equated on average (in May 2020) to 1.3% of the total amount held by all savers in premium bonds. Whilst you may win £1 million (hardly anyone will, of course) or nothing, this average is useful to compare with the interest rates paid on savings accounts. However, most people earn even less than that average as the million pound prizes are built into it which takes up huge chunks of the overall pay-outs. It means that for most people, you are more likely to get a higher return in a normal savings account than in Premium Bonds, based on average luck, given you can normally earn more than 1.3% elsewhere.

If you win anything, Premium Bond prizes are tax-free. That may appear a big boon but 95% of people don't pay tax on their savings anyway.

4 The savings supermarket: Should you get an ISA?

When putting money into standard savings you have a number of choices to make, many of which were detailed in the previous section. One further choice is whether to save in a normal savings account or use a cash **Individual Savings Account (ISA)**, available to anyone who is 16 or older.

Figure 5 ISAs arrived on the UK savings scheme in 1999

Cash ISAs are like standard savings accounts but there is no tax to pay on the interest. Cash ISAs are distinct from Stocks & Shares ISAs which are a way of investing in **company shares** and other **securities**. We'll look at Stocks & Shares ISAs later in this session.

Each tax year, the government sets an annual limit on the amount of new savings that can be placed into ISA products. In 2020/21 this was £20,000.

Note that the choice between standard savings and a cash ISA is not the no-brainer it once was. Until 2016 the cash ISA was the clear winner due to its tax-free status.

But since then, the **personal savings allowance** has come in (explained later in this session) which means the vast majority of people do not pay tax on their normal savings anyway, so in many cases the choice comes down to getting the best rate when looking at both normal savings and cash ISAs. Do note that ISAs will hold their tax-free status indefinitely (unless the rules change) so may still win in the long run, as you may pay tax if your normal savings build up.

Special ISAs for the under 18s

A Junior ISA can be opened by a child or their parent or guardian specifically for their child's future. Only the child can access the money saved and only from the age of 18.

Like normal ISAs, they can be opened as either cash or stocks and shares ISAs, with an annual limit of £9,000 in new money a year during the 2020/21 tax year.

Yet as a Junior ISA, the money is locked away until the child's 18th birthday. It's then theirs to do *whatever* they want with.

4.1 ISAs for your first home or your retirement

Figure 6 LISAs can help you build your pension

There are two other types of ISAs which are important to mention, one of which you can still open, the other which is still running but is shut to new applicants.

Lifetime ISAs

LISAs can be opened by anyone aged between 18 and 39, as a means to save for a first home or your retirement, and you can save up to £4,000 per tax year. In addition to tax-free interest, the state will provide a bonus of 25% of the amount you save each year until the age of 50. So it is possible to accumulate bonuses of up to £33,000 by saving the maximum of £4,000 per year and getting a £1,000 (25%) bonus for 33 years.

However, LISAs have strict rules about what you can do with these savings. These can only be used to:

- Help with a first-time property purchase in the UK. The property must be used as a primary residence – and only cost up to £450,000.
- Help build up a fund to provide pension income from the age of 60.

If you withdraw money from your LISA before you're 60 for anything other than a first-time property purchase, you will incur a 25% penalty on what you withdraw. The only exemption from this charge is if you are terminally ill. So, if you open a LISA, be completely sure that you won't need the money for any purposes other than to buy your first home or to provide retirement income. But even if you use it for an income in later life, there are risks and you may be better off saving via other means (e.g. maxing employer contributions via a workplace pension), so do some more homework first.

Help-to-buy ISAs

These are no longer available for new applicants, but if you have one already, they can be used towards a first property purchase. The state tops up these cash ISA accounts by 25%, up to a maximum of £3,000.

There are no penalties if you withdraw the money and don't use it to buy a property, but you will not get the bonus from the state.

Activity 4 Tax breaks for savers

Allow approximately 5 minutes for this activity

Why is the government incentivising savings via tax breaks and bonuses (on LISAs)?

Provide your answer...

Answer

You saw earlier in this session that the UK has a poor record when it comes to saving.

Households with access to savings can manage mini-crises – for example the need to pay for household repairs or replacement appliances – without resorting to borrowing money, perhaps via expensive methods such as using a credit card.

Additionally, the difficulties that young people have in getting on to the housing ladder is arguably the catalyst for the support now provided by LISAs and, until recently, by the availability of Help-to-buy ISAs.

LISAs can also help those who need to build up their pension funds to sustain them in retirement. Given the shortfall in the funds many people need for their retirement, this support from the government – although not substantial – is helpful. Though as mentioned above, there may be better ways to save for retirement.

5 The savings supermarket: Understanding interest and tax

Figure 7 Interest rates have been at historic lows in recent years

A short, but important, interlude now that explains how interest earnings are taxed. This will help you when deciding whether or not you need to opt for a cash ISA when looking for a home for your savings.

The financial services industry is required to show interest rates on all savings products in a way that enables them to be easily compared. As you know from earlier in this course, interest rates on debt products are expressed as the Annual Percentage Rate (APR). For savings products the comparable rate is called the **Annual Equivalent Rate (AER)**. The AER is the annual interest rate that savers receive, taking into account when and how often interest is actually paid (for instance, annually or monthly).

A few things to note about the accounts mentioned:

- The interest on both variable and fixed-rate accounts is normally paid to you either annually or monthly – sometimes you get a choice, sometimes you don't.
- Products can offer varying arrangements for where the interest is paid. Commonly interest earned is simply added to the balance of your account, but you may be able to request that it is paid instead into your bank account so that you can spend it.

The Personal Savings Allowance – and why it's important

Another brief interlude here, which will help explain how much of the interest you'd get in the accounts mentioned is taxed, which will help you make a decision about whether to plump for a cash ISA or not (explained in a minute).

Under the Personal Savings Allowance, basic-rate (20%) income taxpayers can, in 2020/21, earn £1,000 in interest tax-free in a standard savings account. For higher-rate taxpayers (40%) the allowance is £500, while top-rate payers (45%) don't get a tax-free allowance.

With interest rates on savings accounts around 1%-1.5% in recent years, a substantial volume of savings can be held outside ISA accounts without any income tax becoming due. By 2019 the Government estimated it meant 95% of savers did not pay any tax on their savings. This helps to explain why cash ISAs have lost much of their shine, as the gain compared to a normal savings account has been greatly diminished.

Activity 5 Monthly or annual interest?

Allow approximately 5 minutes for this activity

On many savings products you are given the choice about when you receive interest. This is most commonly a choice between receiving interest annually or monthly.

But if you opt for monthly, the stated interest rate paid (called the gross rate) is always slightly less than the annual equivalent rate (AER) – for example, a 1.29% rate if paid monthly or 1.3% annually. Why is this?

Provide your answer...

Answer

If interest is paid annually then the gross rate and AER should be the same, as there's no interest compounding.

Yet when interest is paid monthly, then the gross rate given is usually a bit less than the AER rate. This is because if the monthly interest was left in the account, then there would be interest on the interest too. The AER makes sure this is included.

For an identical account, if interest is paid monthly it would be a 1.29% gross rate, but if interest was paid annually it would be 1.3% gross. Leave the money there over a year, though, and both would receive the same amount, as the AER for both is 1.3%.

6 The savings supermarket: some final points

Figure 8 Window shopping for savings products

Current accounts can earn you interest too

Some of the most attractive interest rates on paper are via specialist current accounts where the interest paid can be much higher than on standard savings accounts. There are, though, some important caveats.

- To get these attractive interest rates you normally have to commit to a minimum deposit (say, £1,000) into the current account each month. In effect this is a ploy to get you to pay in your monthly salary or pension. This helps to ensure a regular, reliable and perhaps fair-sized cash inflow into the account - so it's a neat way for the bank to get in funds and get you to use it as your main current account.
- There are limits on the maximum balance on which the high interest rate is paid – say £2,500. This prevents people from placing huge balances into these current accounts – something which would be very costly to the banks. Therefore, for many people they are simply a way to earn interest on your monthly incomings (which may later go out as bills).
- You may need to pay out a certain number of direct debits per month. Again, this is a ploy to make you use this as your main current account and not a savings account.

You may want to use your current account as a way to save some of your money. However, the interest you could earn should be used as one of the factors to help you select a current account, rather than determine your savings strategy.

How do I want to operate my accounts?

Finally, you need to check out the way you can operate your savings account. Check if it's an online only account (increasingly savings accounts are online only) or can you also use the account in a branch (good if you like transacting face-to-face) or perhaps you can operate the account by post (although this has become very outdated). Do check these features when opening a new account. Online only accounts may offer a marginally higher rate than those which can be operated in additional ways, as these are cheaper for banks and building societies to run.

7 Money in a savings account is almost always safe

Putting money into savings accounts is about as low risk as you can get. The value of the capital (money) you place in savings accounts does not go up and down like share prices, and interest earned will add to the balance.

Figure 9 Keeping your money safe

The only minor risk would come if the financial institution goes into liquidation. The good news for virtually all savers is that you are protected up to £85,000 per person, per financial institution for savings in a UK-regulated **Authorised deposit taker** by the official **Financial Services Compensation Scheme (FSCS)**. Beyond that you are not covered, which is where the risk comes for people with lots of cash.

If you're lucky enough to have lots of money then it is prudent to spread your eggs amongst many baskets, as the old saying goes.

If you're close to the limit then check the rules. The limit varies periodically as it is currently based on the UK sterling equivalent of €100,000 – and so it does change as the exchange rate between the Pound and the Euro alters. The way the limit is set could change when the UK leaves the European Union after the end of the 'transition' period. So keep an eye on the FSCS website.

Extra protection if you suddenly run into lots of money

Sometimes you may have substantial amounts of money in a banking or savings account for a brief period due to a 'life event'. Such 'temporary high balances' may be substantially in excess of the £85,000 FSCS limit. To cover this particular risk the FSCS provides protection for up to £1 million for a maximum of 6 months. If you seek protection under this rule you will need to provide proof of the source of the 'high balance' to the FSCS. Eligible events include:

- selling a property
- payout under an insurance policy
- personal injury compensation
- pay-off after redundancy
- benefits payable on retirement
- inheritance.

Other savings risks

While not a risk to your actual capital, also be aware of the following:

Inflation risk applies to savings accounts. There is a difference between the cash or '**nominal**' amount held in an account and the value of the savings in '**real**' terms after price inflation is considered. So if your savings earn 1% AER and price inflation is 2% **per annum (p.a.)** then the real value of your savings will be falling.

If this persists for several years you may find that, despite the interest earnings, what you can eventually buy with your savings will be quite a bit less than you could have bought before you started saving!

While saving accounts are very low risk the 'real' returns they offer once price inflation is taken into account are usually low and, at times, negative. So keep an eye on this!

Savings accounts can also expose you to interest-rate risk.

If you put money into a variable rate account, your interest earnings will fall if interest rates go down. As explained earlier, if you save money in a fixed-rate account you will not benefit if the level of interest rate rises during the term of your investments.

The reverse applies too, of course. You benefit from rates rising if you have a variable rate account, and you avoid the downside if you have savings in a fixed-rate account when interest rates fall. So there are swings and roundabouts – but you do need to be alive to this risk.

Finally, there is 'access risk' – the risk that you cannot withdraw your savings without incurring a charge on a fixed-rate account. The simple way to deal with this risk is to manage your finances to ensure you never need to access your fixed-rate accounts before the end of their term (of, say, 1 year). This way you always avoid such charges.

8 Drawing up your savings strategy

With all this knowledge to hand let's consider how you can devise your strategy for your savings.

Figure 10 Comparing savings strategies

The key is to match the savings accounts you choose to your reasons for saving and, of course, to pick the highest rate possible. We will try to help you do that below, but it must be said there is no one answer to the question 'Which savings account should I choose?' as there is so much complexity in drawing up the many pieces in the jigsaw of what is available and what your circumstances are.

Instead, it is best to work on more general principles rather than fixed rules on what you should or shouldn't do. Here goes…

- Firstly, you don't need to have just one savings account. You can mix and match as you may, for example, want to keep some for the long term in a fixed-rate account and some in an easy access account for drawing on whenever needed. Or another combination altogether.

  Plus, if you have more than £85,000 in savings, then you definitely want to spread it between different financial institutions so your money is safe.
- Carefully consider your tax situation to help you decide between standard savings accounts, cash ISAs and Premium Bonds. Remember, 95% of people do not pay tax on their savings so for most people, the right approach is simply to go for the best rate, regardless of whether it is a standard account or an ISA – that can be the literal interest rate or the Premium Bond 'rate'.

However, even if you don't pay tax now, consider that if you may soon do (if you've lots of savings and/or are close to going up a tax band) that by saving in an ISA, your money is tax-free forever (unless the rules change).

- Access to your money and choosing between fixed vs variable rates are also important, though these decisions go hand-in-hand given the way accounts are structured.

  The first key point to consider is whether you may need access soon. If that's the case then easy access is naturally best, but keep an eye out in case the rate drops given it's variable.

  If you don't need easy access then the best rates are normally in regular savers, but you're limited in how much you can put in.

  If you want rate security for the long run and don't need to touch your money for a while, then a fixed rate gives you that certainty, plus it normally offers higher rates to start with than an easy access account, but you won't benefit if rates rise.
- Another consideration is whether you want to open a current account to get a better rate. Do note that as we were writing this course, the availability of really good current account savings rates was dwindling, but they're worth checking out in case the market had improved by the time you read this.

  If the rates do beat normal savings accounts when you read this, then great. But note that you may well need to effectively operate them as your main current account to get the rate, which means paying a certain amount in each month and having direct debits going out.
- If you are saving for a first home and you are aged 18-39 then LISAs are a no-brainer for most people, though only open one if you are sure you will use it for that purpose and your home will cost less than £450,000, otherwise you won't reap the rewards.

It's now time for a quick quiz and then you'll start to learn about investment products. You may never invest in these directly but almost certainly you are an indirect investor – particularly through pension schemes. So, it makes sense to learn about the investments being made on your behalf by those that manage these funds.

9 Half-time quiz

Now it's time for a short quiz to see how much you've learned this session.

Half-time quiz

Open the quiz in a new tab or window then come back here when you've finished.

10 Investments – the riskier (but possibly rewarding) side of saving up

Up until now we have focused on savings accounts where the money deposited is not at risk unless the institution defaults, and even then there is decent protection, as detailed earlier.

Figure 11 The FTSE-100 share index 1984-2020

With investments (which can include shares, bonds or investment funds that can hold these types of assets), the investment itself can fall or rise in value which adds a significant risk, but can also lead to much bigger rewards. Do also note that while we don't go into too much detail on the fees for investing, there is normally something to pay – whether to a broker to buy shares, a fund manager to manage your funds or the government in tax. So check before you invest.

Later we'll explore investment funds, which represent the usual way that personal investors invest in shares and other assets such as commodities and property. This is done by pooling lots of investors' money into a giant fund where a manager may invest that cash in all manner of different investment types – so you don't need to be too active and can let someone else do the hard work for you (for a fee, of course).

You may think that investments like this are not for you, but if you have pension savings, then whether you know it or not, you are almost certainly an investor as your money will be in one or a number of funds. The next sections will help you learn more about how your money is invested.

To understand the nature of these funds, let's first look at how the chief types of investments work in case you want to invest directly in them, or if you simply want to know the information to understand more about the building blocks of funds.

11 Understanding shares

Figure 12 Company **dividends** have to be approved by the shareholders

Shares are also called 'equities'. They entitle the holder to a share or part ownership in a company. Depending on the type of share, this may entitle the shareholder to vote on how the company is run. Shares also usually entitle their owners to receive dividends that may be paid by the company out of the profit it makes. The receipt of these dividends is, for the shareholder, the income element of the return from their investment in the shares.

Table 3 Share prices of selected UK retailers 4 October 2019 (pence, p)

High (p)	Low (p)	Company	Price (p)	+/- (p)	Yield (%)	P/E
754	319	JD Sports	754	+19	0.2	28.4
299	172	Marks & Spencer	172	-7	10.3	86.2
255	177	Morrison (W)	195	+2	3.4	15.2
6320	3991	Next	6032	+4	2.7	13.4
253	190	Tesco	237	+1	2.4	17.7

(Source: *The Times*, 5 October 2019, p. 69 and *The Sunday Times*, 6 October 2019, p. 14)

Look at the table above showing some UK companies' share prices. Take time to familiarise yourself with the key terms that are used when analysing the performance of a company's shares.

Here's an explanation of the information presented in the columns of the table.

- High: the highest price of share in a certain time period, for example over the last year.
- Low: the lowest price of share in a certain time period, for example over the last year.
- Company: the name of the company whose shares are shown in the table.
- Price: the current price of share, shown in pence (this is usually the price at the end of the previous working day).
- +/-: the change in the quoted share price from the previous day.
- Yield: the dividend income per share after tax expressed as a percentage of the price of the share. High figures can suggest higher income from investments, but a high yield can also indicate that the company is not growing very fast or is quite risky.
- P/E: the 'price/earnings ratio' is the share price divided by the earnings per share. So, if the share price is 200 pence and the earnings per share are 5 pence the P/E ratio would be 40 (note that earnings are the company's profits after tax, i.e. net profits). Investors are prepared to pay more for shares whose earnings they think are

> going to rise strongly, so demand pushes up the share price, which in turn increases the P/E ratio. The P/E ratio is often seen as a barometer of confidence in a company's prospects.

Share prices can be seen in most newspapers which may include some of the additional details set out above.

The price at which a particular share can be bought or sold will vary from minute to minute depending on the balance of investors who want to buy them and existing holders who want to sell. If investors are able to sell shares at a higher price than they originally paid, they make a capital gain. If they sell for less, they make a capital loss.

Shares are bought through a stockbroker. A stockbroker can be a specialist company or an arm of a high street bank. You can find one via a number of methods, be that word-of-mouth, through the internet, or through the
Personal Investment Management and Financial Advice Association (PIMFA).

Activity 6 Understanding information about shares

Allow approximately 5 minutes for this activity

Have a look at the data in the table above. Without researching further, what do you think the information is telling us about how the companies are performing?

Provide your answer...

Answer

The most telling information is where the current share price is in relation to the high and low points in the past year. Those with a share price close to the year's high can be viewed by investors as doing better than those whose share prices are close to the year's low. Note, though, that if all (or most) share prices are near their low for the year, then this almost certainly reflects that the equity market as a whole is experiencing a period of weakness. The information from the yield and P/E data is more complex to interpret – for example, a high yield may result from a company paying a high dividend to keep investors happy at a time of difficulties for the business.

12 Understanding bonds

The other main kind of financial investment product is a bond, which can be issued by companies or governments. Bonds are also referred to as ‘fixed interest’ investments.

Figure 13 Bonds make promises to investors

A bond is a loan made by an investor to a borrower (typically a company or government). You buy a bond with cash and the borrower promises to repay the money invested on a set date. The borrower also pays you interest on defined dates (usually annually) during the life of the bond. The interest rate is normally fixed, for instance, at 2% or 5% per annum.

Bonds have a ‘nominal value’ – this is the amount on which the interest is calculated and can be divided into small amounts for sale, usually £1000 or less. For example, an investor could buy £100 nominal of a ‘five-year 5% bond’. This will pay 5% a year for five years on £100 nominal – that is, £5 a year. The interest may be paid quarterly, semi-annually or annually, depending on the type of bond bought. At the end of the five-year period, an investor would receive £100 in repayment of nominal (or ‘face’) value.

Bonds tend to be less risky than shares because they have a promised interest rate, and because company bondholders rank in front of company shareholders in the event of a company being liquidated.

Although less risky than shares, bonds are riskier than savings accounts. This is because with savings products, typically the amount of capital you receive back is fixed – if you deposit £100, you get £100 back (plus interest).

With a bond, if it is sold before maturity, then more or less than the promised nominal amount may be paid. Whether it is more or less will depend on movements in the level of interest rates after the bond has been issued. If interest rates fall, the market value of an earlier issued fixed-rate bond will rise since it offers investors an interest rate higher than that currently being offered on newly issued bonds. The reverse applies if interest rates rise.

An additional risk of bonds is, if the issuer of a bond goes bust then you normally have no protection and may lose your investment. However, UK government bonds, known as gilts, are seen as safer than bank and building society accounts, as the government is even less likely than a bank or building society to default.

Bonds can be bought through stockbrokers or, in the case of gilts, through a special Purchase and Sale Service organised by the Debt Management Office (DMO), the government department responsible for issuing government debt.

One important note before we move on: some bonds that are advertised as being 'long-term savings products' may well involve shares or other forms of investment, and so their value can go down as well as up. These types of bonds are not like the savings products you looked at earlier. They can be very risky. So beware and read the details closely to avoid being misled!

13 Understanding commodities

A further category of investments is commodities. This is where the investment is made in assets such as oil, gold and other metals or even agricultural products.

Figure 14 Commodity prices can be volatile

Generally there are two major attractions to these investments:

- The prices of commodities tend to rise during periods of price inflation. They consequently offer a '**hedge**' against the risk that inflation erodes the real value of your investments.
- Commodity prices also often move in the opposite direction to other asset classes such as shares and property. Indeed, during periods of weakness in equity markets, investors are inclined to move to gold. As a consequence, investing in commodities can be an effective way to balance the risks on a portfolio also containing assets like shares and property.

The other side of the coin, though, is that commodity prices can be volatile and are certainly at risk of periodic sharp falls. You can see this in the chart above which depicts gold prices between 1989-2020. In some ways, such investments have the same risk as investing in an individual share as opposed to investing in a balanced portfolio of shares.

How can investments in commodities be made? Three options exist for the ordinary investor.

First, where practicable, the investments can be made in physical form with the commodity itself being purchased and stored. This is feasible when it comes to commodities such as gold – witness the trade in gold coins. There is, though, insurance to be considered given the risk of theft or damage. Additionally, for the ordinary investor, stockpiling holdings of commodities such as oil or corn will simply be impracticable.

A second option is simply to buy shares in companies whose financial performance is most related to the underlying commodity you want to invest in. So mining companies' shares are useful if you want to invest in defined metals; oil companies' shares if you want to invest in oil. While this presents a straightforward way to get exposure to commodities this method of investment has risks. In many cases, the financial performance of such companies and the movements in their share prices are only loosely correlated to the commodities associated with them. The performance of major oil companies, for example, is linked to an array of factors – such as the taxation of petrol – which are unrelated to the price of oil.

The third option is to invest in funds that track the price of a specific commodity or defined basket of commodities. This can be done by placing money into **exchange traded funds (ETFs)**. This way of investing in commodities allows you to customise and risk manage your exposure to commodities.

14 Understanding property investment

For many years property has become a serious alternative to other kinds of investments.

Figure 15 Buy-to-let is a popular way to invest in property

For most people the biggest investment they have – excluding that held in their pension fund – is in their own home. Check this yourself if you own your home – work out the difference between the market value of your home and the remaining mortgage you may have on it. This difference is called the ‘equity’ you hold in your property, and it could amount to a very large sum for those who have paid off their mortgage or are close to doing so.

You may see your primary home as an investment, as well as a place to live in, as you hope it will rise in value. Alternatively, you could invest in a second (or third, fourth, etc.) home, though note that if selling anything other than your primary home, you will have to pay **Capital Gains Tax (CGT)** on any profit made. And when buying anything other than your primary home then you pay additional stamp duty too.

There are a number of ways property investment can be profitable.

You may buy in an ‘up and coming’ area where property prices rise more than the average; you could buy at below the ‘true’ market value; or you could add value to a property by finding, for instance, a run-down home suitable for refurbishment and, when completed, sell at a profit over and above the total cost of the purchase, interest and refurbishment. Yet it is possible that your property could fall in value for many different reasons.

You may also make money simply from the rent generated from properties, though many landlords use that income to make mortgage payments, keep the property maintained to a high standard and for extra costs. So they rely on house price growth as the way to grow the value of their investment. The risk here, though, is that you can't find a tenant so you may struggle to pay any mortgage.

An alternative way to invest in property without directly owning specific properties is through investment funds – particularly **Real Estate Investment Companies (REICs)**.

15 Understanding investment funds

There are good reasons to invest in funds.

Interactive content is not available in this format.

Figure 16 With different compositions of investments the returns from different investment funds vary substantially

Buying shares in a single company or even holding shares in, say, three companies, can be seen as a risky form of investment. This is because the fortunes of a company, on which its dividends and share price depend, are subject to all sorts of risk. These risks can be broad economic risks, such as recession or an increase in the cost of oil, or risks specific to each company, such as the loss of a major contract or increased competition. The same applies to buying bonds issued by companies and other institutions, although the price of these is normally less volatile than shares.

To spread these risks, investors can invest in shares (and other assets, such as bonds) through investment funds. An investment fund pools the money of lots of investors and uses it to hold a wide range of shares, bonds and/or other assets. Even relatively small amounts of money placed into such funds can be spread across a wide variety of shares or other assets.

So the first things you need to be clear about when considering investing in a fund are the types of assets the fund holds and in what proportions. This is because your investment, however small, will hold these assets in equivalent proportions.

The proportions held will also determine the risk profile of the fund. Look at the three funds in the table below and the ways they are divided between different assets. Fund 1 would be usually classified as low-risk – where the risk means exposure to a fall in value. Fund 2 is medium-risk and Fund 3 is high-risk. The key determinant of the degree of risk is the proportion of the fund invested in the shares, since these are the riskiest of the three categories of assets.

Table 4 Funds and risk profiles

	Fund 1	Fund 2	Fund 3
Bonds	78%	53%	30%
Shares	12%	37%	60%
Property	10%	10%	10%
Typical Classification	Low-risk	Medium-risk	High-risk

The investments in funds may be selected by managers, based on research which aims to assess the prospects for shares and other bonds (called ‘actively managed’ funds). Investors pay fees for the services of the fund managers and are provided with periodic reports on their investments – usually quarterly.

Other funds (called ‘passively managed’ or ‘**tracker**’ funds) simply hold investments designed to move in-line with a specified share index, such as the FTSE-100 – the index for the shares of the 100 largest firms listed on the London Stock Exchange. Passive funds normally have lower charges as they involve less work for the fund managers.

Investment funds come in many forms, including:

- **Unit trusts**: this is an arrangement whereby trustees hold shares and/or other assets on behalf of investors and a management company makes decisions about what and when to buy and sell. Investors hold units in the unit trust and the value of the units directly reflects the value of the underlying assets in the fund.
- **Open-ended investment companies (OEICs)**: these are very similar to unit trusts but are structured as companies rather than trusts.
- **Investment trusts**: these are companies that are quoted and traded on the stock market. The purpose of an investment trust company is to run an investment fund. Investors buy shares in the company. The price of the shares reflects both the value of the assets in the underlying fund (called the 'net asset value' or NAV) and the balance between investors buying and selling the shares on the stock market.
- **Exchange-traded funds (ETFs)**: these are also companies traded on the stock market but, in this case, the share price is directly linked to the value of the underlying investments. Traditionally, ETFs are **tracker** funds. This could be, for example, a **FTSE-100 Index** tracker or a more unusual index tracking, say, the price of commodities or works of art.
- **Life insurance funds**: some types of life insurance can be used as investments. The investor pays in regular premiums or a single lump sum premium, and the policy builds up a cash value that may be drawn out either as a lump sum or as a stream of income payments.
- **Pension funds**: Contributions may be invested in one or more underlying funds. The value of the pension scheme depends on the performance of those funds. We'll spend more time in the next session looking at pension funds.

Investment funds can be bought directly from fund managers, through stockbrokers or through specialist websites (often called 'platforms').

One way that you can invest money in a fund is through **Stocks and Shares ISAs**. The investments you make each year must, along with any savings made into cash ISAs, not exceed the annual limit set by the government – which was £20,000 in 2020/21.

A Stocks & Shares ISA is an investment product which means that the capital you invest can rise and fall in value. When buying these ISAs, look closely at the asset combination of the fund you are buying into, to ensure that you are comfortable with the risks you are taking.

Activity 7 Being a socially responsible investor

Allow approximately 5 minutes for this activity

An additional consideration for many people is a desire to invest their money in a socially responsible way.

There are different aspects to what constitutes socially responsible investment. Can you think of some positive and some negative criteria people use to identify when an investment is socially responsible?

Provide your answer...

Answer

Positive criteria can include investing in companies that treat workers fairly or are engaged in environmental protection. Examples of negative criteria include avoiding funds that invest in companies involved with fossil fuels, animal experiments, arms, violating human rights or pornography.

One difficulty for an investor is that ethical or social responsibility is a relatively subjective term. One way of checking whether a fund that claims to be ethical or socially responsible shares your own views is to check the main companies the fund invests in.

16 Investment strategies: how to manage your risk

Figure 17 Attention to detail is required when monitoring your investment risks

We have to be careful here as we are not giving investment advice, which is a regulated activity. So we won't be telling you where to put your money. And as we have said before, remember that the value of your investments can go up and down, while past performance is not always an indicator of future returns.

But there are some key principles to help you make those decisions:

- Investing is for the long term, as you may well need the time to ride out any periods where your investment falls in value. Don't expect to make short-term gains or you could well be disappointed.
- Don't lose too much sleep if the value of your investments fall early on. The only prices that matter are the one you buy at and the one you sell at, and there may be time for markets or your investment to recover. There is a danger in selling at the bottom of the market which only serves to crystallise any losses.
- Be careful about putting all your eggs in one basket, as the old saying goes. That is one of the reasons why investment funds are popular, as you are not limited to one company's shares. It's perfectly fine to have a mix of investments.
- Consider the tax benefits of investing via a stocks and shares ISA – though remember the limit on new money placed into all types of ISAs is £20,000 per tax year (as of 2020/21). With a stocks and shares ISA you don't pay tax on your returns,

but you don’t necessarily pay tax anyway if your returns are below the dividend or capital gains allowances, so for smaller investors they aren’t as beneficial. There’s lots more help on this in MSE’s stocks and shares ISAs guide.

Activity 8 Age-adjusting your fund choice

Allow approximately 5 minutes for this activity

One common recommendation is to select funds with low risk and price volatility as you get older! What is the reason for this?

Provide your answer...

Answer

If you are young and can invest for the long term, there is scope to invest in funds with greater risk and, as a result greater potential price volatility than ‘safer’ funds, because if the fund loses value there is more time to make it back. But as you get older – and particularly as you approach the need to draw on your investments in retirement – then you may need greater certainty about the value of, and returns from your investments. So investing in shares (equities) when young and in bonds (‘fixed-interest’) when approaching retirement is viewed by some as good sense (though we are not making that recommendation ourselves). Yet as is mentioned throughout, there is no such thing as a sure thing when it comes to investing, so whatever you do you will be taking some risk.

17 Understanding peer-to-peer products

To complete the review of investment products, let’s look at one that has only been around for a few years – but which has rapidly become popular – peer-to-peer lending. But it is also an area yet to be tested by a severe economic recession, and as we were putting this course together, the financial effects of the Covid-19 pandemic were only just starting to hit. So before investing in peer-to-peer, be very careful.

Interactive content is not available in this format.

Figure 18 Peer-to-peer lending and crowd lending have emerged in recent years

This market has grown because beleaguered savers who have seen returns on their accounts fall to miserly levels in recent years, and to levels below the rate of price inflation, are being increasingly tempted by peer-to-peer (P2P) lending. However, it must be stressed that these are investments that come with risks and are not savings products – in fact, some firms have been reprimanded by the FCA for making them look like savings products.

This growing market involves investors pooling their funds with other investors to lend to individuals and businesses. The P2P providers undertake the credit checks on those borrowing from the schemes, and they take a cut as their profit. There are no banks or other financial intermediaries. The returns offered by investing in a P2P pool are attractive relative to those on ordinary savings accounts – assuming borrowers pay the money back.

The attractions of this alternative investment have seen this form of lending growing, with £3 billion being lent in the UK in 2018, according to the Peer2Peer Finance Association. The Peer2Peer Finance Association was absorbed by Innovate Finance in 2020.

Note that peer-to-peer lending is different from another product you might hear about – ‘crowdfunding’. Peer-to-peer lending provides loans, whereas crowdfunding provides equity finance to companies. In effect, crowdfunders are buying shares in the companies they are lending to.

Beware the significant risks of P2P lending

Although P2P is regulated by the **Financial Conduct Authority (FCA)**, it does have risks that investors need to be aware of. Risks certainly exist – why else would the returns markedly exceed those on no-risk investments such as National Savings & Investments (NS&I) products? The key risk is of defaults by those who have borrowed from P2P funds – although those managing the funds mitigate this by spreading the funds invested across a number of borrowers. Even if the money lent is fully recovered from a defaulting borrower, there is likely to be a long wait to receive back the funds you invested.

Another key factor to bear in mind is that P2P investments are not currently covered by the Financial Services Compensation Scheme (FSCS), meaning investors could lose all their money if a P2P provider went bust.

One final tip before investing in P2P: check the FCA website to make sure the company is registered with the regulator.

Activity 9 Testing the robustness of the P2P market

Allow approximately 5 minutes for this activity

Some analysts claim that the attractiveness of the P2P market can only be tested if the economy experiences a sharp economic slowdown. What is the reason for this opinion?

Provide your answer...

Answer

The key risk to investors in P2P products is borrowers defaulting on repayments. In benign economic conditions with the economy growing and interest rates low, the rate of defaults may be very low, perhaps giving a false impression of the riskiness of this way of investing. The acid test would be to see how the default rate changes if the economy is in difficulties – e.g. a major recession. Only then will investors have a fuller picture of the risks they are taking for receiving interest earnings well above the prevailing level on conventional savings products. At time of writing, we don't yet know the full economic effect of the Covid-19 pandemic – this will be the acid test about whether P2P investments are robust, and we await the results with some trepidation.

18 Do I need financial advice when choosing an investment or should I go it alone?

We've just taken you through a session that includes lots of complicated and risky products. That risk does not make them bad products, but it is key to get good advice before making any investment decision if you're not 100% sure you know what you are doing.

Figure 19 Getting a steer from your adviser

Before we go further, we should add that when talking about advice we are talking about investment advice and not savings advice, as the risks of getting it wrong with investments can be huge. With savings, your capital is safe if within the FSCS limits, so the only risk is not getting the best possible interest rate.

For cash savings products, it's easy for most people to make decisions using sites such as MSE or comparison sites. Ensure you do this research, as simply going to your bank could mean you get a poor rate.

Now onto investment advice. Should I get it?

The benefit of getting advice is that you should get the products that meet your needs and your risk appetite, but it is not a sure-fire way to make money. Advisers are only human beings and do not have access to a crystal ball to determine if your investment will be successful or not.

To make a recommendation, advisers should carry out a fact find, where they ask details about your circumstances, goals, time horizons for these goals and your capacity to absorb losses on investments.

Note that some advisers are independent, in that they are not tied to a specific set of investment products. Independent advisers can provide guidance on the full range of products you are interested in investing in. By contrast some advisers just offer a 'restricted' service, linked to a defined range of products and not the full market. Advisers do have to disclose whether they're 'restricted' or not in the guidance they provide.

There is a clear difference between advised and non-advised product sales. Non-advised sales involve being talked through options with the decision about which product to invest in being left with you.

Advised sales point you to particular products. If you end up with an unsuitable product after being recommended it by an adviser, then you may have a case for claiming that it has been 'mis-sold' to you. 'Unsuitable' is not the same as 'loss-making': as investments are risky some people do lose money even after making what sounded like a good investment at the outset.

If your answer is no to at least one of the following questions then seeking financial advice is worth considering. If the answer is no to all three questions, advice is arguably essential.

If your answer is yes to all three questions, you may consider yourself able to make your own decisions and to transact without advice using a low-cost provider (e.g. an internet platform) of the products you want.

The key questions to ask yourself are:

1. Am I an experienced investor?
2. Can I afford to lose at least part of the capital sum invested?
3. Have I the time to both put in the research ahead of investing and then monitor the investment after I have acquired it?

For pension products, advice should arguably be sought. For workplace pensions your employer should either provide advice or access to advice about the scheme(s) on offer and their costs to you. For a private pension it is sensible to seek advice even if you consider yourself to be knowledgeable about investments. The consequences of investing in an inappropriate pension product can be financially devastating. The new rules on access to pension funds, that came into effect in 2015 and which we look at in Session 6, really make it important to know what you are doing, not only when entering into a pension product but also in accessing the funds it generates as you move towards and into retirement.

What do I get charged for advice?

Sadly, there is no menu of fees we can show you, as this can be as complex an area as investments themselves. For some, the cost can be minimal, for others it can cost £100s or even £1,000s over many years.

Advisers must set out explicitly the fees charged for the advice provided. These fees vary from adviser to adviser so don’t just glance at them, look at the fees carefully and check how they compare with those of other advisers.

If you are seeking general financial advice or advice in respect of specific products, advisers will normally charge a fee and be required to advise you of the fees they charge up front. Some advisers may be prepared to provide an initial consultation free of charge – so why not ask if they do this when arranging an appointment.

Before 2013, advisers often earned their income by receiving commission from the product providers which was then deducted from customers’ initial or ongoing investment. This practice has now been stopped on pensions and investments to ensure that there is complete transparency about fees charged.

Do note the difference between the fees charged by advisers and the ongoing management charges applied by product providers, particularly when the investments are ‘managed’ (looked after actively by fund managers) as opposed to being placed passively (and left unmanaged) throughout the life of the investment.

Where do I go to find an adviser if I need one?

You may find a good adviser through word-of-mouth or online. But always be careful that the adviser is not just steering you solely towards the products offered by an institution they are associated with or work for.

Two sources are particularly useful when it comes to locating advisers and obtaining financial advice.

The **Money and Pensions Service** provides guidance on the use of financial advisers: Explore their guidance.

Additionally, unbiased.co.uk provides a list of authorised financial advisers. You can also check that the adviser is regulated by looking them up on the FCA register.

You're nearly at the end of the session now. Next it's time for the end-of-session quiz before the session is rounded up.

19 End-of-session quiz

Now it's time to complete the end-of-session quiz.

End-of-session quiz

Open the quiz in a new tab or window then come back here when you've finished.

20 Summary of Session 5

You've covered plenty of ground in this session, examining the array of savings accounts available, and assets you can invest in, including shares, bonds and commodities. You have looked at the risks and returns associated with these different products and at how investing in funds can be an effective way of spreading (or 'diversifying') your investment risks.

You've also looked at the costs of investing and at whether you should seek guidance from a financial adviser.

You have also learned about how to select those investments that are consistent with your risk appetite and the time period you plan to invest for.

So best wishes for your future savings and investment activities. Hopefully this session has given you the knowledge and skills to undertake these activities with confidence.

If you want to learn more about savings and investments follow these links for guidance from MoneySavingExpert.com, covering:

- how savings work
- how cash ISAs work
- how Premium Bonds work
- how Lifetime ISAs work
- Annual Equivalent Rate (AER)
- financial advisers
- basics of investments
- stocks and shares ISAs
- peer-to-peer (p2p) investments

Get started with Session 6: Planning for retirement.

Session 6: Planning for retirement

Introduction

Pension planning is arguably the most important aspect of personal financial management.

Video content is not available in this format.
Video 1 Introduction to Session 6

Ensuring enough income for a comfortable and hopefully enjoyable retirement has always been important, and with growing **longevity**, the average time people have in retirement has risen in recent decades. Those aged 65 in the UK currently have an average expected life span of a further 19 years for men and 21 years for women (ONS, 2019a). That is just the average expectation: many people are living into their tenth decade and beyond.

It has always been important to plan for income in later life but growing longevity makes it essential. Other factors have reinforced this need to prepare early for life in retirement:

- The age at which people can start to draw their state pension has been rising – particularly for women – and will rise further in future years. With growing longevity, the cost to the government of the state pension is pushed upwards. So, increasing the age at which people can claim it is one way to contain this cost.

- Low investment returns over the past decade, with interest rates at record low levels, have made it more difficult to amass savings to augment pension income.

This session looks at how to plan for a sufficient income in later life.

You will study state pensions, occupational and personal pension schemes, as well as other means of obtaining cash for use in retirement.

You will also look at the pension reforms introduced in 2015. These have provided more options for people to use their pension funds.

There are complex tax issues surrounding pensions too and you will learn about these.

It's never too early to think about pension planning, so let's get going by looking first at how your spending changes when you retire. Before knowing how much income you need in retirement, you require a good estimate of how much you expect to spend.

At the end of this session you should understand:

- how the UK state pension works
- occupational and personal pension schemes
- the differences between defined benefit ('salary-linked') and defined contribution ('money purchase') pension schemes
- the flexibility now available to use the money held in your pension fund (and the risks this may expose you to)
- the key tax issues that apply to pension planning
- your options if your pension income is insufficient to meet your spending in retirement.

This Session is one of a suite comprising the course *MSE's Academy of Money* and has been made possible by financial and content contributions by MoneySavingExpert.com.

1 How does spending change in later life?

Understanding how much income you will need when you retire requires a good estimate of how much you will be spending. This may seem to be an impractical exercise as your planned retirement date may be many years or even decades away. During these intervening years prices of goods and services will change. However, it is possible to do this forward planning exercise using current prices of goods and services, if it is assumed that the pension income you will receive in the future roughly rises in line with price inflation.

Figure 1 What are your plans for when you retire?

When forecasting spending you need to decide whether to look at the individual or the household. The danger of basing your retirement planning on the household is that many households change over time as, for example, children grow up, couples split up, family members and friends decide to share a home or leave, or people die.

Traditionally, partners have adopted the household approach. However, the resulting financial plans for retirement have often proved inadequate in the face of death, divorce or separation. This is a key reason why women account for such a high proportion of the poorest pensioners today.

The advantage of a retirement plan based on the individual is that each member of the household has their own pension arrangements, which they retain even if the make-up of their household changes.

Spending in retirement can be estimated from the individual's or household's current level and pattern of spending. Yet, as you can see from the list below, there are some good reasons to think that spending in retirement may be different from spending while working, and that spending needs in early retirement may differ from those later on.

- By retirement, most – but not all – homeowners will have finished paying off any mortgage, so the amount that these pensioners spend on housing may fall.
- Pensioners often spend more time at home, so bills for gas and electricity could rise.
- There will be savings on work-related costs such as pension contributions and commuting.
- There may be an increase in travel to see friends and relatives, but pensioners often qualify for reduced-rate or free travel, especially on public transport.
- Pensioners may spend more on holidays, especially in early retirement, but may save money by going away at off-peak times.

In later retirement particularly, pensioners may have to spend significantly more on health-related items such as help with personal care.

Activity 1 Spending in retirement

Allow approximately 5 minutes.

Think about your own current spending. How might your own spending change when you reach retirement (or, if you are already retired, over the next ten years)?

Provide your answer...

Discussion

Your spending could change for reasons of both necessity and choice, as you saw in the list. One thing to remember is that these are only estimates – no one can be sure of the spending they will need to undertake in retirement, because personal circumstances at the time may differ from those anticipated beforehand.

You can also use the downloadable budget grid to start building your forecast expenditure and income in retirement. Work out your current spending first and then adjust it for life in retirement using the list above to guide you.

With your forecast of spending prepared, the next stage is to check what pension arrangements you already have in place, how much income these are expected to produce by the chosen retirement age, and whether this forecast income covers your forecast spending.

In the next section you'll start your forecast of pension income by looking at how much state pension you expect to receive.

2 State pensions

Limited state retirement pensions were first paid in the UK in 1908. These were improved in the 1946 National Insurance Act which brought in flat-rate universal state pensions (with effect from 1948).

Figure 2 How much state pension will you get... and when will you get it?

While various developments in state pensions have taken place since then, one aspect of policy has been to limit public expenditure on state pensions, given that they constitute the largest single item of government expenditure.

The UK government plans staged rises in the age at which people can receive their state pension, to reach 67 years in 2028 and 68 years in the mid-2030s, with further increases likely. One aim of these moves is that, on average, no more than a third of adult life should be spent in retirement. So, the longer the population lives on average, the higher will be the state pension age.

There are two state pension schemes in place in the UK. The 'old' scheme for those who reached state pension age before April 2016 and the new, so-called 'flat-rate', pension scheme for those reaching state pension age from April 2016 onwards.

The old scheme (pre-April 2016)

The 'old' scheme has two parts:

- The basic state pension which is paid at a flat rate (in 2020/21, £134.25 per week for a single person). Those not entitled to the old ('basic') state pension, or who are entitled to less than the full amount, may get a top-up of up to £80.45 per week subject to their spouse's or civil partner's National Insurance Contributions record.
- The additional state pension (or second state pension). This is restricted mainly to employees. It was first introduced in 1978, when it was called the **State Earnings Related Pension Scheme (SERPS)**.

The new scheme (from April 2016)

From April 2016, for those reaching the state pension age (SPA) the state basic and additional pensions have both been replaced by a single flat-rate pension (in 2020/21, £175.20 per week for a single person). As explained below, the new state pension is not really 'flat-rate' since not everone will receive the full amount.

This is because entitlement to the state pension depends on paying, or being credited with, **National Insurance Contributions (NICs)** paid by employees and the self-employed during working life. Credits are given for certain periods out of work, such as being ill, unemployed or caring for children.

Many people have been 'contracted out' of the state additional pension, which means that this part of their state pension has been replaced by a workplace or personal pension scheme in return for reduced or refunded National Insurance Contributions. This reduces the amount of state pension they are entitled to.

People who reached state pension age before 6 April 2010 needed to have National Insurance Contributions (NICs) covering roughly nine-tenths of their working life to get the full ‘old’ basic state pension. This was subsequently changed to a 30-year contribution record.

For the ‘new’ state pension the required contribution record for the full amount is 35 years. You get a reduced pension if you have a shorter record of paying NICs. You also need a minimum of 10 years of contributions to get any state pension.

From 2011, the state basic pension has increased each year with the higher of either earnings inflation, price inflation or 2.5%. Provided this policy, known as the ‘triple-lock’, is retained – and there is some doubt about this – the basic pension should retain its value relative to earnings or even rise a little faster.

One choice those approaching state pension age have is to defer the date at which they start to receive the pension. For every nine weeks of deferral the amount of state pension paid rises by 1%. This may be an attractive option for those planning to carry on working beyond their state pension age.

2.1 How far does the state pension go?

Figure 3 As a pensioner you could be entitled to a lower price on many services

In 2020/21, the UK government's assessment of the minimum weekly income required by pensioners is £173.75 for a single person and £265.20 for a couple (whether married or not) (Age UK, 2020). Consequently, for a single pensioner, the 'old' state pension in 2019/20 is, at the most, only three-quarters of the minimum income deemed to be necessary for a pensioner. Therefore, anyone relying solely on the 'old' state pension will need to claim a **means-tested** top up. Means-tested retirement benefits can discourage saving for retirement because building up a small private pension simply reduces the amount of benefits that can be claimed.

The change to a flat-rate pension from April 2016, which is higher than the state basic pension under the 'old' scheme, is intended to ensure that fewer state pensioners fall short of the minimum income they need. As a result, fewer pensioners need to claim means-tested benefits and there will be less of a disincentive to saving for retirement.

If those on a state pension do find that their income is less than the minimum standards set out above, then the recourse is to claim pension credit. Unfortunately, large numbers of people entitled to pension credit do not claim it, with the result that they lose out on the additional income it provides, as well as access to other state benefits that come with it. A link is provided at the end of this session to further information about pension credit.

Activity 2 What is your expected state pension?

Allow approximately 10 minutes

Check your record of National Insurance Contributions. How many years of contributions do you expect to accumulate by the time you are entitled to receive the state pension? The government website YouGov can help you check your years of contributions, as can this calculator provided by the Money Advice and Pensions Service.

Provide your answer...

Discussion

Entitlement to the state pension is linked to your record of National Insurance Contributions (NICs). Currently 35 years of contributions are needed under the 'new' scheme that started in 2016 to get the full state pension. Note that credits are given for certain periods out of work, such as being ill, unemployed or caring for children.

Remember to take into account the years you may have been 'contracted out' of contributions towards a state pension. This commonly applies to those in occupational pension schemes provided by employers.

Even if you get the full 'flat-rate' state pension this currently (2020/21) amounts to an annual income of only £9,110. This is clearly not enough for a comfortable retirement.

Hopefully you will have an occupational or personal pension plan to add to what the state will provide. You will start to look at these next, starting with occupational schemes.

3 Occupational pension schemes

As the term suggests, occupational pension schemes are offered by employers to their staff.

There are two types of occupational schemes:

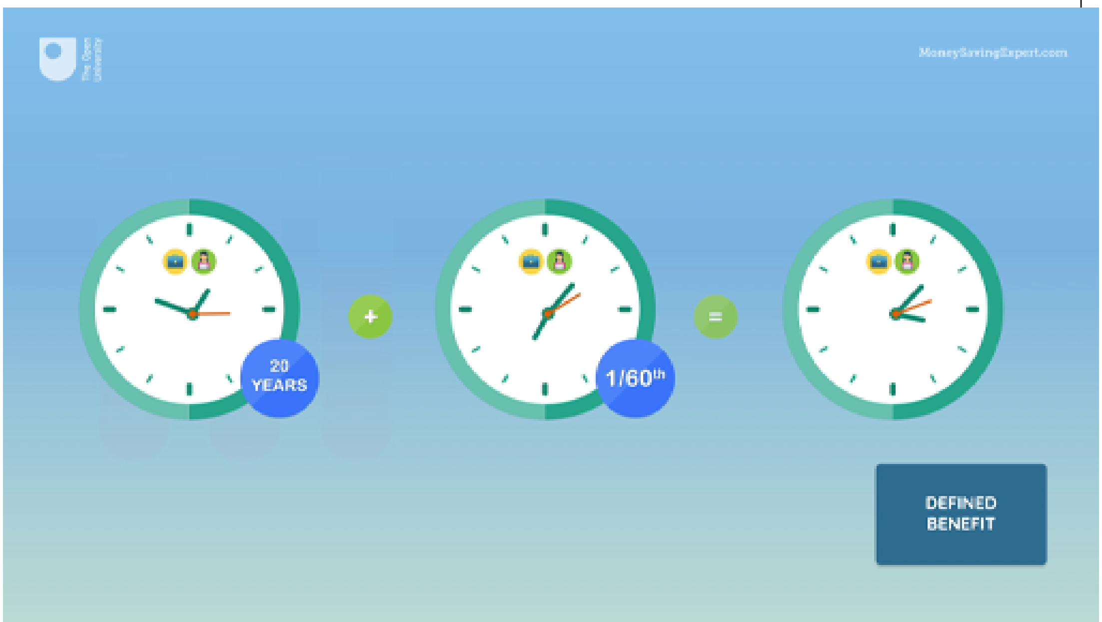
1. Defined contribution schemes (also called money purchase schemes). These schemes are the most common type these days. Here, what you get from your pension scheme will depend on the size of the pension fund (or 'pot') you accumulate.
2. Defined benefit schemes. Few of these are now open to new joiners as they are expensive for firms to run. With defined benefit schemes the size of your annual pension is usually linked to your salary – for example, the salary in your last year prior to retiring, or your average salary during your time as a member of the scheme. Those lucky enough to already have one should recognise that these are the gold-plated pensions as they tend to pay out the most.

If you are starting a pension now it is highly likely that defined contribution scheme will be the one you'll have to go for. In fact, membership of such schemes has increased significantly in recent years, as a result of the closure to new membership of many defined benefit schemes and the policy of 'automatic enrolment' onto pension schemes (you will look at automatic enrolment later in this session). In 2018 there were nine times as many employees who were **active members** of **private sector** defined contribution schemes as there were in defined benefit schemes (ONS, 2019b).

Watch Video 2 and learn about the differences between the two schemes, then try the activity below.

Video content is not available in this format.

Video 2 Understanding pension schemes



Activity 3 Who bears the pension risk?

Allow approximately 5 minutes

Having watched Video 2, who do you think bears the risk when it comes to the pension provided under:

- a defined benefit scheme?
- a defined contribution scheme?

Provide your answer...

Discussion

With a defined benefit scheme the employer is making a promise about the amount of the pension an employee will receive. This is set out through an equation linked to the employee's earnings and the number of years of membership of the scheme. So, the employer bears the risk.

With defined contribution schemes the risk is shifted to the employee. The employer makes no defined pension promise. The pension obtainable will be linked to the size of the employee's pension fund on retirement – something that cannot be forecast with certainty.

Defined contribution schemes are also less costly for employers as most pay far less into this type of scheme than they would into a defined benefit scheme. This means a reduction in the money going into an individual's pension pot, which reduces the eventual pension.

3.1 Occupational schemes: moving to average salary pensions

Increasingly, and where they still open, defined benefit schemes are shifting from 'final salary' schemes to those linked in a different way to a scheme member's earning. One common example is pensions based on a 'career average revalued earnings' (CARE) basis. This has particularly applied to **public sector** workers. This means the pension is based on average pay over all the years in the scheme, after adjusting each year's pay for inflation between the time it was earned and the person retiring or leaving the scheme. This measure replaces the final salary in the computation of the pension payable.

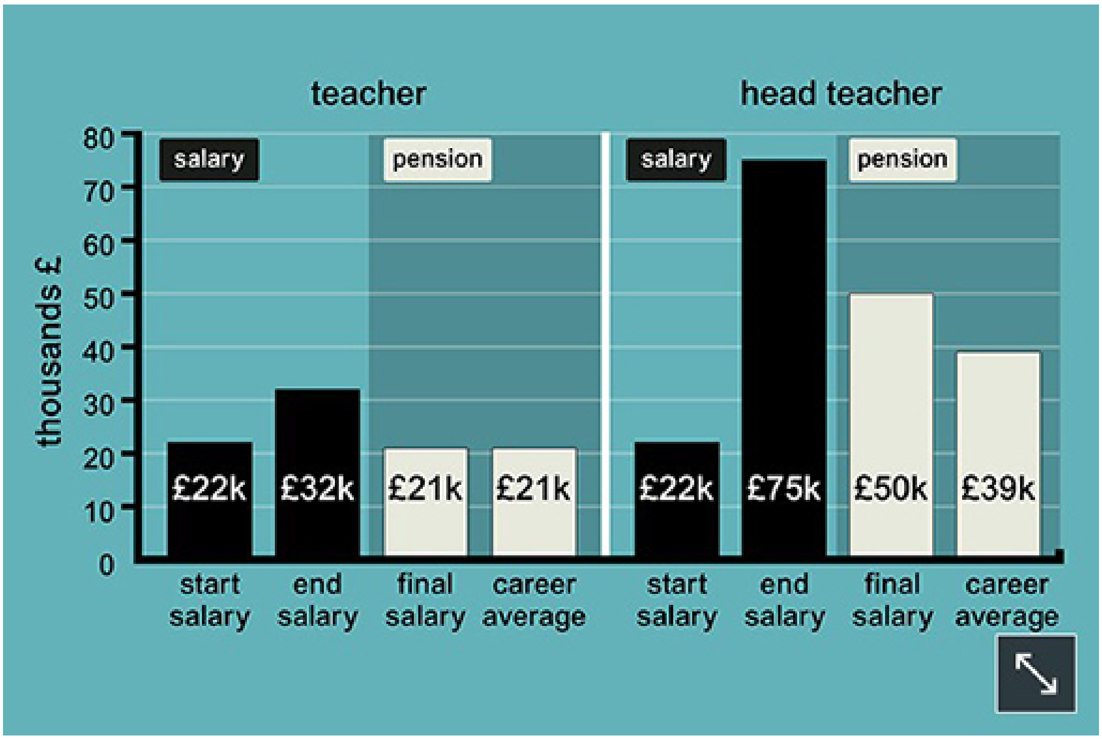


Figure 4 Salaries and pensions, based on a 40-year career (Click to expand)

Activity 4 CARE schemes and the cost to the government

Allow approximately 5 minutes

How do you think a switch from final salary to CARE schemes for public sector workers could help to reduce the cost to the government of providing pensions?

Which employees might gain, and which might lose from such a switch? To help you identify winners and losers, take as an example a profession such as teaching.

Provide your answer...

Discussion

Using career salary averages to determine the annual pension payable will reduce the cost to the government as, even with inflation adjustments, a career average salary is normally less than the salary in the final year of employment.

Workers whose pay tends to peak in mid-career might gain from a switch, whereas workers whose pay tends to peak towards the end of their career would lose. So, in the example of teachers, a person who reached the position of head teacher would lose out in relative terms from this change.

Most employees are likely to lose out by the move to career average schemes – but, in relative terms, those who will lose out most will be those who see their salary rise the most during their career as a result of promotions and the climbing of the career ladder.

3.2 Occupational schemes: they work like a pay rise

All employers now must automatically enrol their eligible employees – currently those aged 22 years or older and who earn at least £10,000 per annum – onto a workplace pension scheme. This may be the employer's occupational scheme or an alternative (particularly in the case of smaller businesses).

Figure 5 Life after work

If employees do not want to be enrolled onto a **workplace pension scheme** offered by their employers they have to take action to opt out. As a result of this arrangement, inertia results in employees becoming (and remaining) enrolled onto a pension scheme. Automatic enrolment has resulted in a huge increase in participation in pension schemes – this rose from 47% of employees in 2012 when automatic enrolment started to 73% in 2017 (ONS, 2018).

Automatic enrolment is an important initiative to get people to contribute to a pension plan, although some criticisms have been voiced about the scale of the fees levied on those enrolled onto schemes.

A big benefit of a workplace pension is that the employer has to contribute to the pension. Under auto enrolment, the employer must contribute at least 3% of your salary (within certain limits), which is a bit like a pay rise – though you will only see the money when you come to draw on your pension in later life.

Additionally, as you saw in the earlier video, you get income tax relief on your contributions to your pension. This applies to defined benefit as well as defined contribution (or money purchase) schemes. Later in the session you'll learn more about the tax rules that apply to pensions.

4 Half-time quiz

A lot of ground has been covered and it's now time for a short quiz to see how much you've learned.

Have a go at these three questions.

Half-time quiz

Open the quiz in a new tab or window then come back here when you've finished.

5 Personal pensions: money purchase schemes

Personal pension schemes, as the name suggests, are those set up by people on their own. Those who are self-employed, for example, have to set up their own pension plan as they do not have an employer's occupational scheme to join.

Personal (or private) pension schemes are almost invariably defined contribution (or money purchase schemes) like those explained in the earlier video. As they are the most common form of private pension, this section provides more details about money purchase schemes.

Figure 6 Are you saving enough for your pension nest egg?

A money purchase scheme is fairly simple in one sense. It's just a pot of cash you build up over the years, made up of contributions into the pension and hopefully some investment growth on top. However, any charges levied by the pension provider will be taken out of your pot.

You will need to arrange a personal pension yourself. As there are no contributions or help setting one up from an employer, the onus is fully on the individual to set up a pension and build up the funds. The tricky bit is where to find a suitable pension with low charges that gives you the flexibility and features you desire.

Unless you are particularly savvy it may be worth getting financial advice. You may find an adviser through word of mouth or online, but beware only taking guidance from a bank as staff might simply try to sell you that bank's products.

Two sources are particularly useful when it comes to locating advisers and obtaining financial advice.

The Money and Pensions Service provides guidance on the use of financial advisers.

Additionally, unbiased.co.uk provides a list of authorised financial advisers.

5.1 Planning your pension: the costs and risks

With a personal pension you will need to decide how much you pay into your fund. It's important to get this decision right because if you pay in too little, your pension will be too small. Pay in too much, and you could limit your current spending and standard of living, but you can't be certain of the correct amount. But a basic principle is to put in as much as you can afford and start as early as possible.

Also remember that saving into a pension is just one form of retirement savings, and other methods may yield big gains.

Figure 7 Enjoy the freedom that can come from a well-planned retirement

How much to pay in?

There is a rule of thumb, used by many in the industry to state how much it is worth investing to help achieve a comfortable retirement, but like anything, when investing money for the long term there are no guarantees it will prove correct in the long run.

It is to take the age you start your pension and halve it. Then put this percentage of your pre-tax salary into your pension each year until you retire.

So, someone starting aged 32 should contribute 16% of their salary for the rest of their working life under this 'rule'. While 16% of your pay may seem a huge commitment, this figure includes your employer's contribution.

The aim is that the pension, when it starts, will provide a regular income, usually paid monthly, until death. The longer you live, the more months of pension that have to be paid out. So, pension planning does require an estimate of life expectancy too.

The costs …

When investing for the long term, what also counts is the investment return after all the charges have been deducted. An investment fund that offers the chance of higher returns but has high charges might be a poor choice compared with a less ambitious investment fund with modest charges.

Also consider inflation as rising prices reduce the buying power of money. To protect against this, you would need to invest extra money to compensate for the effect of inflation, both over the years when the savings are building up and once the pension starts.

Where is the money invested?

You can choose to actively manage how your money is invested in some types of pension, such as a SIPP (self-invested personal pension) or allow the pension provider to choose where to invest it, based on your attitude to risk. Some workplace pensions go a step further and simply have a default fund that tends to be medium risk, so you don't have to make any choices.

… and the risks

Defined contribution (or money purchase) schemes lead to individuals shouldering the risks up to the time when the pension starts. This means that different people saving the same amount can receive very different pensions, and a person's pension can be markedly different depending on when they retire.

Figure 8 Transparent pension planning!

Activity 5 Are you paying in enough?

Allow approximately 5 minutes

The 'rule of thumb' set out above provides a good guide to how much you should be contributing to your pension scheme. Try the rule for yourself and then check how much you are currently contributing – your salary slip will help if you are in an occupational scheme. Are you under, over or on the recommended contribution level?

Provide your answer...

Discussion

If you are contributing enough (or more) then that is good news. If you are short of the 'rule of thumb' level – and particularly if you are well short – you really need to review your pension plan and aim to contribute more.

6 Understanding pension tax allowances

The tax limits for pensions have been changing in recent years. What are the key details you need to know?

Figure 9 Pension income is taxable

You get tax relief on your contributions: a key benefit of saving in a pension

You get income tax relief on the contributions, up to an annual limit set by the government (these apply to those in defined benefit schemes too). In plain English, it means the government tops up your pension, which is great. Say you are a basic rate taxpayer and you put £80 into your pension of your own cash – what actually happens is £100 goes in. That's because if you earn £100 you'll only see £80 of it after tax, so the government puts the £20 difference in your pot.

For most people, all tax relief will likely be at the 20% level, but if you are a higher or top rate taxpayer, you are entitled to additional tax relief up to the level of the tax rate you pay, be that 40% or 45%. However, you may need to claim that additional money back from HMRC if your occupational scheme is not already set up to automatically take the full relief.

Some occupational schemes also let you claim National Insurance relief via what is called 'salary sacrifice', and these are automatically set up to give employees their full tax relief entitlement whatever tax band they are in. Here, your employer will put aside the portion of your salary you want to put in a pension, and deposit it for you from your pre-tax earnings so it never gets taxed nor does any National Insurance get taken off.

The annual tax relief allowance

You can currently get income tax relief on all contributions you make as long as you do not pay in more than £40,000 per year or the value of your annual salary, whichever is lower. If you exceed either of those totals you still get tax relief up to that amount but not on anything above.

If you earn more than £150,000 a year your annual limit will fall. Unused relief may be rolled forward for use in the following three years.

You do not get relief on the contributions your employer makes in an occupational scheme.

The lifetime tax allowance

There is a lifetime allowance (LTA) for the total of all your personal pension funds, currently of £1,055,000, whether as a result of contributions or investment growth. To work out your total in a pension for lifetime allowance purposes, for defined contribution schemes, it is as simple as adding the value of your pension pot(s) together.

For defined benefit schemes, you calculate the total value by multiplying your expected annual pension by 20 plus any tax-free cash lump sum if it is on top of the pension. In many schemes, you would only get a lump sum by giving up some pension, in which case the value of the full pension multiplied by 20 gives the implied value of your pension pot for the purposes of the lifetime allowance.

If the amount you take out of a pension exceeds this total, the excess is subject to extra tax. Lump sum withdrawals are taxed at 55%. Income withdrawals – e.g. to buy an annuity – are taxed at 25%, on top of normal income tax.

Given the complexities and the frequent changes to the taxation of pensions – and particularly given the amount of money that may be involved – it is advisable to seek financial advice when making important decisions about your pension. Links to help you find an adviser were given in Section 5 and a further link is provided at the end of this session.

Activity 6 Is tax relief on pension contributions fair?

Allow approximately 5 minutes

Tax relief on pension contributions means that the income taken into account when calculating income tax is reduced. For example, someone earning £60,000 of gross income in a year and making £5,000 of pension contributions will have a taxable income of £55,000. This has been criticised as benefiting high income earners more than low income earners. Why?

Provide your answer...

Discussion

High income earners – like someone on an income of £60,000 – will have part of their income taxed at the higher rate of tax (40%). Reducing taxable income through pension contributions will save them 40% of the total contributions via reduced income tax. Basic rate taxpayers, by contrast, will save 20%.

On the face of it, this seems unfair to those not on the higher rate of income tax. The counter argument is that those paying the higher rate will be paying more income tax in total than those only paying the basic rate. So, if tax relief is provided, it is only fair that their higher tax burden is reduced by providing relief at the higher rate (of 40%).

7 What can I do with my pension when I retire?

When you reach 55 you can withdraw (or 'drawdown') up to 25% of your pension pot tax-free. This has been the case for several years.

Figure 10 There are now more options when deciding how to use your pension pot

What has changed more recently is what you can do with the rest. People retiring with defined contribution scheme pensions before April 2015 had few options other than to convert their remaining pension funds into an **annuity**. This is where you give your pot to an insurance company and in return you get an income – in most cases for the rest of your life.

In effect, this is insurance against living for longer than your pension pot would otherwise last. However, the annuity provider will take a slice of the pension pot in charges before what remains is turned into income.

In April 2015, however, the options for using accumulated pension funds available to those on defined contribution schemes changed radically as a result of new government legislation, and you now have more freedom. These reforms and their impact are examined next.

8 The 2015 pensions revolution: freeing up access to pension pots

In his 2014 Budget Statement the then-Chancellor, George Osborne, unveiled proposals for pensions reform which have changed the financial options for those approaching retirement. These proposals took effect from April 2015 and have led to restrictions on access to pension pots being eased.

Figure 11 George Osborne – Chancellor of the Exchequer 2010-2016

These are the key features of the pensions revolution:

The 2014 Taxation of Pensions Act provides greater freedom for those in 'defined contribution' schemes aged 55 years or more to access their personal pension funds (or 'pots'). Basically, you now have many more options:

- Those retiring with defined contribution pensions now have alternatives to buying an annuity with their pension savings, though they can still do just that. On retirement, up to 25% of the fund can be taken as a tax-free lump sum (as previously applied prior to 2015) but you can still buy an annuity with the rest.
- What is new is that you can access the funds as cash to do what you want with, say, to invest in a range of assets (such as property) or to pay off a mortgage or other debts, or simply to finance current consumption. 25% of the funds accessed from the fund is tax-free. The rest is taxable as income and so could currently attract tax of up to 45% (for taxable income above £150,000).
- You can simply leave the money invested and draw down at a later date.
- There is also greater flexibility to pass on a pension to dependents after death. For those who die prior to the age of 75, income from pension assets can be passed on to beneficiaries tax-free provided this is done within two years of death. This tax treatment previously only applied to lump sums from a pension 'pot'. For those who die aged 75 or over, normal income tax rates apply. Arguably, this reform removes an unfair excess tax charge on pension pots for which the deceased have spent their lives contributing to. An alternative view is that it provides a way to avoid **inheritance tax**, with those in retirement drawing on savings and other investments while leaving their pension funds untouched.

One key thing to remember whatever option is chosen is that pension income – including state pension – is liable to income tax. The good news, though, is that National Insurance Contributions (NICs) are not payable.

While the greater flexibility that these reforms provide for pensioners should be welcomed, a few concerns cannot go unmentioned.

First, one motivation for these greater freedoms seems, in part, to be the belief that annuities are poor value and, by inference, that other ways of investing pension funds may be better for pensioners. Yet while there have clearly been issues about how some insurance companies have sold annuity products, it is unfair to say that they are all poor value. The low annuity rates prevailing today simply reflect growing longevity and the currently prevailing low interest rates. Currently (in 2020) – and depending on the features of the product – an annuity of between £4000 and £5000 per annum is paid at 65 years of age for each £100,000 in a defined contribution pension fund. These figures apply to a single person. For a dual-life annuity (i.e. for a couple) annuities are less than £4000 per £100,000 of a pension fund.

Second, there are concerns that many pensioners will spend large portions of their pension pot and not invest the funds to provide the income stream needed in retirement. The risk is that within a few years, some pensioners will find themselves short of the income needed for a comfortable retirement.

Finally, there is a concern that the pensions industry is not resourced to deal with the advice required as a result of these wider freedoms now available to pensioners and those moving towards retirement.

Activity 7 Pros and cons of the revolution

Allow approximately 5 minutes

What is your opinion of the new pension freedoms? Do you think the benefits outweigh the risks?

Provide your answer...

Discussion

Whilst it must be right to give people the right to use their pension funds as they see fit the risk is, for a small minority at least, these pension funds will be quickly exhausted, leaving pensioners with a poor quality of life in later retirement.

Financial services regulators are closely monitoring how the new freedoms are being used. There is certainly evidence of widespread access to pension ‘pots’ since 2015, but evidence too that the money withdrawn is being used rationally – like paying off any remaining mortgage, or buying further property to let out and generate rental income.

9 A shortfall in your pension plan – the options

It's time to confront the realities of your pension plan.

Figure 12 Confronting the reality of not having enough

Earlier you looked at how to forecast your spending in retirement. Now you need to aggregate the pension income you are expecting. This includes your state pension and the income from any occupational and private pension schemes. Remember to include the pension provided by the occupational schemes at previous workplaces unless you have transferred these funds into your current pension scheme. If you are in an occupational scheme your employer's **HR** department should be able to help here, if needed.

Reviewing your position is essential for anyone with a defined contribution pension scheme (which includes those with a personal pension plan) because stock market performance is unpredictable, and the pension pot may not build up at the rate that was originally assumed to be likely. Most pension schemes and plans issue statements yearly. This enables you to check regularly how your pension is building up.

Ideally the comparison of spending in retirement versus pension income should be done based on an annual budget. Using a monthly budget may not pick up all items of spending which do not occur each month (e.g. spending on holidays).

If you have a forecast where income exceeds spending, you are on course for a retirement you can fully enjoy. If the reverse is true you need to take action – and you should not wait to put in place a plan to resolve the financial issues facing you in later life.

What are your options?

If you are still some decades away from retirement, the first option you should look at is to increase your contributions to your pension scheme. Making additional voluntary contributions is normally available under occupational schemes. With personal schemes it is always your choice about how much you want to contribute. If you are an income tax payer, you will benefit from the tax relief on contributions up to the annual limit set by the government.

If you are close to retirement, it still makes sense to consider topping up your pension fund, provided you do not exceed the lifetime limit for pension funds set by the government (currently £1.055 million).

When you are close to retirement there may, though, be limited scope to build up your fund and with it the size of your eventual pension income. Other alternatives may have to considered.

- Cut spending. Have a look again at your forecast for spending. Are there some economies you could make? Can you cut your bills by switching to cheaper providers? Could you forego certain of the activities you were planning for retirement?
- Defer retirement and work on for a few more years. This may not be what you want to do, but working a few more years would help to accumulate your pension fund. More people in the UK now work beyond state pension age, and since 2011 for most occupations you have the right to do this. In 2017, 1.2 million people aged over 65 were working in the UK – up from 272,000 in 1997 (Smart Pension, 2017). One benefit of working beyond state retirement age is that National Insurance Contributions (NICs) are no longer payable regardless of your earnings.
- Draw on savings. If you have savings and investments outside those held in your pension scheme – for example in **ISA** products – you can draw on these to top up your pension income. This could just be the income from these – the interest and dividend earnings. However, you could also draw on the capital invested – in effect using the savings and investments as a fund to drawdown in stages during your retirement years. If you do this, though, the interest and other earnings you receive will be lower than if you leave the capital untouched.
- Draw on your pension lump sum. If you take part of your pension in the form of a tax-free lump sum, this provides another source of capital to invest or drawdown. Whilst many people use the lump sum for specific objectives – such as paying off any remaining mortgage – others use it as another source of money to draw on in stages over several years.
- Make use of other assets. This could include antiques, jewellery or your home. Increasingly people are turning to equity release products to use the home they own to generate cash to support them in retirement. It is, though, an expensive way to borrow money and is not without complications – for example, it will reduce the size of the inheritance your family or other beneficiaries may be anticipating. If you want to learn more about the equity release market, there is a link provided to more information at the end of the session.
- One final idea for making cash from your home is to rent out a room to a lodger, if you do not mind someone else in your home. Earnings from such rented accommodation are tax-free up to to £7500 a year for an individual or up to £3750 a year each for a couple, under the so-called ‘rent-a-room’ scheme.

Activity 8 Boosting your finances for retirement

Allow approximately 5 minutes

Looking at the options above, which would you consider as being:

- feasible?
- necessary?

Provide your answer...

Discussion

Clearly your answer will reflect your personal circumstances. Delaying retirement may seem like an unpleasant option – it really depends on whether you like your job. For many people the social environment – as well as the income, of course – provides good compensation for putting off retirement for a year or two. Cutting your spending plans might be feasible – although clearly this would detract from the type of retirement you envisaged.

10 End-of-course quiz

Now it's time to complete the end-of-course quiz. It is similar to the previous quiz but this time instead of answering three questions there will be fifteen. It will test your knowledge of the whole course, not just this session.

End-of-course compulsory badge quiz

Remember, this quiz counts towards your badge. If you're not successful the first time, you can attempt the quiz again in 24 hours.

Open the quiz in a new tab or window and come back here when you've finished.

11 Summary of Session 6

There has been a lot to digest in this session.

Figure 13 Enjoying a long retirement

Ensuring that you have a good plan for a pension or other sources of income is essential for an enjoyable retirement. Ideally you should start planning from early in your adult life, as leaving it to later in life risks failing to accumulate sufficient funds for an adequate pension.

While the state pension provides a start to your target income in retirement, you will need to make additional provisions yourself to provide you with the lifestyle you want when you finish working.

In this session you have examined the different types of pension schemes found in the UK, and looked at alternatives to providing cash in retirement, like equity release. You also have seen that pensions are subject to various tax rules – and this alone is good reason to consider using a financial adviser to guide you through the pension options available to you.

The great news is that recent decades have seen people in the UK living longer lives. Enjoying a longer life makes it essential that you are meticulous with your pension planning, and that you don't postpone taking action to implement your plan.

Video content is not available in this format.

Video 3 Summary of Session 6

MSE and other links

- If you want to assess your pension position, follow this link to the Money Advice Service (MAS) pension calculator.
- If you want to find out more about state pension credit, follow this link to key points for retirement saving on the MoneySaving Expert website.
- If you want to learn more about what to consider when choosing a financial adviser, check the MoneySavingExpert website.
- If you want to learn more about the equity release market, follow this link to the MoneySavingExpert website.

- To find out more about Pension Credit, follow this link: MoneySavingExpert and Pension Credit.

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This resource is part of the 'Wellbeing and Mental Health Collection' collated by The Open University in Wales. You can find out more and discover other courses, articles and interactives on the collection homepage.

Tell us what you think

Now you've come to the end of the course, we would appreciate a few minutes of your time to complete this short end-of-course survey (you may have already completed this survey at the end of Session 3). We'd like to find out a bit about your experience of studying the course and what you plan to do next. We will use this information to provide better online experiences for all our learners and to share our findings with others. Participation will be completely confidential and we will not pass on your details to others.

Glossary

Budget
: A financial plan for a forward period – typically a month or a year – that sets out expected income and expenditure.

Consumer Price Index (CPI)
: A measure of consumer prices in the UK and the main basis for measuring price inflation.

Council Tax
: A tax raised by local authorities in England, Scotland and Wales. The tax is based on the valuations of properties.

Gross income
: Income before any deductions, including income tax, National Insurance Contributions (NICs) and pension contributions.

HMRC
: (Full term: Her Majesty's Revenue and Customs.) The UK body responsible for collecting tax revenues.

Income tax
: A tax on earnings in the UK.

ISA
: An Individual Savings Account. A savings account where the interest or other earnings are tax free.

Marks and Spencer
: A UK-based department store chain.

National Insurance Contributions (NICs)
: Deductions from earnings in the UK, with the record of contributions helping to determine entitlement to certain state benefits like State Pension.

Net income
: Income after all deductions from gross income.

Premium Bond
: A lottery bond issued by the UK government through its agency National Savings and Investment (NS&I).

Progressive tax

A tax where the amount paid as a proportion of gross income increases as income rises (commonly by step ups in the marginal rate of taxation, e.g. from 20% of gross pay to 40% of gross pay).

Banks

Companies owned by shareholders, whose main business activities are borrowing money and lending it to individuals and business, and offering bank account services.

Broker

A financial intermediary who arranges financial products for customers.

Building societies

Mutual organisations – meaning that they are owned by their customers – whose main business is offering savings accounts and mortgages. Other financial products like current accounts are offered too by the larger societies.

Compounding (of interest)

The process of receiving interest on previous interest earned (on savings accounts) or paying interest on previous interest paid (on loans).

Council Tax

An annual tax levied by local authorities based on the value of the property they are living in.

County Court Judgment (CCJ)

A court order made in England, Wales and Northern Ireland against those who fail to repay money owed by them. See also Decree.

Debt

Borrowed money.

Decree

A court order made in Scotland against those who fail to repay money owed by them. See also County Court Judgment (CCJ).

Discounted rate

A reduction in the normal interest rate for a defined period at the start of a loan or mortgage. This is used to make the early repayments more affordable and hence make the product attractive to borrowers.

Early repayment charges

A charge that your lender will make if you leave your mortgage before the allotted term. This usually applies to fixed rate mortgages but can be a feature of tracker mortgages too.

Financial Conduct Authority (FCA)

The UK financial services regulatory body that has responsibility for consumer protection.

Fixed rate

Where the interest charged on a loan or mortgage is fixed for the entire life of the product or for a defined initial period.

Interest rate

The charge on the amount of money borrowed (or paid on the amount of money in savings). This is usually expressed as a percentage (%) amount for each year (or ‘per annum’ or ‘p.a.’) e.g. 3 % p.a.

Monetary policy

The use of interest rates and control of the money supply to assist in the management of the economy and, in particular, the rate of price inflation.

Mortgage

A loan to buy property or land.

Nominal

Not adjusted to take account of price inflation. See Real.

Overdraft

A negative balance on a bank account (or 'current account').

Personal debt

Borrowed money owed by individuals and households.

Price inflation

A rise in the general level of retail prices in the economy. Retail prices are those paid by households.

Profits

The surplus of earnings from sales over the costs associated with the goods or services sold.

Real

Adjusted to take account of price inflation. See Nominal.

Rent-to-own

A payment contract for buying household goods. This typically involves monthly payments over a year or few years. During this time the borrower retains the goods, but ownership is only secured when all the payments under the contract have been made.

Secured debt

Debt that is linked to a contractually specified asset (e.g. a property). If the borrower fails to repay the money lent, then the asset can be used by the lender to recover the outstanding debts.

Trillion

One thousand billion.

Unsecured debt

Debt that is not linked to a contractually specified asset (e.g. a property). If the borrower fails to repay the money lent, then the lender has no recourse to the assets that might have been purchased with the borrowed money.

Compounding (of interest)

The process of receiving interest on previous interest earned (on savings accounts) or paying interest on previous interest paid (on loans).

Early repayment charges

A charge that your lender will make if you leave your mortgage before the allotted term. This usually applies to fixed-rate mortgages but can be a feature of tracker mortgages too.

Financial Conduct Authority (FCA)

The UK financial services regulatory body that has responsibility for consumer protection. https://www.fca.org.uk

Freehold

Outright ownership of a property and the land it stands on.

Ground rent

A payment made by the leaseholder of a property to the freeholder of the land on which the property is built.

Help-to-Buy ISA

An Individual Savings Account that provides a bonus from the government when used by first-time buyers to help buy a property.

ISA

A savings account where the interest or other earnings are tax-free.

ISA Allowance

The maximum amount each UK adult can deposit into an ISA account in each tax year. This allowance is set by the government.

Leasehold

Ownership of property for a defined term (the term of the lease, e.g. 99 years) but not of the land it stands on.

Lifetime ISA (LISA)

An Individual Savings Account that provides an annual bonus from the government. LISAs must be used either to help buy a property (if you are a first-time buyer) or to help set up a pension plan.

Maturity (of a bond or savings account)

The point in time when an investment – like a fixed-rate bond – reaches the end of its life and at which the investor is returned the sum invested and any remaining earnings (e.g. interest) on that investment.

Nominal

Not adjusted to take account of price inflation. Often alternatively called ‘in cash terms’. See Real.

Notice Accounts

Savings accounts that require a period of notice – typically of between 1 and 6 months – in order to access the funds in the account without a charge. Such accounts offer slightly higher interest rates than those with no notice periods.

Real

Adjusted to take account of price inflation. See Nominal.

Reversion rate

The mortgage interest rate applied by the lender at the end of the term of a mortgage deal – e.g. when a fixed-rate term comes to an end. This will typically be the lender’s standard variable rate (SVR).

Stamp Duty Land Tax (SDLT)

A tax on the cost of property or land purchased in England and Northern Ireland. In Scotland the equivalent tax to SDLT is Land and Buildings Transactions Tax (LBTT) and in Wales it is Land Transaction Tax (LTT). The Scottish Parliament and Welsh Assembly have the power to apply their own rates for these equivalents of SDLT.

Unit trusts

Pooled investment schemes – typically in company shares – managed by fund managers.

Annual Equivalent Rate (AER)

The effective annual rate of interest on a savings product after taking into account how much and how often interest is paid in each year.

Authorised deposit taker

A financial institution that is permitted to accept deposits (savings) from the public in the UK.

Bid-to-ask spread

(Also called bid-to-offer spread.) The variance between the price that a market maker will pay for an asset (the 'bid') and the (higher) price at which they will sell the same asset (the 'ask' or 'offer').

Capital Gains Tax (CGT)

The lax levied on the profits made on the sale of assets (e.g. second homes) in the UK.

Company shares

Financial assets that provide part ownership of a company.

Compounding

The process of earning interest on past interest earnings as well as the original sums saved (or, for borrowers, of being charged interest on past interest as well as the original sum borrowed).

Credit ratings

Assessments of credit worthiness made by credit rating agencies.

Discount rates

The factors applied to forecast future cash flows to give them their present value – also expressed as the value in today's money.

Dividends

The payments typically made anually or semi-annually to a company's shareholders.

Equity release

The use of financial products to access the equity held in a property, and turn it into cash, without having to sell the property.

Exchange traded funds (ETFs)

Companies traded on the stock market where the share price is directly linked to the value of the underlying investments they hold.

Financial Conduct Authority (FCA)

The UK regulator of financial services companies and markets.

Financial Services Compensation Scheme (FSCS)

The scheme to protect savings and investments made by the public in the UK in the event of default by the entity with whom the investments have been made.

FTSE-100 Index

The index of the 100 largest companies listed on the London Stock Exchange.

Hedge

A means of counterbalancing the adverse price movement of an asset or group of assets.

Index

The statistical measure of a defined group of assets – for example the FTSE-100 index measures the movement in the aggregate share value of the top 100 companies listed on the London Stock Exchange.

Individual Savings Account (ISA)

A savings (Cash ISA) or investment (Stocks & Shares ISA) where the interest or other earnings are not subject to tax.

Inflation

A rise in price levels.

Interest

The percentage (%) rate of earnings on a savings account, usually paid anually.

Market maker

A person or financial institution that quotes prices for buying and selling defined financial assets (e.g. company shares).

Money and Pensions Service

The UK financial guidance body that has incorporated the Money Advice Service (MAS), the Pensions Advisory Service (TPAS) and Pension Wise.

National Savings and Investments (NS&I)

The UK state owned savings bank. The government uses this body to borrow money from the public.

Nominal

In the context of investments, the face value of an asset. More widely, the term means not adjusted to take account of price inflation. Often alternatively called 'in cash terms'. See Real.

Per annum (p.a.)

Per year.

Personal savings allowance

The maximum amount of interest that can be earned each tax year free of income tax. This does not apply to interest on ISAs which is always tax-free.

Premium Bond

A lottery bond issued by the UK government through its agency National Savings & Investments (NS&I).

Present value

The value in today's money of a future cash flow or a series of cash flows.

Real

Adjusted to take account of price inflation. See Nominal.

Real Estate Investment Companies (REICs)

Companies whose business can comprise buying, selling, renovating and letting properties and financing property developments.

Securities

Financial assets (like bonds) that can be invested in.

Tracker

A financial asset whose price is linked to a defined index (e.g. the FTSE-100) or interest rate (e.g. Bank Rate).

Active members

People who are currently contributing to a pension scheme – as opposed to pensioners who are drawing a pension from the scheme or non-pensioners who have stopped making contributions (for example, people who have stopped contributing to an occupational scheme on moving to a new job).

Annuity

A guaranteed income given by an insurance company in exchange for the value of your pension pot.

HR

Human Resources, abbreviated.

Inheritance Tax

A UK tax on inherited money, property and other assets.

ISA

Individual Savings Account. ISAs are tax-free accounts for savings and investments.

Longevity

Life expectancy (in demography) or just living to an old age.

Means-tested

Payments, such as state benefits, which are dependent on the assessment of an applicant's income or other resources.

National Insurance Contributions (NICs)

A form of taxation of incomes payable by those aged up to the state pension age.

Private sector

The part of the economy not under state control.

Public sector

The part of the economy under state control.

State Earnings Related Pension Scheme (SERPS)

A supplementary state pension to the 'old' basic state pension.

Workplace pension scheme

A pension scheme provided by an employer to eligible employees (who are automatically enrolled onto the scheme unless they opt out).

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Acknowledgements

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