Wealth in the Downturn: Winners and losers

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EXECUTIVE SUMMARY

Following the financial crisis, UK households experienced the longest period of falling real wages since records began.[1] They were poorly prepared for this, having run down savings and taken on increasing amounts of debt during the 2000s. It is estimated that the high levels of household indebtedness held back consumer spending, thus deepening the 2008-09 recession.

The economic uncertainty during the downturn prompted a reversal: saving dramatically increased and indebtedness fell. Now, having repaired their balance sheets, forecasters expect consumer spending to begin to rise again. Alongside this, debt is expected to increase, and savings to fall.

However, the analysis in this report suggests that we should not be so sanguine about the UK's personal finances. Whilst it is true that on average there has been deleveraging, a very different picture emerges among some groups. In particular, those on the highest incomes are more secure today than those in the highest incomes before the downturn; but the opposite is true for those on the lowest incomes.

Our analysis is based on the UK Longitudinal Household Survey (also known as Understanding Society) and its predecessor, the British Household Panel Study (BHPS). These surveys provide data on thousands of households from across the UK. Unlike most surveys, Understanding Society and BHPS track the same individuals over time. This means that they can be used to go beyond simple analysis of snapshots in time, to examine the specific changes that individuals experience over a number of years.

In 2005 and 2012-13, the surveys also asked respondents for detailed information about their financial assets and debt (excluding mortgages). This provides a unique dataset to analyse whose fortunes have improved, and whose have deteriorated. We divide individuals into five equally-sized income groups, ranging from the bottom incomes to the top incomes. We do this for both 2005 and 2012-13. We also look at individuals split by other characteristics, including by age group and type of housing.

The winners include:

- **The top 20%:** The top income group are far more financially secure today than those in the top incomes going into the downturn. Median financial wealth in this group increased by 64% between 2005 and 2012-13. They are now less likely to be in debt compared to the middle-income group – a reversal of the pre-crisis trend. The proportion of individuals with non-mortgage debt in this group fell from 43% in 2005 to 31% in 2012-13. The top 40% have also seen an improvement, although the increase in financial security is not as substantial.

- **Homeowners:** Homeowners have been able to add more to their savings than other individuals, as they have benefited from lower housing costs. While those who were renting in 2005 saw no overall changes in financial wealth over the course of the subsequent seven years, those who started off as outright homeowners added an additional £750; and those with mortgages added £300. Those that paid off their mortgage between 2005 and 2012 saw a gain of £2,500. This is above and beyond the any gains made from increases in property values.

The losers include:

- **The bottom 20%:** The lowest income group are less financially secure today than those on the lowest incomes going into the downturn. By 2012-13, median financial wealth among the lowest income group was 57% lower than in 2005. Over the same period, the proportion of those on the lowest incomes with non-mortgage debt increased; and the value of that debt rose faster than incomes – by 67%. The use of overdrafts has risen, most likely as a consequence of general pressure on finances.

- **26-35 year olds:** The intergenerational gap in incomes and wealth has widened. Wages for younger workers fell substantially during the downturn – at a greater rate than the average. 26-35 year-olds today are less likely to own a home. In 2005, 74% of 26-35 year olds owned a home; by 2012-13, this had dropped to 54%. Whilst the average deposit for first-time buyers has risen, the amount 26-35 year olds have in savings has fallen by 36%. On average, they have less than one week's worth of income in savings. And whilst the proportion of 26-35 year olds in debt has slightly fallen, the amount debt-holders in this age group owe has increased by 45%. As with the low income group, the use of overdrafts has increased.

The link between wealth and income has become much more pronounced in the seven years since 2005. Most of the deleveraging that took place in the aftermath of the crisis happened among the top income group. Those on the lowest incomes have not built up their financial resilience. On average, they have less than six days' worth of income in savings. Just under a quarter of them hold non-mortgage debt; and that debt is, on average, equivalent to around 28% of their income.

There is a need to support those on the lower incomes and younger age groups to save more. But this will be challenging, especially for those with little income to spare once necessities have been paid for. The process of repairing personal finances will most likely only begin once the expected growth in wages materialises.

Forecasts of GDP growth in the next parliament rely on growth in consumer spending remaining strong. Yet this analysis suggests that only those in older age groups and on higher incomes are in a position to start spending more. There is a limit on the UK economy's ability to depend on consumer spending for growth. For a large number of people, the imperative is not to increase spending, but to rebuild the state of their personal finances.

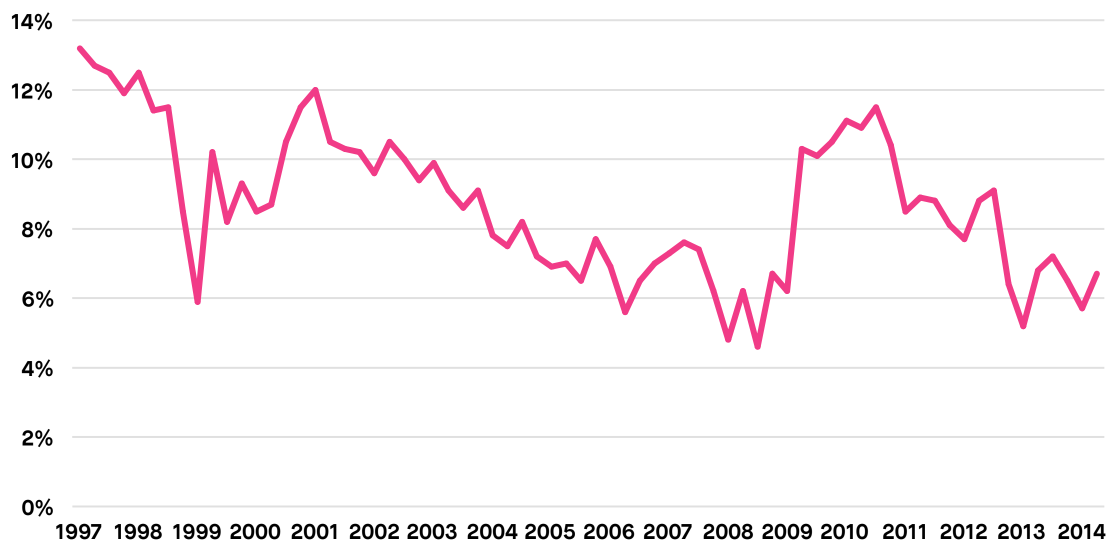
INTRODUCTION

The aftermath of the financial crisis saw stagnation in wage growth and rises in the cost of living. Real average household disposable income fell by £1,200, or 4% between 2007-08 and 2012-13. For non-retired households, the fall was £2,100, or 6.3%.[2] It took until the latter part of 2014 for wages to finally start growing faster than inflation.[3]

UK households were poorly prepared for the downturn

Households went into the recession poorly prepared. Saving as a proportion of income had been declining since the early 2000s, reaching a low in 2008. Household debt rose from around 100% of household income in 1999 to a peak of 160% in 2008, in large part, but not solely, due to an increase in mortgage debt.[4]

Figure 1: UK Household Savings Ratio 1997-2014



Source: OBR, Economic and Fiscal Outlook December 2014 (2014). Includes pension saving. The saving ratio compares the level of saving to disposable household income.

Several other developed countries also saw a fall in household saving during the 2000s. However, by the mid-2000s, the UK had the lowest savings rate of all the G7 countries.[5] So on the eve of the financial crisis, UK households appeared to be relatively ill-prepared. The effects of low savings and higher indebtedness went beyond individual households; it has been estimated that household indebtedness increased the depth of the 2008-09 recession, as households cut spending by an additional 2% after 2007.[6]

After the crisis

In theory, a decline in real income levels and low interest rates, as seen after the crisis, could discourage saving and make holding debt more attractive. This is because lower income reduces a household's capacity to accumulate assets and reduces the rewards of saving.

But a significant feature of the downturn was a striking increase in economic uncertainty. As GDP growth rates fell and unemployment rates increased, so too did the risk of job loss and severe reductions in income. Temporary and precarious employment also became more prevalent. Greater uncertainty or pessimism in economic outlook incentivises households to create 'precautionary' savings, or 'buffers', to protect against potential future adverse shocks or fluctuations in their income.[7]

So in the aftermath of the crisis, as real income levels declined, so too have debt levels, and savings have increased. Empirical evidence estimates that at least two-fifths of the increase in households' saving rates in the first few years after the crisis was due to increased uncertainty about wage prospects.[8]

Into the recovery

Now, seven years after the financial crisis, the economy has begun to recover and real wages have begun to rise. However, there are still uncertainties ahead. Risks to economic growth include the performance of the wider global economy, including the UK's main trading partners, and the extent to which the recovery is sustainable over the longer-term. Those with mortgages have been able to keep housing costs down as interest rates fell over the last few years,[9] however, when they do rise again, these households will see rising levels of repayments. And, of course, even in times of economic stability, many households see changes in their personal circumstances, such as job loss, illness or household break-up that can test their financial resilience.

But since 2011, official statistics show that savings rates have started to fall again.[10] The OBR expects household debt as a proportion of income to increase in 2015, reaching its pre-crisis peak in 2018.[11] There is a risk that now that confidence has returned, the task of building financial resilience will once again resume a lower priority in the lives of individuals. Also there are likely to be substantial differences in savings and debt behaviour across different groups depending on their differing experiences of the recession. Those that have seen particularly large falls in real incomes are less likely to have had the ability to repair their finances, despite the potential motivations to do so.

So how have households and individuals fared since the downturn? Which groups have greater financial security now and which groups have seen a deterioration? And how prepared are different individuals for potential risks ahead?

In this paper, we analyse the financial position of individuals today, and how this has changed since 2005. We focus on financial wealth, looking at both assets and debt. Pension wealth, the purpose of which is to provide an income in later life, rather than to help cope with hardship during working lives, is excluded from our analysis.[12] Similarly, housing, whilst an important component of overall wealth, is not examined in detail in this report due to the fact that, as an asset, it is relatively illiquid.

The unit of analysis in this report is at the level of the individual. This allows us to follow specific individuals over time, looking at how their personal, and jointly-held assets and debt change over time, even as households form and split up. We look at all individuals, both retired and working-age, however, we also show differences between age groups. Additional detail on on data sources, definitions and methodologies is set out in Annex 1.

We use data from the UK Longitudinal Household Study (also known as Understanding Society), and its predecessor, the British Household Panel Survey. This dataset is unique in allowing longitudinal analysis of individuals and households over time, with detailed information about demographics, income, household composition, employment, and a range of other factors. In

2005 and 2012-13, detailed data on assets and debt was also collected, allowing analysis of how wealth changed between these two years for these individuals.

- **Chapter 1** sets out the net financial position of individuals in 2012-13; how this differs by income group, and how the shape of UK wealth has changed since 2005.
- **Chapter 2** looks at which groups have seen an improvement in their financial position, and which have seen a deterioration.
- **Chapter 3** concludes by showing current levels of financial resilience, and who is most at risk, focusing on three specific groups: those on low incomes, mortgagors and 26-35 year olds.

Throughout the report, 2012-13 prices are used.

CHAPTER 1: WEALTH AND DEBT AFTER THE DOWNTURN

In this chapter we look in detail at financial wealth and debt, comparing individuals' financial position in 2012-13 against 2005. Financial wealth is made up of savings (including investments); financial debt is made up of loans, overdrafts and hire purchase agreements.

We start by looking at the overall trend in levels of financial wealth, and then look at how different income groups are now positioned. We find that deleveraging – that is the rise in savings and fall in debt - has not happened across the board, leaving some groups less secure than before the downturn.

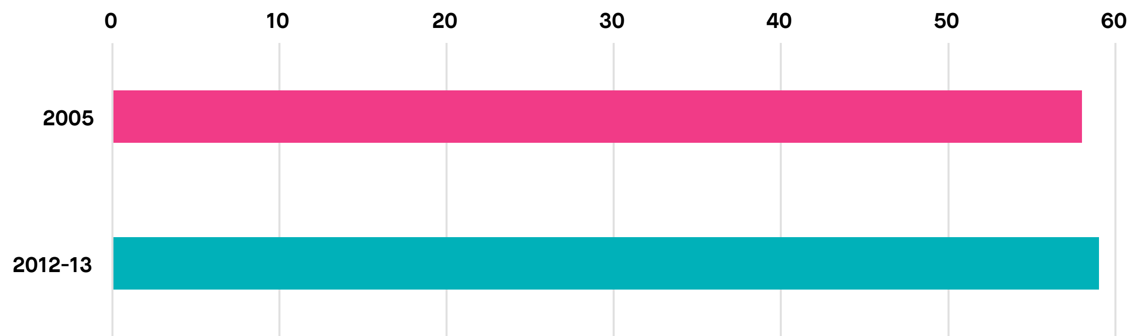
Full definitions of financial wealth and debt are given in **Annex 1.**

While incomes stagnated, British individuals – on average – deleveraged.

The Understanding Society data that we use in this report shows that real household median income grew by 8.8% between 2005 and 2012-13. However, the majority of this increase was among those of retirement age. For the working-age population,[13] real median household income growth was almost flat, totalling 1.4%. During this time of stagnant incomes and rising prices, many households cut back on spending, helped in part by lower interest rates, which kept housing costs down.[14]

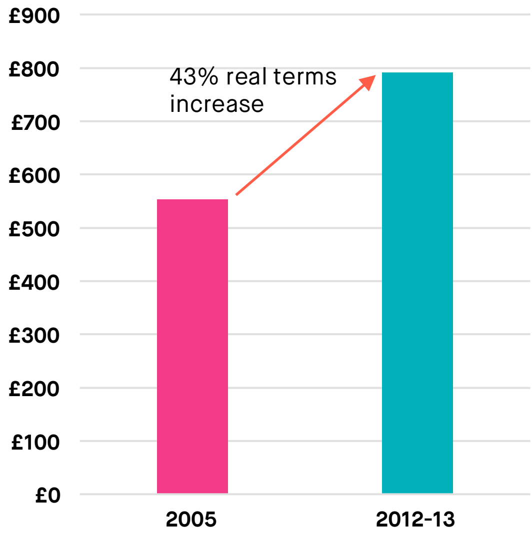
This spending cut meant that – on average – by 2012-13, individuals were in a better position than before. Having gone into the downturn with high levels of debt and low levels of saving, households started the process of repairing their balance sheets. The proportion of people with positive net financial wealth – that is the value of their financial assets exceeded their (non-mortgage) debts - went up by one percentage point to 59%. The change in the net value of financial wealth was starker: with median net financial wealth seeing a 43% real terms increase, far faster than the increase in incomes.

Figure 2: Proportion with positive net financial wealth (%)



Source: SMF and Understanding Society Policy Unit analysis of BHPS and UKHLS

Figure 3: Median net financial wealth (£)



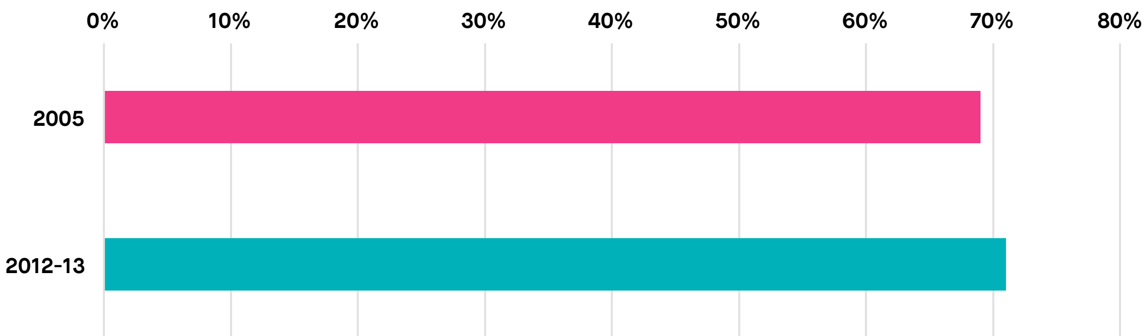
Source: SMF and Understanding Society Policy Unit analysis of BHPS and UKHLS

What have individuals done to help them deleverage? Below, we look in turn at the two components of net financial wealth – financial assets and non-housing related debt.

Savings have increased

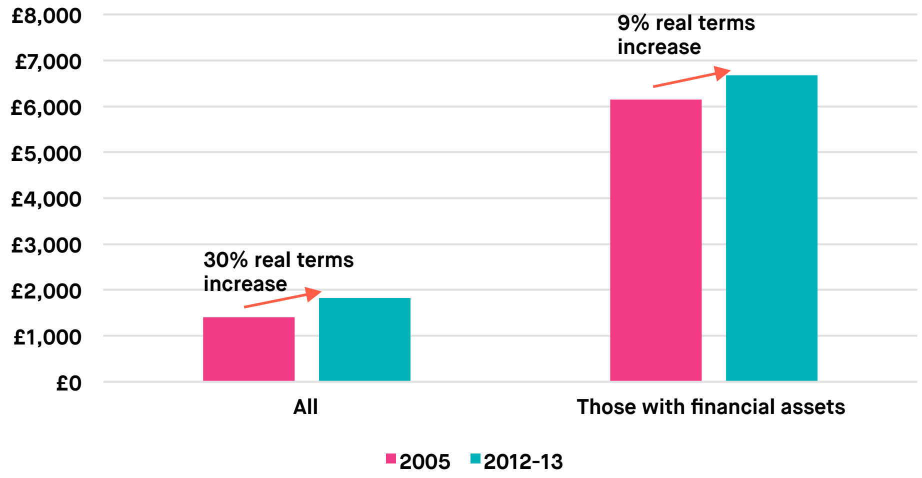
In 2012-13, around 71% had some form of financial wealth, a slight improvement since 2005, when 69% had some form of financial wealth. Further, the amount of savings tied up in financial wealth has also increased, to a median value of just over £1,800. However, many have no financial wealth at all. Amongst those with at least one type of financial asset, the median value is just under £6,700.

Figure 4: Proportion holding financial assets (%)



Source: SMF and Understanding Society Policy Unit analysis of BHPS and UKHLS

Figure 5: Median financial wealth of those with and without financial assets



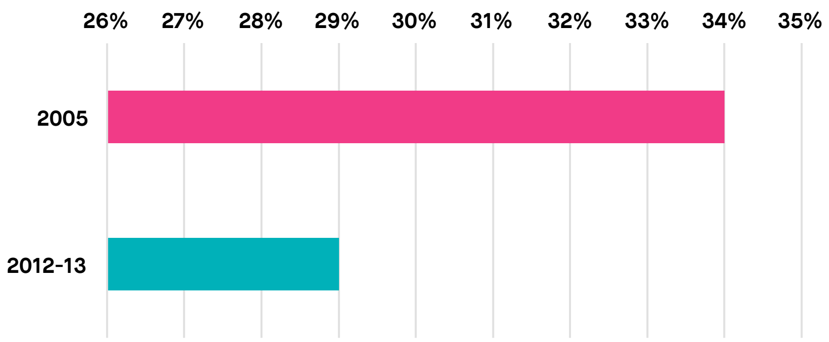
Source: SMF and Understanding Society Policy Unit analysis of BHPS and UKHLS

So between 2005 and 2013, individuals built up a larger financial cushion against shocks. By 2013, only slightly more individuals had at least some savings, but the value of those savings had increased. The data used in this paper captures levels of wealth at two points in time; we cannot directly estimate the actual amounts that are put aside as savings. Increases in wealth could therefore be due to better returns; however the relatively low rates of return on savings during the period we look at suggest that any increases in wealth are likely to be primarily due to more money being put aside.

Debt has fallen – but not everywhere

Whilst savings have increased, many individuals have also paid down debt. The proportion of individuals with non-housing debt is 29%, a drop since 2005, when 34% had a least one form of non-housing related debt. This pattern is also reflected in data on mortgage debt, which shows that in 2012-13, 37% of individuals lived in a house with mortgage debt, down from 45% in 2005.

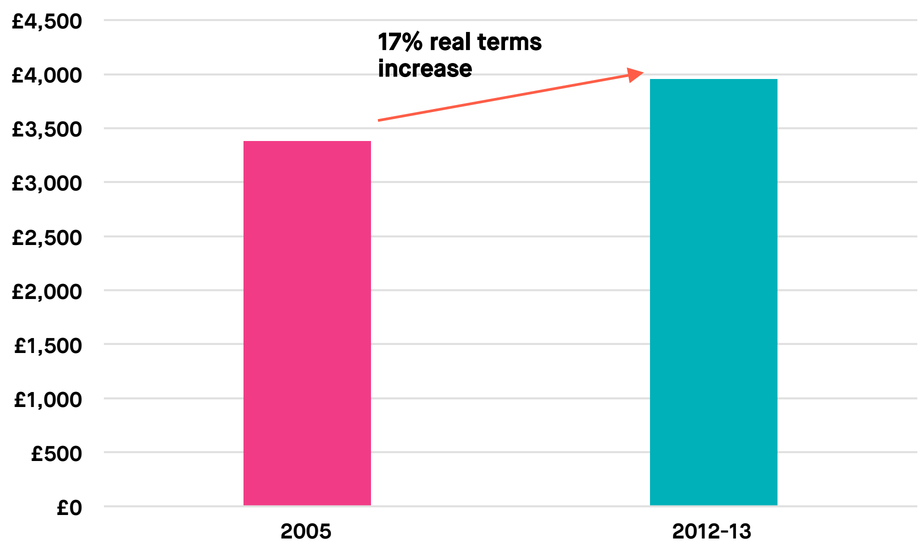
Figure 6: Proportion holding debt (excluding mortgages)



Source: SMF and Understanding Society Policy Unit analysis of BHPS and UKHLS

But those that do have debt owe a larger amount than debt-holders in 2005. In 2012-13, the median non-housing debt was just over £3,900, a rise of 17% since 2005.

Figure 7: Median debt (excluding mortgages)



Source: SMF and Understanding Society Policy Unit analysis of BHPS and UKHLS. Base for median debt: those that hold non-housing debt.

So overall, the primary contributors to deleveraging are:

1. Individuals who are saving substantially more, with saving increasing faster than incomes;
2. The large proportion of individuals that have paid down debt altogether.

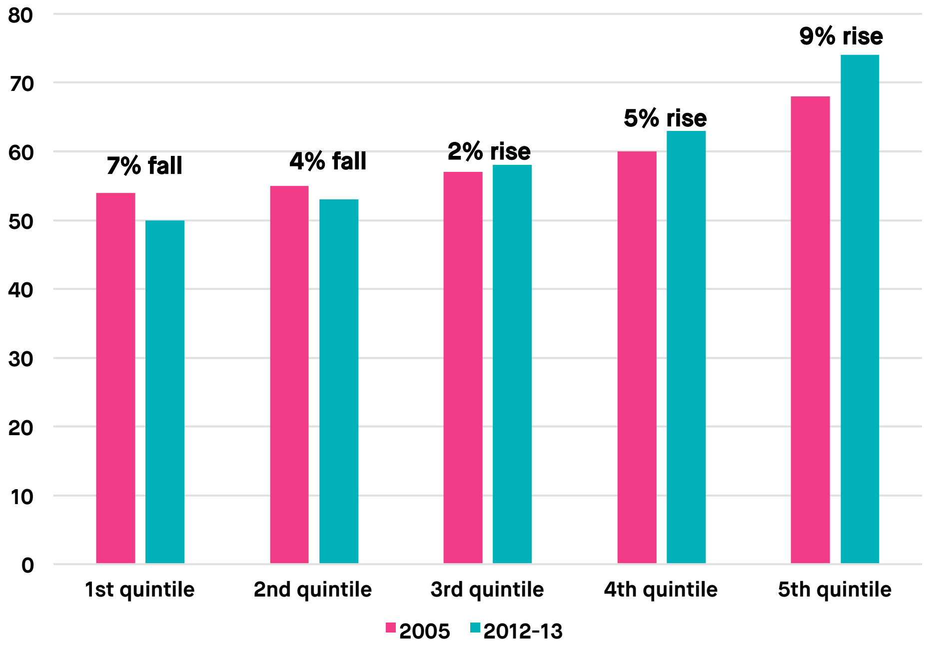
However, not all individuals are in a better position than previously: among debt-holders, debt levels have risen. And the increase in financial security has not happened across the board. In the rest of this chapter, we show how the shape of wealth and debt across income groups has diverged. For both 2005 and 2012-13, we split individuals into five income groups, with those on the lowest incomes in the 1st quintile, and those on the top incomes in the 5th quintile. For each income group, we show net financial wealth, financial wealth and financial debt.

Deleveraging has been unequal

Despite the overall pattern of deleveraging, there are substantial differences between individuals across different incomes. As would be expected, those in higher income groups, on average, have higher levels of net financial wealth. What is more surprising though, is the extent to which this trend has become more pronounced, over the course of just seven years.

Figure 8 shows that in the bottom two income groups, there are now lower levels of positive net wealth. That is, in these groups, fewer individuals now have financial wealth that exceeds the value of their (non-housing) debts. In the lowest income group, only a half have financial assets that exceed their (non-housing) debts. In contrast, those in the top fifth of incomes now are more secure than the top fifth in 2005; 74% now have positive net financial wealth.

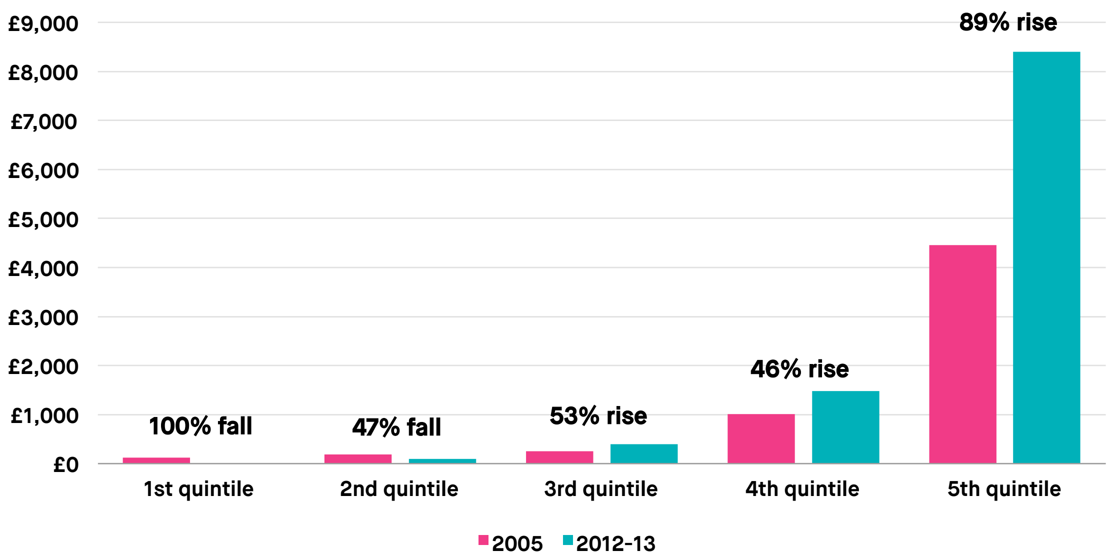
Figure 8: Proportion with positive net financial wealth (%)



Source: SMF and Understanding Society Policy Unit analysis of BHPS and UKHLS

The value of net financial wealth has diverged even more. In 2005, median net financial wealth among the bottom fifth of incomes was around £120. By 2012-13, that had fallen to zero. The second to bottom group had 47% less in net financial wealth compared to 2005. Meanwhile, in the top income group, median net financial wealth rose by 89%.

Figure 9: Median net financial wealth (£)



Source: SMF and Understanding Society Policy Unit analysis of BHPS and UKHLS

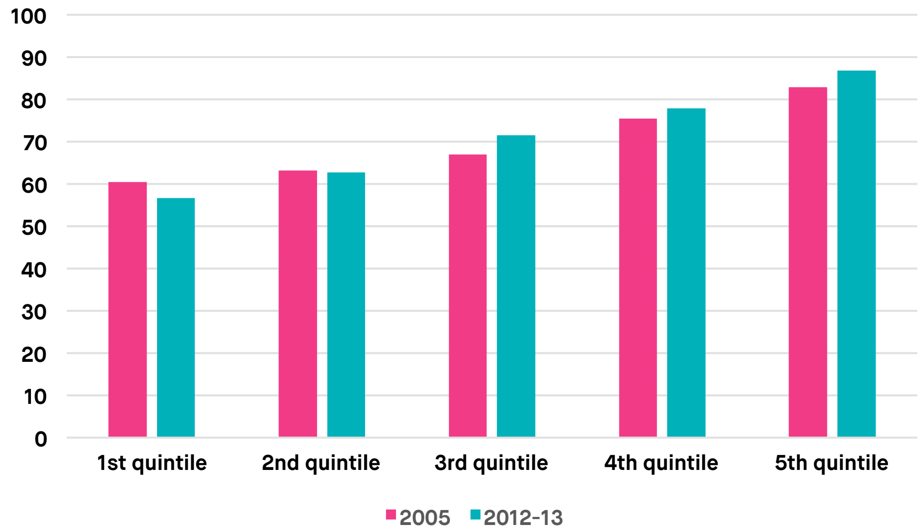
As can be seen in Figure 9, those in the top income group are much more financially secure today than those in the top income group in 2005. The majority of the deleveraging has taken place at the top of the income distribution. The divergence in wealth across income groups has become much more pronounced. If we were to face another financial crisis, the poorest individuals would be less well-prepared today than they were in the late 2000s.

Patterns in both savings and debt contribute to this trend, as we show below.

The richest now have more savings

Looking specifically at financial wealth – savings and investment – Figure 10 below shows that those on the lowest incomes are now less likely to have any form of savings or investments. Whereas in 2005, 60% of the lowest income group had some form of financial wealth, that proportion has now fallen to 57%. Meanwhile, the proportion of the top income group with financial wealth has grown, from 83% to 87%.

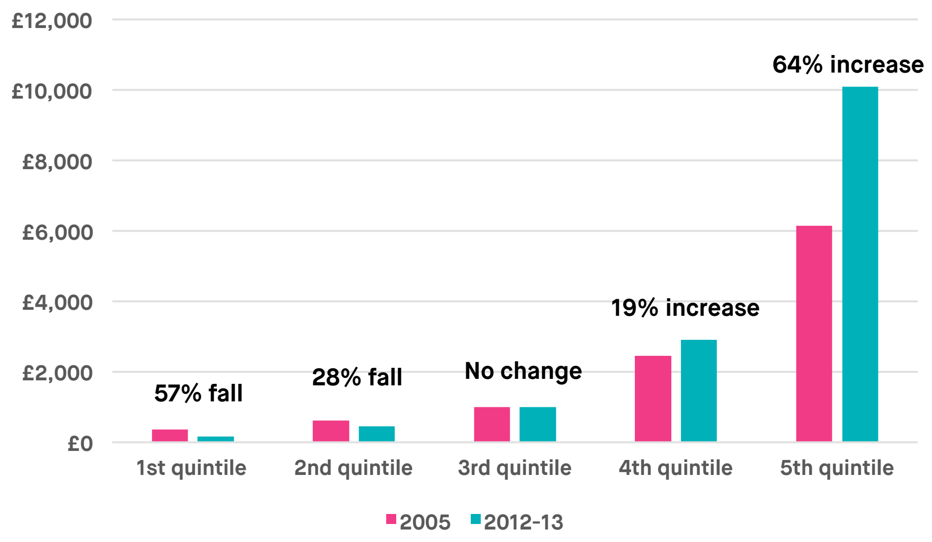
Figure 10: Proportion with financial wealth (%)



Source: SMF and Understanding Society Policy Unit analysis of BHPS and UKHLS

As with net financial wealth, the differences are even starker when the amount held in financial wealth is analysed. The bottom income quintile now have 57% less in financial wealth than the bottom in quintile in 2005. In contrast, the top income group has 64% more in financial wealth than the top income group in 2005.

Figure 11: Median financial wealth (£)



Source: SMF and Understanding Society Policy Unit analysis of BHPS and UKHLS

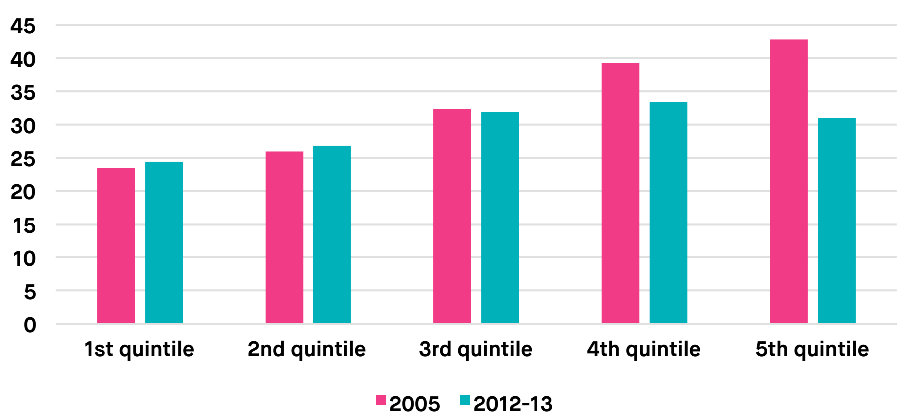
The lowest income group are also less well-off in other types of assets. Home ownership rates have fallen across the board, but the fall has been steepest in the lowest income group. In 2012-13, 54% of those in the lowest income group owned a home, compared to 63% in 2005 – a nine percentage point fall. Among the top income group, home ownership rates fell by only 5 percentage points, from 91% to 86%.

And the richest are less likely to have debt

Previously, the likelihood of having debt increased with income: this is primarily because those in higher income groups have greater access to credit.[15] But by 2012-13, the pattern had shifted. Now, debt is less common in the top income group compared to those on middle incomes - a reversal of the previous trend.

The drop in the proportion of individuals with debt is substantial in the top income group – falling from 43% in 2005 to 31% in 2012-13 – a drop of 13 percentage points. The story is different further down the income distribution. Individuals on the lowest incomes today are now slightly more likely to have debt than in 2005.

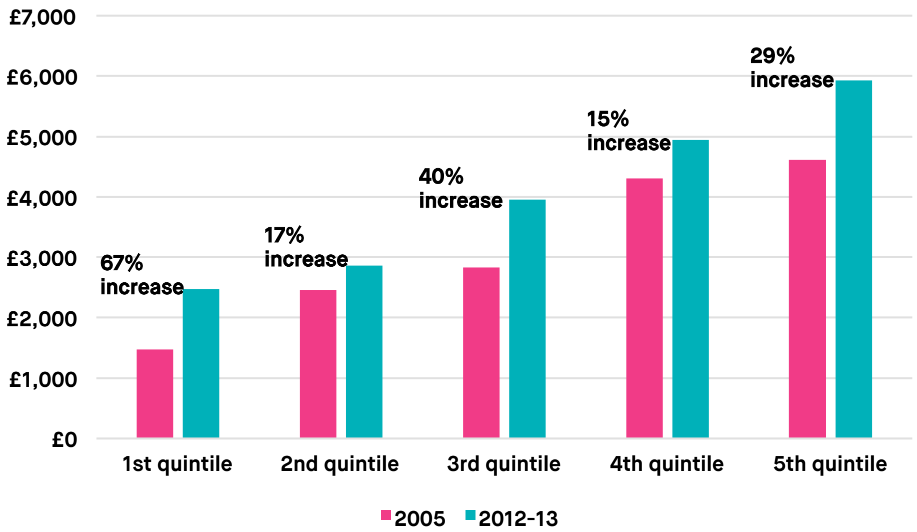
Figure 12: Proportion with non-housing debt (%)



Source: SMF and Understanding Society Policy Unit analysis of BHPS and UKHLS

As set out earlier, whilst the proportion holding debt has generally fallen, the amounts that debt-holders owe has gone up. Debt-holders on higher incomes are likely to owe more; this is at least partly due to their greater access to credit.[16] The increase in the value of outstanding debts is substantial across debt-holders in all income groups. But the increase has been most substantial among debt-holders in the bottom income group, where the amount owed increased by 67% from 2005 to 2012-13.

Figure 13: Median non-housing debt (£)



Source: SMF and Understanding Society Policy Unit analysis of BHPS and UKHLS. Base: debt holders only

In summary:

- On average, individuals have saved more and paid down their debts, although those with debt now owe more.
- But a very different picture emerges among lower income groups. Savings and debt patterns by income group have become more pronounced.
- Those on the lowest incomes in 2012-13 have less in savings and more in debt than low income groups on the eve of the downturn.

In Chapter 2, we go on to look in more detail at who has been able to save more and pay down debt, by tracking individuals and their circumstances over time.

CHAPTER 2: FINANCIAL FALLERS AND CLIMBERS

This chapter looks at who has been able to improve their financial position, and who has seen a deterioration. In Chapter 1, we compared snapshots of the population at two different points in time. This demonstrates how the shape of financial wealth and debt has changed across society, highlighting the strengthening link between income and net wealth.

However, it is not clear what the reasons are for these changes. Individuals' incomes change over time, and there is often substantial movement across the income distribution. An individual who is in the lowest income group in 2005 will not necessarily be in the same group seven years later, and similarly for those in the top income group. As individuals go through different life stages, such as entering the labour market, starting a family, or retiring, they can move between different income groups. In addition, other household circumstances can change, such as becoming a homeowner, or changing job.

In this chapter, we look at how changes in wealth and debt are influenced by these factors. We analyse changes by tracking individuals through time, looking at their circumstances in 2005, how those circumstances have changed, and how this relates to changes in wealth and debt.

The data in this chapter is focused on individuals who took part in both the British Household Panel Study in 2005, and the Understanding Society survey in 2012.[17] This means that the sample differs from that analysed in Chapter 1. In particular, it does not include young adults who were too young to take part in the 2005 survey.

Assets: savings

In the seven years to 2012, there was an across-the-board increase in the proportion of savers. However, patterns differ substantially across different groups.

Both age and starting wealth are closely linked with wealth accumulation. In line with findings elsewhere, our analysis shows that the amount put aside in savings tends to increase with age, as pressures on spending ease, before falling again in older age groups as people retire and run down their savings.

We also find that those with higher levels of wealth in 2005 are more likely to have drawn down on their wealth: this is most likely at least in part due to the fact that much saving is for specific purposes, such as future anticipated expenses. This is particularly the case among lower income groups.[18]

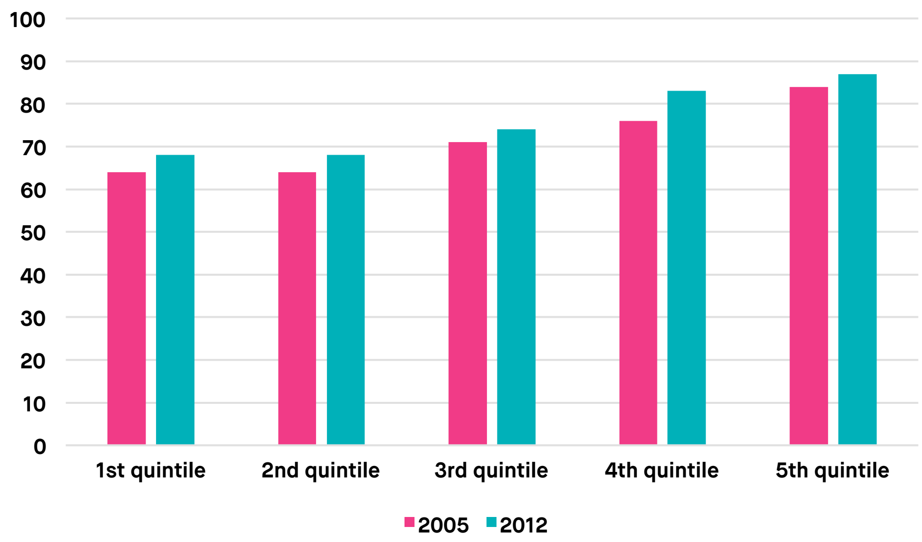
Table 1: Median change in financial wealth, by 2005 age group (£)

Age in 2005	Median change in financial wealth
16-25	Negligible change
26-35	No change
36-45	No change
46-55	£989
56-65	£949
66-75	No change
76 and older	-£31

Source: SMF and Understanding Society Policy Unit analysis of BHPS and UKHLS

Aside from this, the main determining factor for the amount by which wealth has increased is the level of income in 2005. As can be seen in the chart below, regardless of income levels in 2005, all groups saw a rise in the proportion of savers. At first glance this may seem to contradict the finding in Chapter 1 that the proportion with financial wealth has fallen among those with the lowest incomes. There are two reasons for this. Firstly, the chart below only includes adults that were surveyed in 2005, and so excludes young adults who took part in the 2012 survey, but were too young to take part in 2005. Secondly, previous SMF research shows that there is often substantial movement between income groups.[19] Those on the lowest incomes in 2012 are likely to number among them those that were on higher incomes in 2005 but saw a deterioration in their incomes and finances in the subsequent seven years.

Figure 14: Proportion holding wealth, by 2005 income group (%)



Source: SMF and Understanding Society Policy Unit analysis of BHPS and UKHLS

More importantly than the proportion of savers, however, is the fact that those that were on higher incomes in 2005 saw both an increase in the number of savers, and also saw an increase in wealth. Given the relatively low returns on savings during this period, much of this increase is likely to be due to more money being put aside rather than spent. Among the top income group in 2005, the median amount saved was just under £1,700 over the course of the subsequent seven years. There is substantial variation, however: the mean amount saved among the top 20% is much higher, at just under £18,000.[20] As shown in Table 2 those that were on higher incomes at the start of the downturn were able to add much more to the wealth than those lower down the income distribution.

Table 2: Median change in financial wealth, by 2005 income group (£)

Income group in 2005	Median change in financial wealth
1st quintile	No change
2nd quintile	No change
3rd quintile	No change
4th quintile	£594
5th quintile	£1670

Source: SMF and Understanding Society Policy Unit analysis of BHPS and UKHLS

This pattern holds even after taking into account a range of factors, including age, gender, tenure and employment status. In fact, when comparing individuals of the same age, gender, tenure and employment status, the differences become even starker: those on the highest incomes in 2005 were able to add around £22,000 more to their savings compared to the middle income group, and the middle income group have been able to add almost £8,000 more to their savings compared to the bottom income group.

Finally, home ownership made a substantial difference to the amount individuals were able to save. Those that owned outright in 2005 – on average - added around £750 to their levels of financial wealth, and those with mortgages in 2005 added just under £300. Renters saw no overall change. This pattern holds even after taking into account other factors such as age, income levels and employment status.[21]

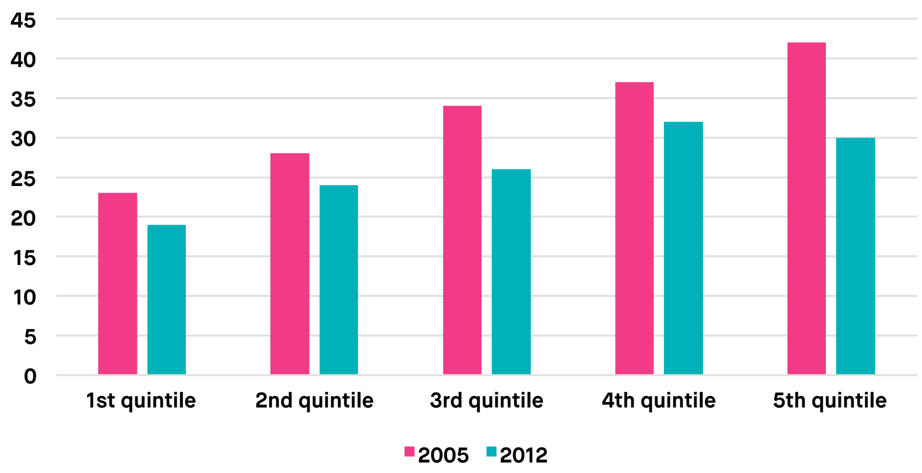
Those that paid off their mortgage between 2005 and 2012 saw even larger increases in financial wealth – of just under £2,500. Again, this also pattern holds when comparing two individuals with similar characteristics in terms of age, gender, employment status, household circumstances and income.

Housing wealth tends to go alongside financial wealth. Those that own property outright are more likely to have added to their financial wealth, and those that have paid their mortgages off have been able to add a substantial amount too. These effects hold even when comparing individuals on similar levels of income. Lower housing costs means that much more can be put away in savings, and the effects are sizeable.

Debt

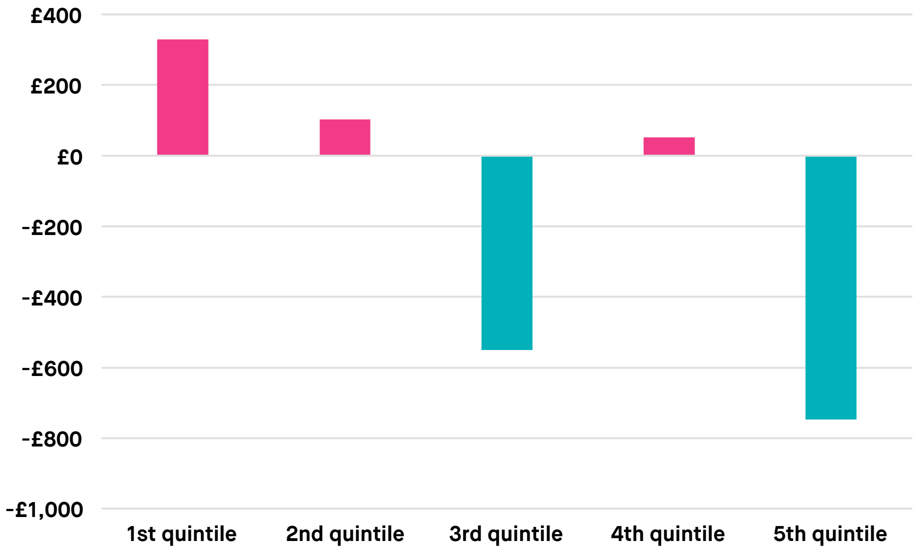
As set out in Chapter 1, the proportion of individuals in debt has fallen since 2005. As can be seen in the chart below, the largest fall occurred among those who were in the top income group in 2005, where the proportion with debt fell by twelve percentage points. However, the pattern in terms of amounts of debt held is less clear-cut. More generally, the factors associated with different patterns in paying down debt are much less clear than is the case for savings patterns.

Figure 15: Proportion holding debt, by 2005 income group (%)



Source: SMF and Understanding Society Policy Unit analysis of BHPS and UKHLS

Figure 16: Change in debt, by 2005 income group (£)



Source: SMF and Understanding Society Policy Unit analysis of BHPS and UKHLS. Base: individuals that were debt holders in 2005

One factor associated with changes in debt levels is change in employment status. Moving from employment to self-employment is associated with reducing debt by around £2,300 compared to an individual with similar characteristics who has seen no change in their employment status. Moving from employment to retirement is associated with reducing debt by £2,200. However, the direction of cause and effect is unclear. For example, in the case of moving into self-employment, those that have been able to pay down debt may be more willing to take on the risk of becoming self-employed, rather than income from self-employment allowing debt to be paid down.

In summary:

- Those that were on higher incomes in 2005 were able to make much more progress in deleveraging that those on lower incomes.
- Home ownership makes a substantial difference. Having a home is a financial asset in itself and also allows much more to be put away in savings as housing costs are reduced.

In the next Chapter, we turn to look at financial resilience today, focusing on potential at-risk groups.

CHAPTER 3: FINANCIAL RESILIENCE TODAY

After a long period of stagnation, wages are showing some signs of recovery, with earnings growing at around 1.4% by the end of 2014.[22] Inflation is currently low, but interest rates are likely to rise in the future, with market expectations of a rise in the Bank rate by 2016.[23] When this happens, those with debt are likely to see the cost of servicing their debt increase.

As we saw in Chapters 1 and 2, some individuals are now in a better position compared to 2005, but many are not. In this section, we set out the UK's levels of personal financial resilience, before focusing on three specific groups of individuals: those on the lowest incomes, those with mortgages, and those in the 26-35 age group.

Financial resilience today

"Financial resilience" can be defined as the ability to withstand financial shocks, such as falls in real income. Financial resilience will depend on the level of wealth that can be drawn down to help manage these falls. Of the different types of wealth, liquid wealth is likely to make individuals more resilient. Debt is also important. Higher levels of debt leave individuals more vulnerable to interest rate rises. And the need to make debt repayments makes it more difficult to reduce overall spending if an individual sees their income fall.

In this chapter, we focus on two specific measures of financial resilience. Firstly, we look the number of weeks' worth of income held in savings. This helps to illustrate the extent to which individuals could withstand an interruption in or fall in income by relying on savings. Secondly, we look at debt to income ratios, as a way of understanding the extent to which individuals are able to service their existing debt, based on their current levels of income.

Our analysis shows that individuals are now slightly better prepared for "rainy days" than they were in 2005. As shown in the table below, the proportion with less than 1 weeks' worth of income in savings has fallen from 45% to 39%. A usual "rule of thumb" is that individuals should have savings equivalent to around three months' worth of income or essential expenditure.[24] 40% of individuals have this level of saving; an increase on 2005, although this does still leave a substantial proportion that are ill-prepared for potential future income shocks.

Table 3: Saving equivalent to income period, by proportion of individuals 2005 & 2012-13 (%)

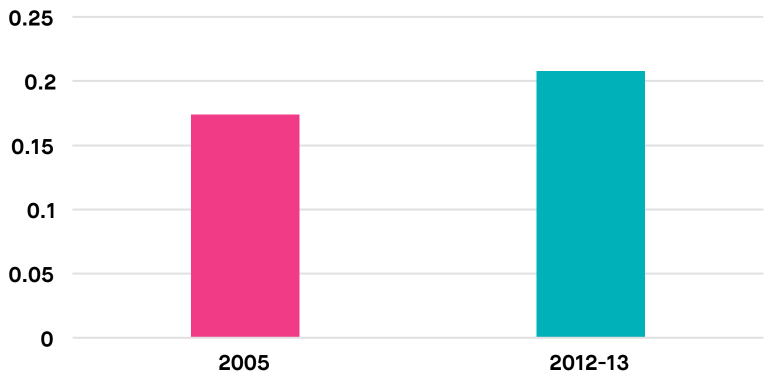
Savings equivalent to...	Proportion of individuals (2005)	Proportion of individuals (2012-13)
Less than 1 weeks' worth of income	45%	39%
1-4 weeks' worth of income	8%	9%
5-8 weeks' worth of income	6%	6%
9-12 weeks' worth of income	5%	5%
13 weeks of income or more	36%	40%

Source: SMF and Understanding Society Policy Unit analysis of BHPS and UKHLS

We do not look at the value of pension wealth in this paper; this is likely to be important for older individuals, particularly as the crisis saw the value of many investments fall. However, analysis of financial wealth shows that older age groups have experienced larger increases in financial resilience than other age groups. In 2005 individuals aged 60 and above had on average 26 weeks' worth of income in savings; by 2012-13 this had risen to 34 weeks. Therefore older individuals by 2012-13 were significantly more financially resilient than their counterparts in 2005. For individuals aged below 60 the equivalent is just under 2 weeks in 2005, with a fall to just under 12 days' worth of savings by 2012-13. This is likely to be due at least in part to the different experiences of income growth during the downturn: by 2012-13, real income among those over 60 had increased beyond the pre-crisis level, whereas for younger age groups, it had fallen.[25]

Turning to debt, as set out in Chapter 1, median debt levels are zero – most individuals do not hold debt, and the proportion that hold debt has fallen. However, among debt-holders, the amount of debt held as a proportion of income has increased, from around 17% of income to 20% of income. As we showed in Chapter 1, median debt increased by 17% - at a time when income largely stagnated.

Figure 17: Debt to income ratio – median



Source: SMF and Understanding Society Policy Unit analysis of BHPS and UKHLS. Base: debt holders

In the rest of this chapter, we focus three potential at-risk groups: those on low incomes, those with mortgages and those aged 26-35.

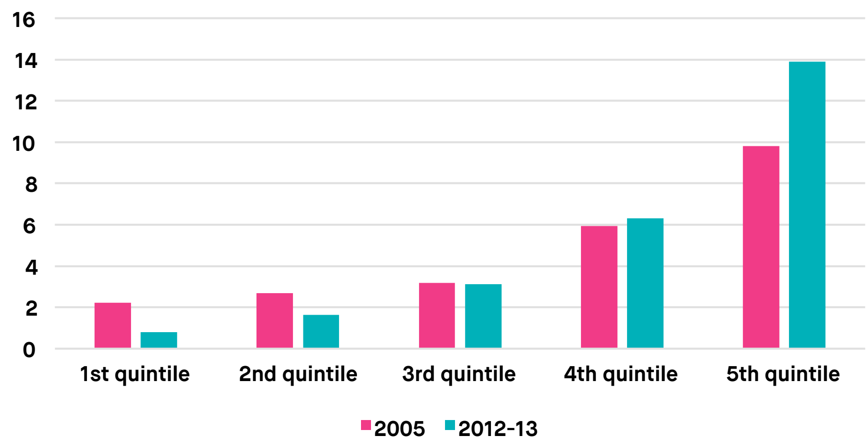
Those on low incomes

As shown in Chapter 1, those on the lowest incomes today are even less financially secure in terms of savings and debt than in 2005. Many have lower levels of saving and higher levels of debt than those who were on the lowest incomes pre-recession.

Real wages fell after 2008, and analysis by the IFS shows that between 2009 and 2011, the falls were proportionately larger at the lower end of the earnings distribution. In terms of household incomes, this was somewhat mitigated by state benefits, which went up with inflation over the same period, although after 2011, real terms cuts to benefits were imposed.[26] Price rises during the period from 2008 to 2013-14 disproportionately affected those on lower incomes. Individuals in this group spend a greater share of their incomes on food and energy, which saw particularly large increases in price during this period. Further, as those on the lowest incomes are less likely to be homeowners on mortgages, they benefited less from the fall in interest rates compared to those on higher incomes.[27] Overall, then, the lowest income group have been much more constrained in their ability to save more and pay down debt.

This is reflected in our two measures of financial resilience. On average, those in the lowest income group have less than one week's worth of income in savings, compared to 14 weeks' worth for those in the top income group. The difference in financial security across the income groups has become much starker. In 2005, those on the top incomes had almost 10 weeks' worth of income in savings; those on the top incomes by 2012-13 had an extra 4 weeks' worth on top of this. In contrast, amongst the lowest incomes, savings have fallen, from just over two weeks' worth of income to less than six days' worth of income.

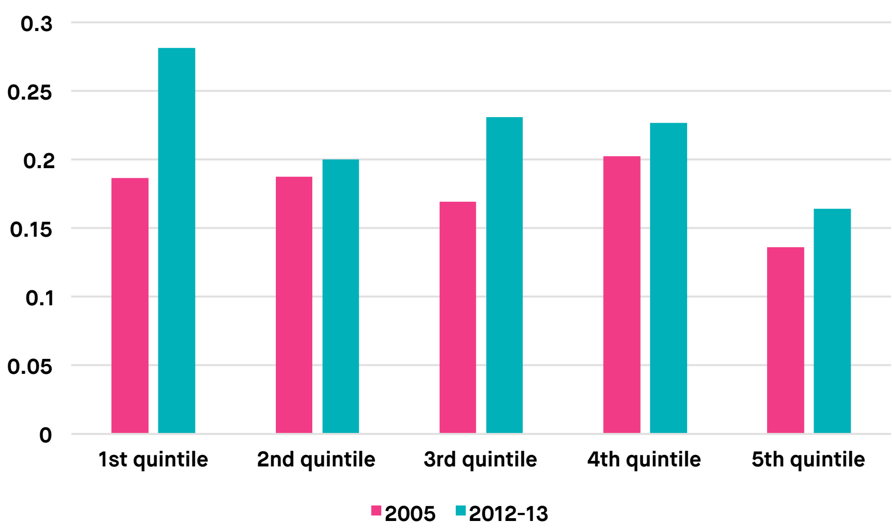
Figure 18: Number of weeks' worth of income held in savings (median)



Source: SMF and Understanding Society Policy Unit analysis of BHPS and UKHLS

Whilst those in the lowest income group are less likely to hold debt than those on higher incomes, those that do hold debt in the lowest income group have the highest debt to income ratio by far. Debt-holders in the lowest income group have debt equivalent to around 28% of their incomes, compared to 16% of top income debt-holders. Further, the increase in the debt to income ratio since 2005 is substantial; the debt to income ratio of low income debt-holders in 2012-13 is almost ten percentage points higher than in 2005. And as we saw in Chapter 1, the proportion of individuals that hold debt has increased in the bottom income group, even as it has fallen for the population as a whole.

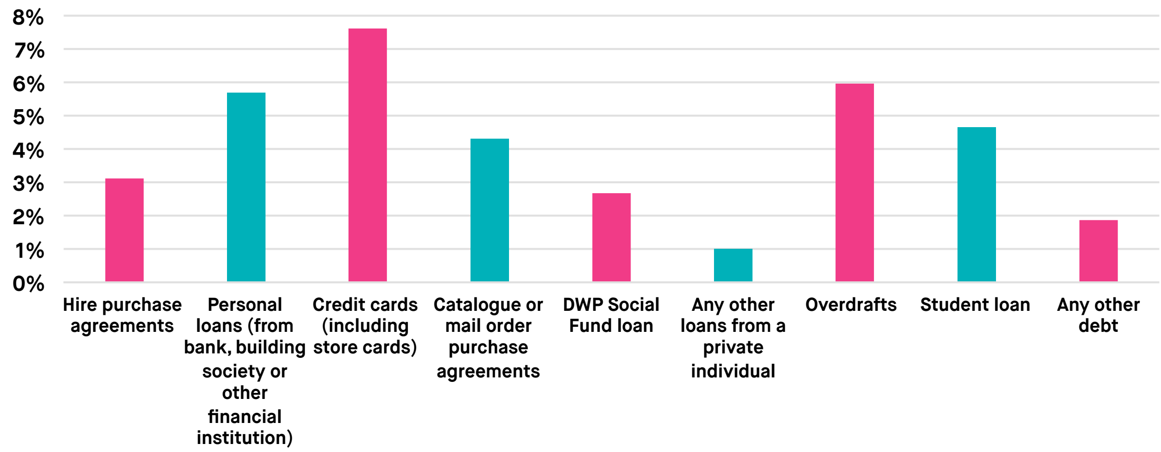
Figure 19: Debt to income ratio by income group



Source: SMF and Understanding Society Policy Unit analysis of BHPS and UKHLS. Base: debt-holders only

The most common types of debt among those in the lowest income group are personal loans, credit cards and overdrafts. Since 2005, the proportion of low income individuals with overdrafts has increased by around a half, whilst the proportion with debt related to hire purchase or mail order catalogues has fallen, by around a quarter and a third respectively. As might be expected, given the squeeze on living standards, debt in the low income group is now less likely to be related to spending on specific items. The growth in overdraft use among the lowest income group is concerning: research by the FCA found that use of overdrafts is often driven by general pressure on finances. In contrast to other forms of debt, consumers are much less likely to shop around for the best overdraft rates, and so risk paying relatively high rates for credit.[28]

Figure 20: Lowest income group - proportion with different types of debt (%)

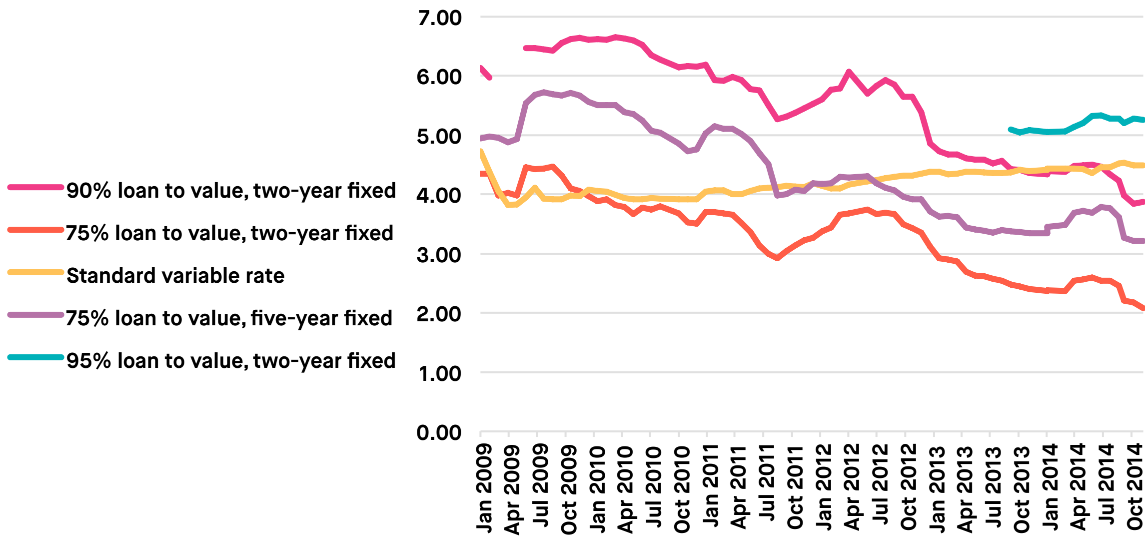


Source: SMF and Understanding Society Policy Unit analysis of BHPS and UKHLS. Credit card debt refers to outstanding debt that the respondent was unable to pay off.

Mortgagors

Low interest rates in the past few years have protected those with mortgages in a period when incomes have been stagnant. Repossessions have been limited, as rates fell, particularly for fixed rate deals.[29] This has meant that housing costs for those on mortgages actually fell as mortgage payments decreased.[30] However, the OBR expects mortgage interest rates to start rising again in around 2017,[31] which will place more pressure on households in the coming years.

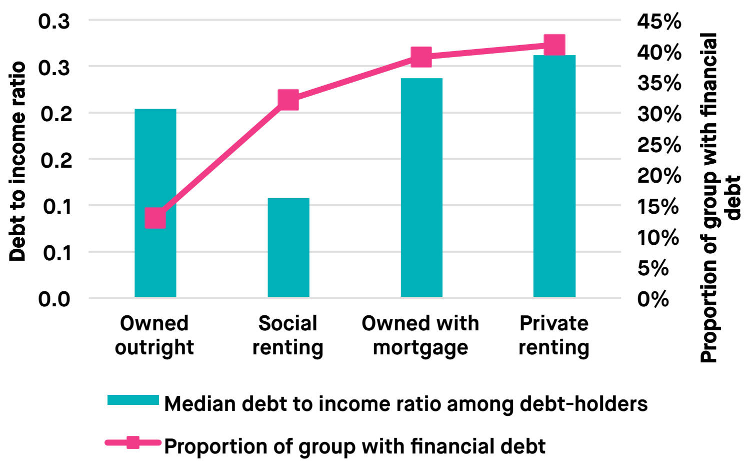
Figure 21: Interest rates on mortgages (%)



Source: Bank of England Trends in Lending January 2015

Loan to-value and loan-to-income ratios on new mortgages peaked before the crisis and have since declined.[32] However, around 40% of those with mortgages also have other forms of financial debt, as shown in the chart below. They are far more likely to have debt than those that own outright, and those living in social housing; and have similar debt levels to those in private rented accommodation.

Figure 22: Who is most at risk? Debt and tenure

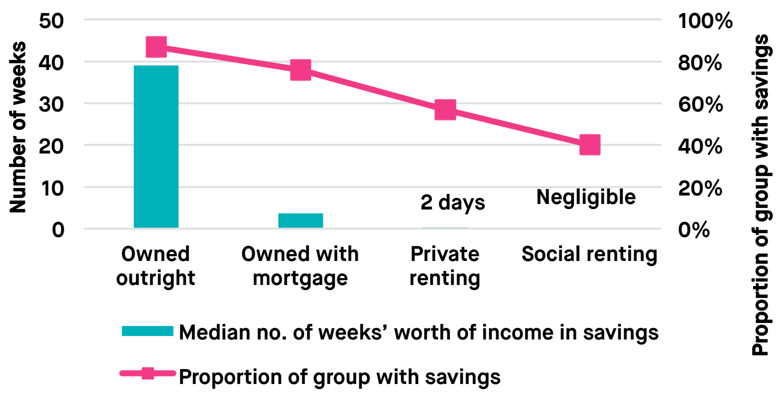


Source: SMF and Understanding Society Policy Unit analysis of BHPS and UKHLS. Non-mortgage debt only

The proportion of those with mortgages who also have other debt has fallen since 2005, when it stood at 46%. However, the value of financial debt among individuals with a mortgage has increased. Mortgagors that also have other forms of debt owe around £5,000, up from around £3,500 in 2005. This is a real terms increase of 36%. This means that 40% of mortgagors also have financial debt, and the median value of this financial debt is equivalent to 20% of their incomes.

Interest rate rises are likely to be even more difficult to cope with for these individuals, who also have other, non-mortgage, debt repayments to make. This means it is likely to be more difficult to cut down on other areas of spending to finance higher mortgage repayments. Relying on savings may be an option for some. But whilst over three quarters of those with a mortgage have some savings, the amounts saved are relatively small – equivalent less than four weeks' worth of income. This compares to an average of 39 weeks' worth of income in savings among those that own outright.

Figure 23: Who is most at risk? Savings and tenure



Source: SMF and Understanding Society Policy Unit analysis of BHPS and UKHLS

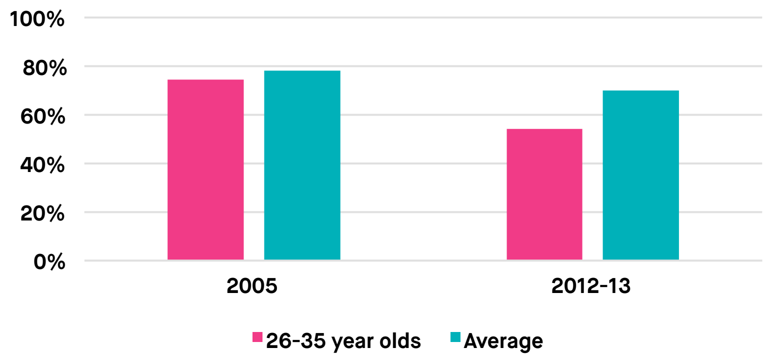
26-35 year olds

Younger people in the early stages of their careers have seen substantial financial pressures in recent years. The fall in real wages affected younger age groups the most. From 2008 to 2013, median weekly wages among those in their twenties fell by around 10%, and for those in their thirties by 7%, compared to less than 5% in older age groups.[33]

Meanwhile, housing has become more expensive. During the period that is the focus of our analysis, 2005 to 2013, house prices rose by around 17%. This has made it harder to save up sufficiently for a deposit. Research shows that the level of deposit put down by first time buyers has been increasing, standing at just under £31,000 in 2012-13.[34]

As a result, home ownership has declined substantially among this age group, as shown in the chart below. Whilst the proportion that own a home has dropped by around ten percentage points on average, it has dropped by around 20 percentage points in the 26-35 age category.

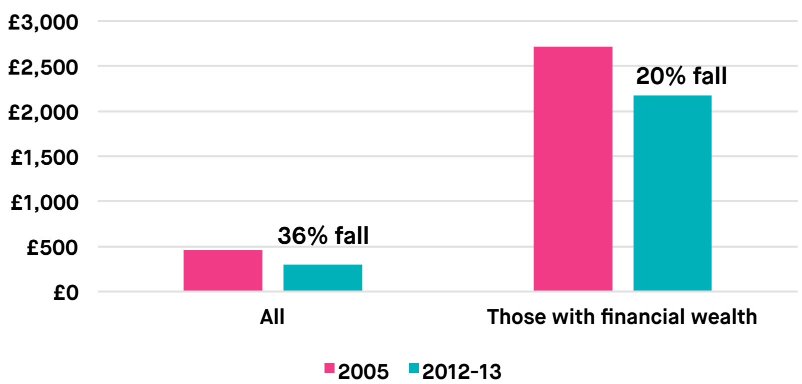
Figure 24: Proportion of homeowners



Source: SMF and Understanding Society Policy Unit analysis of BHPS and UKHLS

Mirroring the drop in property wealth, the 26-35 age group also has less in saving than previously. The proportion with financial wealth in this group has dropped slightly – from 65% to 63%. However, actual amounts held have dropped by an even larger amount – by 36% across the entire group. The median value held is far below the level of an average deposit on a home. Whilst the amount needed to buy a home has been increasing, the amount this group has in savings has been falling. This is in sharp contrast to the population average: as seen in Chapter 1, the average trend has been for financial wealth to increase.

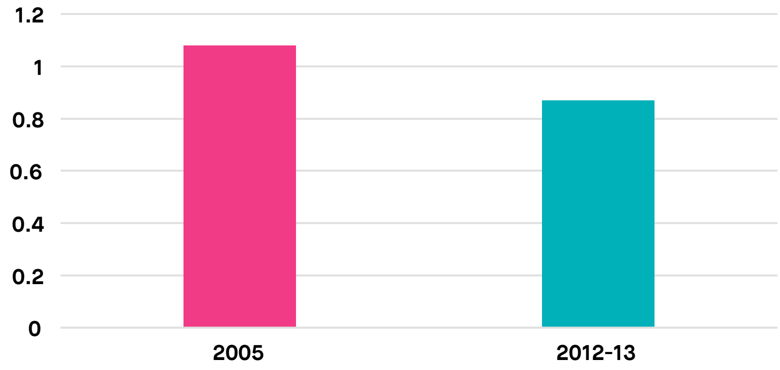
Figure 25: Amounts held in financial wealth - 26-35 year olds



Source: SMF and Understanding Society Policy Unit analysis of BHPS and UKHLS

Further, the 26-35 age group are less well-prepared for potential interruptions in, or falls in income compared to the rest of the population. On average, they have less than one weeks' worth of savings, compared to four weeks across the rest of the population. As can be seen from the chart below, this is a deterioration from 2005.

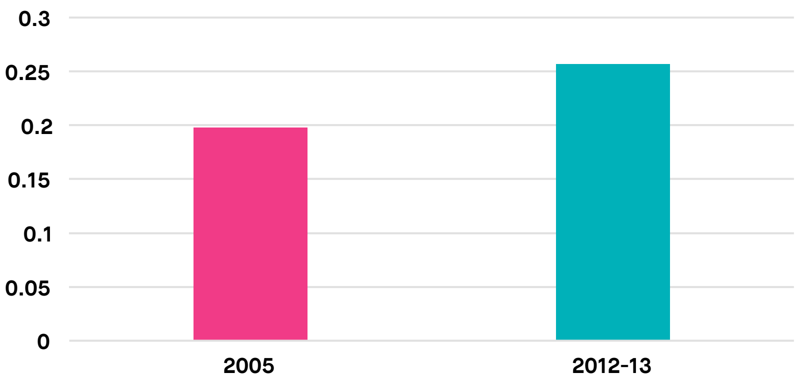
Figure 26: Number of weeks' worth of savings, 26-35 year olds



Source: SMF and Understanding Society Policy Unit analysis of BHPS and UKHLS

And whilst the proportion of this age group with debt has slightly fallen – from 55% to 51%, the value of debt held has increased. Among debt-holders in the 26-35 year old category, the median debt value in 2012-13 was £5,300, a real terms increase of 45% since 2005. This means that the debt to income ratio has risen, as shown in the chart below. Debt for this age group is around 26% of income.

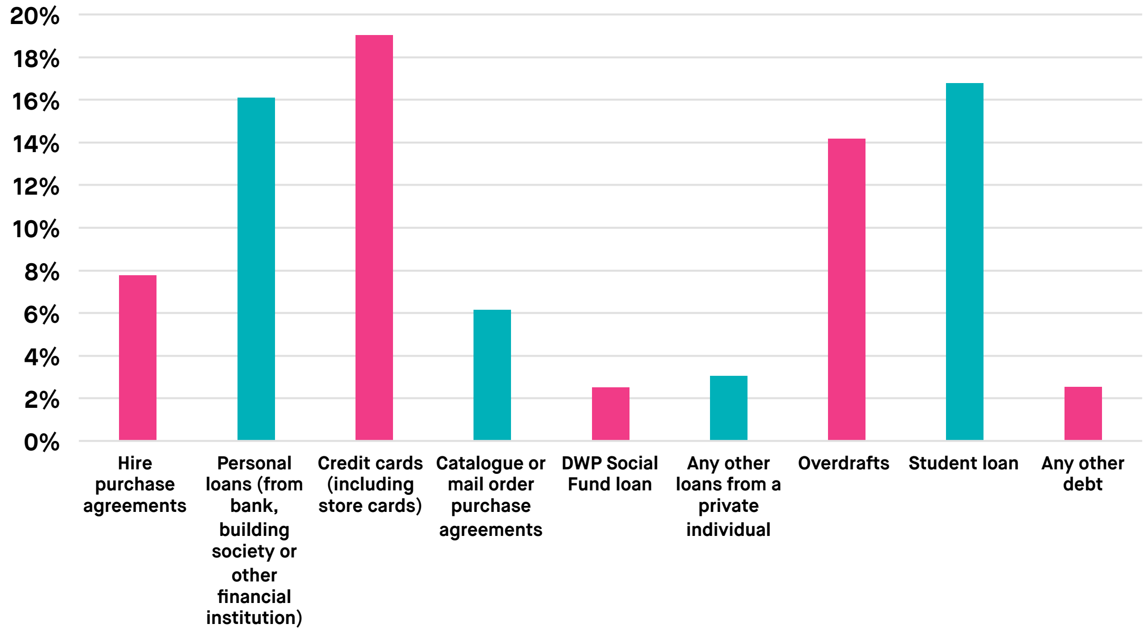
Figure 27: Debt to income ratio, 26-35 year olds



Source: SMF and Understanding Society Policy Unit analysis of BHPS and UKHLS. Base: debt-holders only

The most common forms of debt among 26-35 year olds are credit cards, personal loans, student loans and overdrafts. Since 2005, the proportion with personal loans has fallen, and the proportion with overdrafts has increased. With research finding that overdrafts can in some cases be as costly as payday loans, a potential risk is that a larger proportion of those in debt are using higher cost forms of credit.

Figure 28: 26-35 year olds - proportion with different types of debt



Source: SMF and Understanding Society Policy Unit analysis of BHPS and UKHLS. Credit card debt refers to outstanding debt that the respondent was unable to pay off.

In summary:

- Financial resilience has, on average, increased. But this masks some substantial differences.
- Those on lower incomes and those in younger age groups are now less financially secure than on the eve of the downturn. Among both these groups, there has been a rise in the reliance on overdrafts, which are often a relatively costly form of credit.
- Meanwhile, a substantial proportion of those with mortgages also have other types of debt, and the value of that debt has risen.

CONCLUSIONS

UK households went into the downturn poorly prepared, with low levels of savings and high levels of debt. Since then, there has been a remarkable rise in savings, as financial uncertainties pushed individuals to pay down debt and put more aside for "rainy days".

But it is clear that not everyone has been able to do this. Poor wage growth and rises in the cost of living have made deleveraging impossible for some. And indeed, many are worse off than previously.

The winners include:

- **The top 20%:** When wealth and debt is broken down by income group, it is clear that the majority of deleveraging has taken place at the top of the income distribution. The top income group are far more financially secure today than they were going into the downturn. They have more in savings, and are less likely to be in debt compared to the middle-income group – a reversal of the pre-crisis trend. The top 40% have also seen an improvement, although the increase in financial security is not as substantial.

- **Homeowners:** Property contributes to overall wealth. But in addition to this, homeowners – particularly outright homeowners – have been able to add much more to their financial wealth, as they have benefited from lower housing costs. But there is an increasing divide in home ownership, with drops in the likelihood of owning a home, particularly among those on lower incomes and those in younger age groups.

The losers include:

- **The bottom 20%:** The lowest income group are less financially secure today than going into the downturn. They have higher levels of debt, which have risen faster than income; and their savings – already fairly small – have shrunk even further. To a lesser extent, the same is also true for the bottom 40%.

- **26-35 year olds:** Wages for younger workers have fallen substantially – at a greater rate than the average. 26-35 year-olds today are less likely to own a home and have less in savings than 26-35 year-olds before the downturn. And whilst the proportion of 26-35 year olds in debt has slightly fallen, the amount they owe has increased.

There are two growing divides in wealth and financial resilience that warrant further attention. The first is the widening wealth gap between those on the lowest incomes and those on the highest. The second is the widening intergenerational gap. Wealth has followed wages in declining substantially among those on low incomes and those in younger age groups. Better support is needed to help these groups improve their financial preparedness. But building the financial resilience of those on the lowest incomes is particularly challenging, because this group has fewer opportunities to save. To some extent, the same is true of younger workers whose wage prospects saw a sharper deterioration than average in the downturn. The changing shape of wealth and debt is likely to increase the reliance on financial support provided from one generation to another.

For many, the process of repairing their personal finances is likely to only begin happening in the next year, if forecasts of sustained wage growth do indeed materialise. At the same time, the next few years is likely to see substantial additional public spending cuts. Pressure to reduce the welfare bill is likely to make it even more difficult for those on low incomes to build up financial security.

The next Government faces a long-standing challenge of how to build a more resilient economy based on financially secure households. Whilst there has been much Government focus on long-term saving, such as pensions, the need to encourage short-term saving is, particularly for some groups, stronger than it has been for some time.

Yet, there is also a trade-off here. Short-term GDP growth depends in great part on consumer spending continuing to strengthen. The current period of low interest rates means that the OBR forecasts that overall household debt as a proportion of income will start rising again in 2015, with consumer spending rising faster than disposable incomes. But the analysis in the paper shows that many are even less financially secure today than before the downturn. For these individuals, there is little room to start spending more.

ANNEX 1: DEFINITIONS AND METHODOLOGY

Data sources and sample sizes

The analysis in this report is based on data from the British Household Panel Study (Wave O, sample size of 11,943) and Understanding Society (Wave 4, sample size of 42,600). The data provides household and individual-level information on assets, debt and wealth for 2005 and 2012-13. The number of respondents that appear in both waves is 6,894.

For some respondents, elements of the data are missing. Individuals may not respond to a specific question, for example a respondent may tell us they have a loan but not the outstanding balance. For such individuals we impute information, based on an 'individual' with similar characteristics, following Crossley and O'Dea (2010) and Banks, Smith and Wakefield (2002). This is known as conditional hot deck imputation. Results in Chapters 1 and 3 make use of the full sample available in the two surveys. Chapter 2 focuses on tracking individuals over time and so only looks at respondents that appear in both waves. We impute wealth and debt based on age, whether an individual is in self-employment, whether they have a degree and their gender. As a precaution, we have checked our results using imputation-free data, and find no substantial differences.

Definitions of assets and debt

The full list of items included in financial assets and debt are set out below.

Financial assets	Financial debt
Savings or deposit accounts (bank, post office or building society) N.B. This does not include current accounts (except for a very small minority)	Hire purchase agreements
National Savings Bank (post office)	Personal loans (from bank, building society or other financial institution)
TESSA only ISA or Cash ISA	Credit cards (including store cards)
National Savings Certificates	Catalogue or mail order purchase agreements
Premium Bonds	DWP Social Fund loan
Unit Trusts/Investment Trusts (excluding ISAs/PEPs)	Any other loans from a private individual
Stocks and shares ISA or PEP	Overdrafts
Shares (UK or foreign/excluding ISAs and PEPs)	Student loan
National Savings Bonds, (Capital, Income or Deposit)	Any other debt
Other investments, (Gilts, government or company securities)	
Other savings (asked in UKHLS only)	

Individuals and households

The data sources we use provide information on debt and assets held individually and jointly (within a household). In this paper, we look at individual-level data on debt and assets. This allows us to analyse changes over time even among individuals whose household circumstances change. For example, slightly fewer than 70% of the people who appear in both waves have the same partner (including people who remain single in both waves) in 2005 as they do in 2012, and they have higher average income than people who either lost or gained a partner, or underwent some other form of household change.

Our construction of individual-level holdings is based on firstly, holdings that the respondent says are held individually, and secondly, a share of the holdings that are held jointly. The share of joint holdings is estimated by dividing the relevant figure by household size.

The principal difficulties in constructing individual-level measures of debt and wealth for joint holdings are (i) missing data from one person in a couple and (ii) conflicting information on jointly held wealth or debt. To overcome these difficulties, we apply the following rules:

- If both partners agree that they have no shared debt/wealth, or agree on the amount of shared debt/wealth, we use this amount without further modification.
- If both partners say they have shared debt/wealth but the amounts conflict, we take the mid-point between the two amounts.
- If one partner says they have an amount of shared debt/wealth, but the other partner says they do not share any, we take the mid-point between the reported amount and zero.
- If one partner gives information on shared debt/wealth (whether they have it or not, and the amount), and the other partner does not respond to the questions, we take the data from the partner who responded.

For income, we use real equivalised household income. Equivalisation adjusts household income to reflect household size and composition, and so is a better measure of individual resources than individual income or household income.

Weighting

Both BHPS and Understanding Society (UKHLS) are samples which are representative of the UK population. However, non-responses and missing data can skew the results when conducting analysis. In order to derive results which are representative of the UK population each sample member is assigned a weight whose value can be thought of as how many individuals they represent. Whilst BHPS and Understanding Society contain a set of pre-estimated weights these are not suitable for this particular piece of research. There are two reasons for this:

1. Household net income data in the BHPS is only available for households where all adults gave a full individual interview.
2. Longitudinal weights in UKHLS are only available for BHPS respondents in 2001, given our base year is 2005 these would be incorrect. Moreover these do not correct for the fact that only a subsample of BHPS respondents were in the BHPS net income data files.

Therefore new cross section weights were required for BHPS cross section analysis and longitudinal weights for analysis of the linked BHPS-UKHLS sample.

To derive these new weights, a logit model was estimated where the dependent variable was set to one if we observed the individuals net household income and zero otherwise. A range of household and demographic variables were included in the analysis. The inverse of the estimated probability of observing net household income is the new cross-section weight. The longitudinal weights are derived in a similar fashion but in this case the dependent variable of interest is whether an individual is still a sample respondent at wave 4 of UKHLS.

ANNEX 2: RESULTS TABLES

As set out in Chapter 2, there is considerable variation in patterns of asset and debt accumulation within groups. In this Annex, we report both medians and interquartile ranges for specific results in Chapter 2 to show the extent of this variation.

Age and change in value of financial assets

Age in 2005	Median change	Interquartile range		Sample size
16-25	1.23	-12.3	1854.84	776
26-35	0	-934.8	2616.21	1187
36-45	0	-1230	5015.94	1510
46-55	988.92	-1045.5	16584.09	1174
56-65	949.56	-4329.6	24716.85	1163
66-75	0	-8602.62	12608.73	762
76 and older	-30.75	-7380	7154.91	320

Tenure and change in value of financial assets

Tenure in 2005	Median change	Interquartile range		Sample size
Own outright	747.84	-6993.78	23630.76	2172
Own with mortgage	296.43	-1230	8095.86	3321
Social renting	0	-246	296.43	940
Private renting	0	-1230	2875.74	459

Change in tenure and change in value of financial assets

Change in tenure during 2005 to 2012	Median change	Interquartile range		Sample size
No change	0	0	0	4924
Private renting -> owning	0	-3563.31	0	146
Owning -> renting (any)	83.64	-615	2570.7	380
Owning outright -> owning with mortgage	0	-984	0	152
Owning with mortgage -> owning outright	2472.3	-259.53	0	983
Other change	0	-86.1	889.29	307

Income group and change in value of non-mortgage debt

Quintile in 2005-06	Median change	Interquartile range	Interquartile range
Quintile 1	329.64	-1867.14	4618.65
Quintile 2	102.09	-2319.78	3713.37
Quintile 3	-549.81	-5557.14	1953.24
Quintile 4	52.89	-4672.77	4220.13
Quintile 5	-746.61	-5078.67	4803.15

ENDNOTES

[1] ONS, Economic Review February 2014 (2014)
[2] In real terms. ONS, The effects of taxes and benefits on household income, 2012/13 (2014)
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[4] Bank of England, Household debt and spending, in Quarterly Bulletin 2014 Q3 (2014)
[5] IMF, United Kingdom: Selected Issues Paper July 2011 (2011)
[6] Bank of England Household debt and spending, Quarterly Bulletin 2014 Q3
[7] Ashoka Mody, Franziska Ohnsorge and Damiano Sandri, Precautionary Savings in the Great Recession, IMF working paper WP/12/42 (2012)
[8] Ashoka Mody, Franziska Ohnsorge and Damiano Sandri, Precautionary Savings in the Great Recession, IMF working paper WP/12/42 (2012)
[9] Nida Broughton, Onyinye Ezeyi and Claudia Hupkau, Riders on the storm, Social Market Foundation (2014)
[10] ONS, Quarterly national accounts, data series NRJS
[11] OBR, Economic and Fiscal Outlook December 2014 (2014)
[12] The full definition of each category is included in Annex 1
[13] Excluding men over 65 and women over 60
[14] Nida Broughton, Onyinye Ezeyi and Claudia Hupkau, Riders on the storm, Social Market Foundation (2014)
[15] Emily Farchy and Jeff Masters, Savings on a shoestring, Social Market Foundation (2014)
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[17] Although Understanding Society as a whole has rolling fieldwork over a two year period (2012-13), the British Household Panel Study members who are still part of Understanding Society are interviewed in the first year of that two year period.
[18] Elaine Kempson and Andrea Finney, Saving in lower-income households: a review of the evidence (2009)
[19] See Nida Broughton, Onyinye Ezeyi and Claudia Hupkau, Riders on the storm, Social Market Foundation (2014)
[20] See Annex 2 for full tables showing means and interquartile ranges
[21] Again, there is substantial variation in the amounts saved. We report medians here as the distribution is heavily skewed, with a "long tail" of individuals experiencing more extreme changes. See Annex 2 for more details.
[22] HM Treasury, Forecasts for the UK economy, February 2015 (2015)
[23] OBR, Economic and Fiscal Outlook December 2014 (2014)
[24] The Money Advice Service recommends having three months of essential outgoings in an instant access account. https://www.moneyadviceservice.org.uk/en/articles/emergency-savings-how-much-is-enough
[25] Jonathan Cribb, Andrew Hood and Robert Joyce, Living standards: recent trends and future challenges, IFS (2015)
[26] IFS, Green Budget 2015 (2015)
[27] IFS, Green Budget 2014 (2014)
[28] FCA, Consumer credit insights: overdrafts (2014)
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[31] OBR, Economic and Fiscal Outlook December 2014 (2014)
[32] Bank of England, Financial Stability Report June 2014 (2014)
[33] IFS, Green Budget 2015 (2015)
[34] Halifax, Largest annual increase in first-time buyers since 2001 (2014)