THEME OF THE MONTH
NOVEMBER 2022

FINANCE BASICS:

INTEREST RATES AND RECESSION

PERSONAL FINANCE BASICS

Whilst everyone may not be required to be a financial expert, it is important that we all at least understand the basics of personal finance to ensure a healthy financial future.

The basics of finances include how you manage your money and how you use it. Finances include a collection of topics such as credit, investing, banking, assets and liabilities. Each is essential to your financial health.

A big contribution to most finance and money issues is lack of financial literacy. We have put together a basic checklist of topics to be aware of.

Interest rates

It is key to understand how to properly use credit cards and be aware how interest rates work. Make sure to have an understanding of this before getting a credit card to ensure you keep money in your pocket and remain debt free.

Take the time to read the fine print and understand what you are taking on with any credit card applications.

Establish and fix credit

Building good credit is essential as it can affect your ability to buy or rent a house or get a car etc. You can fix low credit scores by:

- Paying bills on time
- Pay down debt - experts recommend using no more than 30% of your credit limit at any point.
- Avoid Hard Inquiries - when a lender checks your credit.
- Boost your credit - using your existing financial history.
- Get help building credit - build credit with the help of others or a secured account.

Everyone should understand how credit works, how you can fix mistakes, how you can increase your score, how to maintain a good credit score, and how to monitor.

Budgeting basics

Budgeting is an essential skill to develop and can prevent future financial problems. You should spend time looking at your bills, living expenses, spendings and savings so you are aware of where your money is going.

At LSP we have teamed up with You Need A Budget (YNAB) to offer a practical solution to budgeting. YNAB is a popular budgeting app designed to help people take charge of their finances. YNAB not only allows individuals to create a budget, but also can help you save money.

As an LSP learner you are eligible to a **free 1-year YNAB subscription, valued at £86.99!** As part of the subscription, you will be able to utilise the app and access free video courses/guidance on how to keep track of your finances.

Request your free subscription link here.

Spend less than you earn

As simple as this tip is, it is essential to remember to ensure you do not fall into the trap of finances.

If you don't live within your means or pay attention to your spending habits, it is easy to run out of money or rack up debt. This is known as 'lifestyle creep' - a financial trap that can sneak up without you noticing.

Lifestyle creep examples include:

- Dining out often and at more expensive places
- Buying new clothes frequently, just because you can
- Spending more on groceries without a budget in mind
- Often upgrading your car to something more luxurious
- Buying or renting a more expensive home

Managing your debt

We are all likely to have debt at some point in our lives, this could be from student loans, credit cards, mortgages etc. So it is essential that you are aware of what debt is from the start.

The aim is to understand how debt works, how you can pay it off faster and be aware of the interest rates. Paying the minimum each month may be convenient but will cost you more money in the long run.

There are three main debt repayment strategies:

Snowball Method

Pay the smallest debt as fast as possible whilst paying minimums on all other debt. Then pay that extra toward the next largest debt.

Debt avalanche

Pay the largest or highest interest rate debt as fast as possible whilst paying minimums on all other debt. Then pay that extra towards the next smallest debt.

Debt consolidation

Combine debts into a single account and avoid any other debt until post-payoff.

Building an emergency fund

Saving money is one of the main finance tips everyone should already be aware of. However, many of us do not ensure to put some money aside for an emergency fund.

An emergency fund is a bank account with money set aside to pay for large, unexpected expenses, such as:

- Home-appliance repair or replacement
- Major car fixes
- Unemployment

Understanding the value of an emergency fund, why you need one, and the purpose it serves is the easiest of the personal finance basics.

INTEREST RATES EXPLAINED

The cost of borrowing money is known as interest, and it is typically expressed as an annual percentage of the loan (or credit card balance).

When you save money it is the rate your bank or building society will pay you to borrow your money. The money you earn on your savings is also called interest.

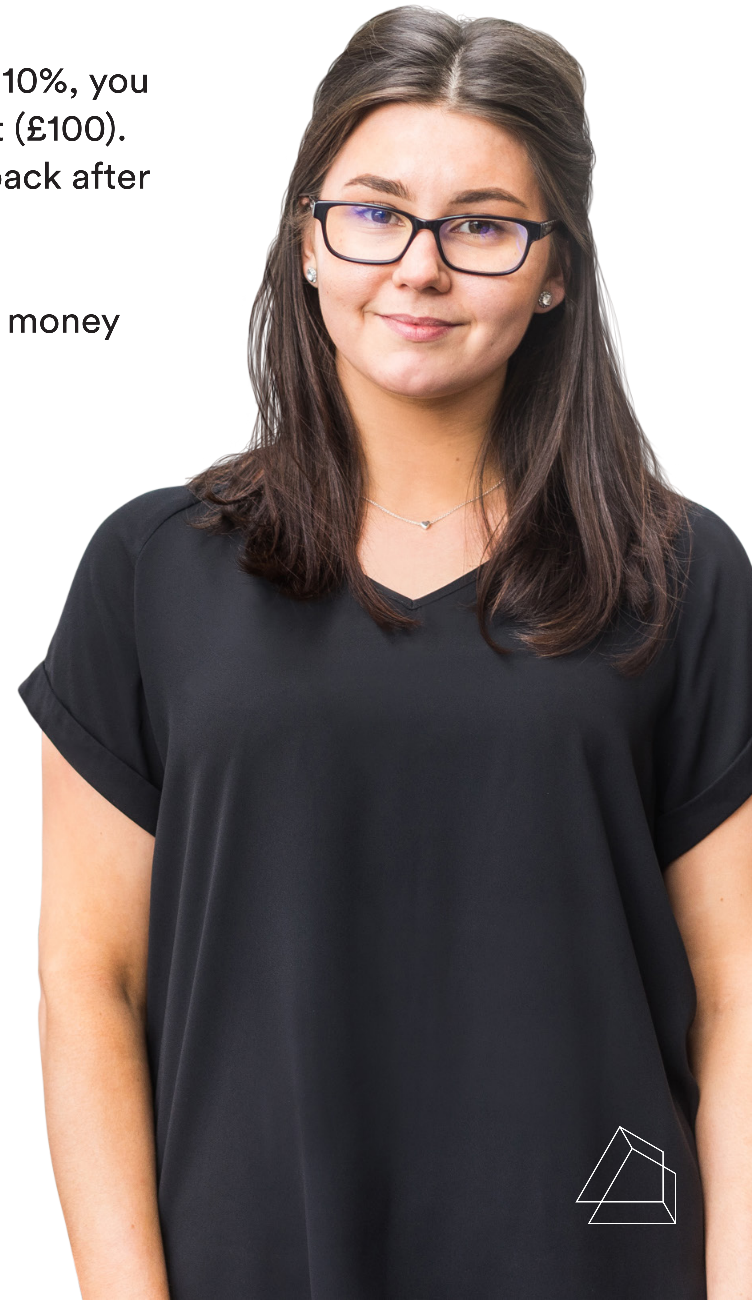
Interest charged on a loan (or other borrowing)

When you borrow money, you'll pay back the original amount loaned (called the 'capital') plus the interest.

Let's say you borrow £1,000 from a bank:

If your loan attracts an annual interest rate of 10%, you will have to pay back £1,000 plus 10% interest (£100). So £1,100 is the amount you will have to pay back after one year.

The total might be different if you borrow the money over a longer or shorter period.



Interest earned on savings

If you place £1,000 in a savings account earning 2% interest annually you will earn £20 in interest, giving you £1,020 after one year.

Again, the interest you earn could be different if the rate of interest changes or the balance within your savings account fluctuates during the period that the interest was calculated.

(MoneyHelper, n.d.)

HOW DO INTEREST RATES WORK?

The Bank of England (BoE) sets the bank rate (or 'base rate') for the UK.

This can influence the interest rates set by financial institutions such as banks. If the base rate goes up, it's likely lenders may want to charge more as the cost of borrowing increases.

This works in the same way for savers. If the BoE base rate rises you would expect to see the interest you earn from your savings to increase. This is because your savings provider has effectively borrowed your money from you.

WHAT IS APR?

When you borrow money, your lender will often advertise an 'APR' (Annual Percentage Rate). This is slightly different from the interest rate because it is made up of the interest rate plus any fees that are automatically included in your loan (for example, any arrangement fees).

The APR is particularly useful as it provides a benchmark when comparing similar financial products.

HOW DOES COMPOUND INTEREST WORK?

Compound interest is calculated by adding interest to your loan or savings where interest has already been charged or included. This means that the added interest charged or earned from previous periods will also have been applied.

For example, let's say you put £1,000 in a savings account earning 2% interest. After 12 months you'd have £1,020. Your savings would grow at different rates of interest, and the impact of compounding. The longer you save for, the greater the effect of compound interest.

(MoneyHelper, n.d.)

WHAT DOES AN INTEREST RATE RISE MEAN?

Interest rates in the UK are set by the Monetary Policy Committee (MPC) of the Bank of England (BoE). This is the interest rate at which banks borrow from the BoE.

When you hear on the news that interest rates have gone up, it means the MPC has decided to increase the base rate.

Banks are not obliged to follow Bank of England interest rate decisions, but they can influence the cost of borrowing, or how much interest you earn on savings.

IMPACT OF INTEREST RATES RISE ON MORTGAGES

When, and if, your mortgage repayments are affected by an interest rate change will depend on what type of mortgage you have and when your current deal ends.

If you have a variable rate tracker mortgage, linked to the BoE base rate you are likely to see an immediate impact on your mortgage repayments if there is an interest rate rise.

Those on a standard variable rate mortgage will probably see an increase in their rate in line with any interest rate rise. How much is decided by your lender, so this isn't guaranteed. If you are unsure, check your mortgage terms and conditions in your original mortgage offer document.

People with fixed rate mortgages are likely to be affected once they reach the end of their current deal. An interest rate rise could make re-mortgaging more expensive.

(MoneyHelper, n.d.)

WHAT IS A RECESSION?

A recession is defined as the economy shrinking over two consecutive quarters, or six months.

When the UK economy contracts, it's usually a sign that consumers are spending less. This has a knock-on effect on businesses, which produce less in the way of goods and services.

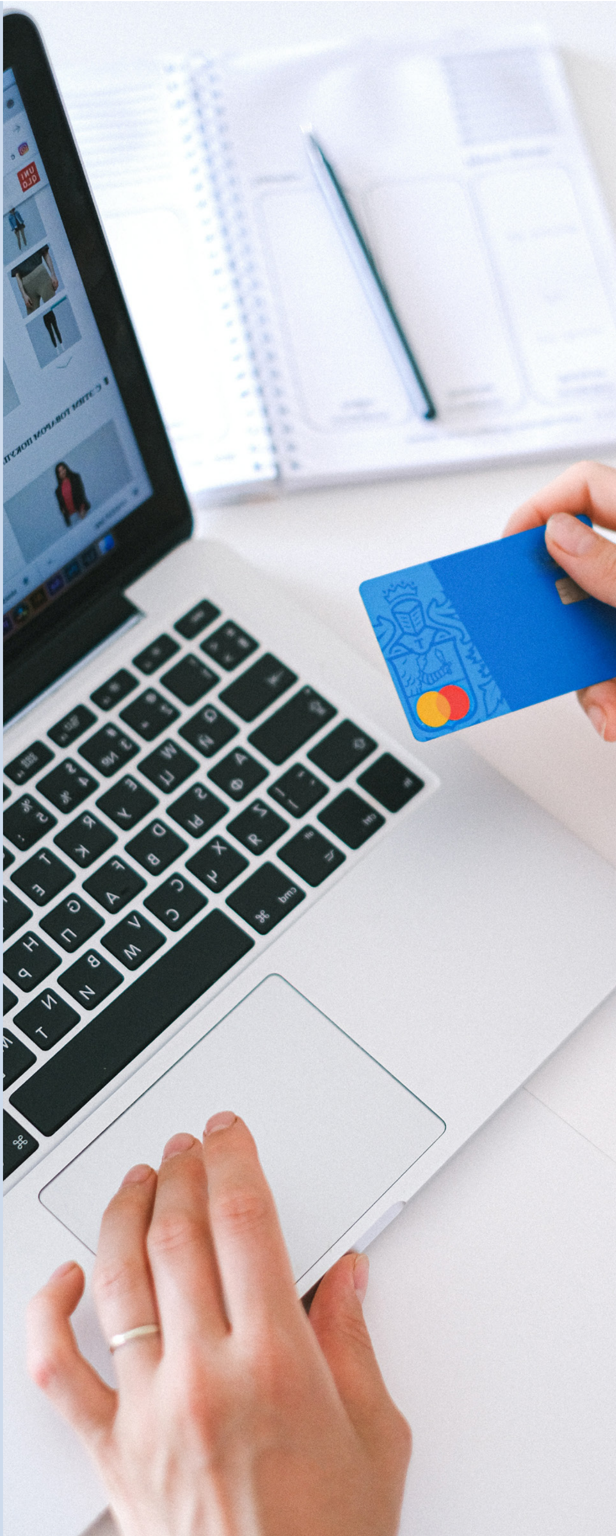
What are the warning signs of a recession?

There are a number of red flags that indicate a recession could be on its way:

- Stock market wobbles
- Increase in the unemployment rate
- Job vacancies fall
- Businesses report losses
- Earnings growth fails to keep up with inflation

What are the effects of a recession?

Recessions cause standard monetary and fiscal effects – credit availability tightens, and short-term interest rates tend to fall. As businesses seek to cut costs, unemployment rates increase. That, in turn, reduces consumption rates, which causes inflation rates to go down. Lower prices reduce corporate profits, which triggers more job cuts and creates a vicious cycle of an economic slowdown.



RECESSION-PROOF YOUR FINANCES

There are some simple strategies to ensure your finances are recession-proof:

Live within your means

When times are good and you can afford to make your monthly payments on time, having debt is not a problem.

However, during a recession, this raises the probability of redundancies. Could you afford to pay off your debt if you lost your job?

We don't know what the future holds, but if you owe a lot of money on loans and credit cards, try to pay it off as soon as possible.

Don't take on any new debt if you can avoid it, and make sure you don't spend more than you can afford each month.

Reduce your outgoings

Many families are having to tighten their budgets as a result of the cost of living crisis.

Now is a good time to examine your finances in depth if you haven't already.

Even small expenditures like a £3 coffee can add up to a lot. Adding up all of the costs and figuring out how much you could save each month or even over a year can be helpful.

Writing down everything you spend and earn can also help you see things in perspective. You might also want to make use of the YNAB subscription so you can see where your money is going.

Protect your retirement

Despite any difficulties, you should resist the urge to reduce your pension contributions.

If you have already reduced your spending, you should begin topping up your pension again as soon as possible.

According to wealth manager True Potential, a 25-year-old who reduces their pension payments by just 2% could lose £60,000 over their lifetime.

There might be other areas of your monthly spending you can look to cut first.

Avoid making impulsive financial decisions

It is not recommended to make impulsive financial decisions at any time, but the worst time is during a recession.

It might be fun at the time to spend a lot of money on luxury items, but if your income is stretched to its limits, you might regret it in the long run.

Consider your finances rationally now and avoid taking significant risks.

You might want to put off major financial decisions for the time being. Instead, focus on putting yourself in a good position to give you wiggle room in tough times.

Earn extra income

If you are concerned about the stability of your employment during a recession, it might be time to consider alternative means of earning extra cash.

Having multiple sources of earnings could protect you if one dries up, so you might want to diversify.

It’s important not to take your job for granted when a recession hits. When other businesses aren’t hiring, you might have a hard time finding a new job if you decide to leave.

MORE HELP WITH FINANCES

If you need support to help you manage your finances, you can seek help and advice from the below sources:

- Citizens Advice
- Help for Households - for support with the rising cost of living
- Money Advice Trust
- Money Helper - to find a free debt adviser
- National Debtline
- Shelter - for help with housing and homelessness
- StepChange
- Turn2Us

LSP'S SAFEGUARDING & MENTAL HEALTH FIRST AIDER TEAMS

If you have any concerns at all, please don't hesitate to contact a member of our Safeguarding or Mental Health teams:

Safeguarding Lead: Andy Hamer
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