Topic 1

Financial planning and money management

Learning outcomes

After studying this topic, you will be able to:

- explain what is meant by ‘financial planning’ and other financial terms;
- explain what is meant by the term ‘money management’;
- outline the need for financial planning;
- identify financial services providers and basic products;
- identify sources of financial planning information and advice.

Introduction

Once we start in the world of work, we have money coming in, bills to pay, things to buy and dreams and hopes to fulfil. We could just let things happen and hope for the best, but that would be asking for trouble! In order to make sure that everything happens as we want, we need to manage our money and make financial plans. This topic will provide an overview of money management and financial planning. We will look at these subjects in more detail in later topics.

As Mr Micawber advised the hero in Charles Dickens’s famous Victorian novel *David Copperfield*:

> ‘Annual income twenty pounds, annual expenditure nineteen [pounds] nineteen [shillings] and six [pence], result happiness. Annual income twenty pounds, annual expenditure twenty pounds [n]ought and six [pence], result misery.’

Believe it or not, £20 a year wasn’t far below a realistic income in 1850. In Victorian times, people who couldn’t pay their debts could be sent to debtors’ prison, and Mr Micawber was speaking from experience, because he was always in debt.

Discuss

What was the key message that Mr Micawber was trying to give to David Copperfield?

1.1 Terminology

Before we consider the main issues in this topic, let's make sure that we understand some important terms. Can you explain what we mean by the terms 'money management', 'budgeting' and 'financial planning'?

Let's see whether you agree with the following descriptions.

- **Money management** is the process of managing money, which includes budgeting, banking, saving, making investments and paying as little tax as possible within the law. It covers pretty much everything, from day-to-day spending to saving for long-term goals.
- **Budgeting** is part of general money management. It's the way that you manage your day-to-day money, making sure that you have enough to pay bills, buy food, save and pay for other essential spending.
- **Financial planning** is another part of money management. It looks at the person's needs and objectives, both in the short term and the long term, and how best to achieve them.

An objective is simply a target: something that a person wants or needs to have achieved within a certain period. In a financial planning context, we can divide objectives into two closely linked types.

1. **Personal objectives** – what the individual wants to achieve. Examples would be buying a holiday home, going on holiday to the Caribbean or buying a new car.
2. **Financial objectives** – how the individual will provide the money to reach their personal objective. For example, if you need to have a sum of money available in five years' time, what is the best way to achieve this?

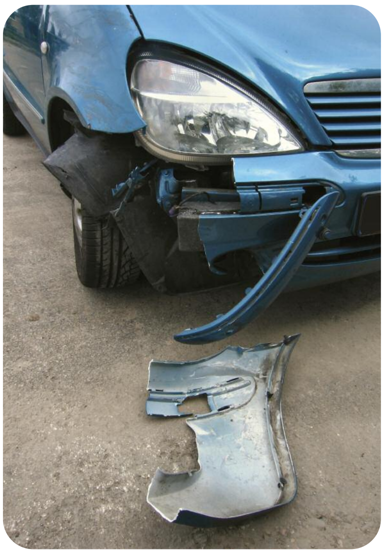
A financial plan will consider what you need and want, now and in the future, and set out the best way to meet those needs and wants. It will include how much you need to save each month and the type of product to put the savings in. Financial planning allows the individual to understand how each financial decision they make affects other areas of their finances.

As you can see, managing your money on a day-to-day basis is an important part of financial planning, and financial planning will help you to manage your money, so the two are very closely interlinked.

1.2 Emergency funds

We all know that life doesn't always go according to plan – washing machines break down,

cars need repairing,



and other financial surprises often occur.

This means that it is important that people build up an emergency fund they can dip into if disaster strikes. The amount needed will vary from person to person, but advisers generally suggest that an amount between three and six months' essential expenditure would be a sensible minimum amount for most families. Some advisers would recommend three to six months' net income (the amount you make after compulsory deductions) as a reasonable amount.

The best place for an emergency fund would be in a building society or bank savings account that allows instant access to the money.

1.3 The benefits of sound financial planning

We'll be considering financial planning in more detail in Topics 2 and 3. Let's look briefly at the reasons why financial planning is so important.

Sound financial planning helps us to:

- Make sure that important people and things are protected.
- Identify what our objectives and needs are, and plan to achieve them.
- Select sensible and affordable borrowing products if we need to borrow, and avoid unnecessary borrowing.
- Know what needs to be done to reach those objectives and goals, rather than hoping for the best.
- Feel relaxed about our finances.
- Make better decisions about spending, saving and borrowing.
- Understand how each financial decision we make affects other areas of our finances.
- Know what we're doing on a day-to-day basis.
- Adapt if our needs or objectives change.
- Ensure that more of our own money is available to us.

1.4 Financial providers and products

The UK is one of the world's most important financial centres, and has a large number of firms and organisations that offer products and tools to help people and businesses to manage their money and plan their finances efficiently. We'll look at some of these in more detail in later topics, so for now we'll consider the key points.

1.4.1 Financial providers

1.4.1.1 Banks

Banks have been around in the UK for over 300 years, and have three main roles:

1. to provide a safe place for people to keep their money;
2. to provide a way for account holders to receive payments and pay bills;
3. to provide loans and mortgages for customers who need to borrow money.

Banks are 'proprietary' organisations, which means that they are businesses owned by, and responsible to, shareholders.

1.4.1.2 Building societies

Building societies have been in existence for almost 250 years. Historically they have provided a place for people to put their savings and receive interest, and the funds raised from savings were used to provide loans for their members to buy a house or pay for other needs.

Providing savings accounts and loans is still the main role of building societies, but they can now also provide current accounts, other investments and many services similar to banks.

They are 'mutual' organisations, which means that they are owned by their members rather than shareholders, although in most respects they are similar to banks.

1.4.1.3 Insurance companies

Insurance companies provide insurance policies that help people and businesses to reduce financial risk caused by a number of events.

The policies are designed to pay out money to help people who suffer loss as a result of a specific event covered by the policy. For example:

- life assurance pays out money if the insured person dies ('assurance' is often used interchangeably with 'insurance' in this context);
- critical illness assurance pays out if the insured person is diagnosed with a specified serious illness;
- buildings insurance pays for damage to buildings caused by a range of events.

We'll take a brief look at the main insurance products later in this topic.

1.4.1.4 Investment companies

Investment companies invest money for people, with a view to making a profit for them. The companies usually offer ‘collective funds’, where everybody’s money is pooled together for investment – the main products are unit trusts and open-ended investment companies.

The idea is that the company has experts who will invest the money efficiently, usually in stocks and shares, and make a profit for the investor – although a profit is not guaranteed. The wide range of funds offered covers the needs of different investors.

There are three potential advantages of pooling everyone’s money together for investment, compared to an individual making their own investments.

1. Some investment costs are fixed, regardless of the size of the investment, and others vary with the investment. Larger investment amounts should result in lower costs for making the investments, due to ‘economies of scale’. An example of ‘economy of scale’ is where a supermarket is able to negotiate a lower price for each packet of biscuits compared to what a small independent shop owner would pay. This is because the supermarket can guarantee to order lots more biscuits and the supplier can cut the price but still make a good profit. Investment firms can negotiate lower variable costs, and can share the fixed costs among all the investors.
2. Sometimes there are quite high minimum investment amounts for certain investments, or investing small amounts just doesn’t make sense for a ‘small’ investor. This might prevent an individual investor from making that investment, but an investment firm will have larger amounts and can gain access to those investments.
3. Investment firms have research teams and investment experts to make investment decisions.

1.4.2 Financial products

1.4.2.1 Current accounts

Current accounts are offered by banks and many building societies. Customers’ money is held in a safe place, and there are various regulations to protect their money.

Current accounts are designed for day-to-day finances, and provide the following main features:

- receiving salaries, pensions and other regular payments into the account;
- payment of regular bills through direct debits (a form of automatic payment that can be set up easily);
- a debit card, which is a special card that allows the holder to pay for things in shops or online, and allows the holder to take money out through an automated teller machine (ATM), sometimes called a ‘hole in the wall’ or a ‘cash machine’;
- cheque books;

A cheque is a form that the account holder can complete and sign as a way of paying a bill or paying money to someone else. Cheques are quite old-fashioned now that we have online banking, but many people still use them. They are particularly useful when paying tradespeople, such as plumbers and electricians, who carry out repairs in people's homes and who may not want the expense of having to buy or lease a card machine like the ones in shops (called 'Electronic Point of Sale [EPoS] systems').

- online facilities – most providers offer online facilities that allow customers to check their account, pay bills and move money;
- some accounts pay interest on the money in the account;
- most accounts provide an 'overdraft' facility, which means the account holder can take out or pay out more money than they have in the account for a short period, as long as they don't go over a certain limit and do pay back what they have borrowed;
- regular printed bank statements, which show the account holder all the money going into and out of the account and how much is in the account on the date of the statement.

Bank statements allow the account holder to check their spending and to keep track of their budget. Online accounts allow the account holder to see an up-to-date statement at any time of day, which gives them even more control.

1.4.2.2 Savings accounts

Banks and building societies offer savings accounts, which offer interest on the money held in the account.

Savings accounts don't usually offer the same features as current accounts, so they usually can't be used to receive salaries or make regular payments. They focus on providing a reasonable interest rate and are ideal as a home for money left over in the current account.

We will look at savings accounts in more detail in Topic 3.

1.4.2.3 Borrowing products

We will look at the range of borrowing products in detail in Topic 10, so for now here is a brief overview.

The main borrowing products are as follows.

- **Mortgages** – these are loans to help people buy houses or flats. They are offered mainly by banks and building societies and can last for up to 30 years. Each month, the borrower makes a payment to the lender, consisting of repayment of some of the debt and interest on the outstanding debt. Mortgages are 'secured' loans, which means that the lender has legal rights over the property if the borrower doesn't make payments as agreed. The rights include taking the property and selling it to repay the mortgage, if necessary.

- **Personal loans** – these are offered by banks, building societies and some specialist firms. They are usually paid back over a much shorter term than mortgages – usually between one and five years – by making monthly payments, consisting of repayment of some of the debt and interest on the debt. Personal loans are not secured (also known as 'unsecured'), which means that the lender has no legal rights over property, or any other things of value (assets), if the borrower fails to make payments. For this reason, interest rates are generally higher for personal loans than for mortgages.

- **Credit cards** – these are offered by banks, building societies and some specialist firms. They allow the cardholder to borrow money, by paying for things using the credit card. As long as a minimum payment is made each month, the cardholder can choose how much to pay back each month, which means that the borrowing could go on for a long time. Credit cards are not secured and are generally the most expensive way to borrow, unless the balance is paid in full every month.

1.4.2.4 Insurance products

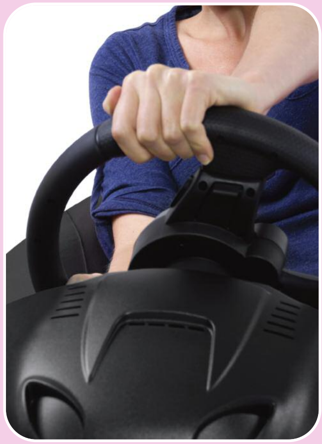
All insurance products require the policyholder to pay for the policy – this payment is known as the 'premium' and is usually paid monthly. The premium amount depends on the risk of the company having to pay out, which is based on what the policy covers and the person and their circumstances. In return for the premium, the insurer agrees to pay a certain amount or to provide a service, known as 'the benefit', if the policyholder suffers a problem covered by the policy.

We can look at car insurance as an example. Car insurance covers a number of things resulting from car accidents, including repairs to cars involved, medical costs for those injured in an accident, lump-sum payments to families of those killed in accidents and other associated costs. It also covers theft of the car and some non-accidental damage.

Did you know?

According to road safety charity Brake:

- Drivers aged between 17 and 24 have a much higher risk of crashing than older drivers.
- Drivers aged 17–19 make up 1.5% of UK licensed drivers, but they are the driver in 9% of fatal and serious crashes.



This shows that young drivers are more of an insurance risk than older drivers, so car insurance is much more expensive for them.

When the insurer works out the premium for car insurance, they will look at a number of things.

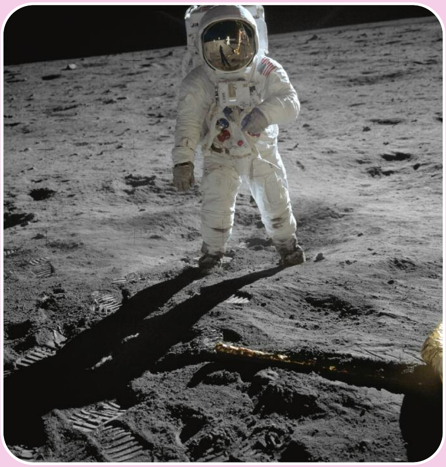
- **The age of the insured person and anybody else who will drive the car** – as explained above, together with their driving record. This covers previous accidents and convictions for speeding and other motoring offences.
- **The type of car** – generally, the more powerful the car, the higher the premium, because it may be driven faster. Certain makes and model of car, such as BMW, Audi, Porsche and other prestigious brands, are very attractive to thieves and so are at higher risk of theft. They are also more expensive to repair.
- **Where the insured person lives** – there are more accidents in big cities, such as London or Manchester, due to the number of cars on the roads. In addition, some towns or cities, or areas within them, have higher levels of car theft and other car crime. Often, the insurer will assess the risk by postcodes, with owners living in high-risk postcode areas paying more.

Examples of risks covered by other insurance policies include the following.

- **Death** – life assurance pays a lump sum if the insured person dies while the policy is in place. In families this is used to support the surviving family members, if a parent or breadwinner dies, by enabling them to pay off debts, such as a mortgage, and/or to provide funds to help with living expenses. Life assurance premiums are based on life expectancy – how long someone is likely to live, based on their age and health. Obviously, healthy older people are more expensive to insure than healthy younger people, as there is more risk of them dying. Some people with very serious medical conditions may not be able to get life assurance at all, because the chance of them dying earlier and the insurer having to pay out is too high to make it a reasonable risk for the insurer.

Did you know?

Due to the huge risks involved, Neil Armstrong, Buzz Aldrin and Michael Collins couldn't get life assurance before they went to the moon with the Apollo 11 spaceflight. Knowing that they would be making history, they created their own form of insurance, by signing hundreds of autographs that their families could sell in the event of their death.



(Source: Business Insider)

- **Serious illness or injury** – policies are available that will pay a lump sum if the policyholder is diagnosed with a specified serious illness, such as getting cancer or suffering a heart attack. Other policies replace the policyholder's income if they can't work due to illness or injury. The insurer will base the premium on the risk posed by the person's age, health, job and other personal factors.
- **The need for medical treatment** – private medical insurance allows the insured person to receive private treatment for medical problems that would require them to have an operation or other hospital treatment. This allows them to avoid long waiting times for National Health Service treatment.

- **Damage or theft relating to a home or business property** – buildings insurance pays for repairs to property that is damaged or destroyed by a range of events, such as fire, storms, accidents, theft and so on. Contents insurance covers the contents of a home, such as furniture, TVs, clothes, bedding and valuables, against loss or damage due to a similar range of events.
- **Medical treatment for pets** – this type of insurance pays for vets' bills.
- **Motor accidents or theft** – we looked at car insurance earlier in this section. It is a legal requirement for all car owners to have car insurance.

1.5 Sources of help

There are a number of sources available for those looking for help with money management and financial planning.

1.5.1 Citizens Advice

Citizens Advice is a registered charity that organises and co-ordinates the activities of 3,300 Citizens Advice bureaux (offices) in major towns and cities throughout the UK. The role of each bureau is to help people sort out their legal and money problems, by providing advice and information. The advice given is free, and advisers will usually be able to provide help with budgeting, state benefits, debt problems and general financial issues.

1.5.2 The Money Advice Service and money advice centres

The Money Advice Service is an independent body, set up by the government to help people looking for advice with their financial affairs. The service is free and impartial, and can be accessed face to face through a UK-wide network of money advisers, through the website, by phone, by web-chat and through printed guides.

The website has sections providing information and general advice about managing money and financial products, and a section containing a range of tools to help people to assess and plan their finances.

In addition to providing advice, the Money Advice Service is the government-appointed body responsible for improving the public's understanding and knowledge of financial matters and managing their financial affairs.

Many local authorities also provide free debt and benefit advice through money advice centres.

It was announced in the March 2016 Budget that the Money Advice Service will be replaced by a smaller, more focused organisation, most likely during 2018. When you have time, do an internet search to find out whether more details have been released.

1.5.3 StepChange Debt Charity

The StepChange Debt Charity is a registered charity whose purpose is to assist people who are in financial difficulty, by providing free, independent and realistic advice from trained advisers. Advice is offered through a free telephone advice line and eight centres in the UK.

> **My finances got out of hand and I found myself in financial trouble. I ended up owing £15,000 to a number of organisations and it all got on top of me. I contacted the StepChange Debt Charity for free advice. The adviser suggested that I manage my debt by agreeing with my creditors to pay back as much as I can reasonably afford.**

1.5.4 Banks and building societies

Banks and building societies are usually able to offer basic advice on money management and planning to their customers without charge. After all, it's in their own interest to make sure that their customers can run their bank accounts and mortgages efficiently. They may charge if the situation is complicated or requires a lot of work.

1.5.5 Financial advisers

Financial advisers offer advice to individuals and businesses, and help with a wide range of financial matters, including:

- general financial planning;
- insurance;
- mortgages;
- pensions;
- investment and savings;
- tax planning;
- debt advice.

Advisers must achieve specific qualifications in order to provide advice to the public, and their activities are regulated by the Financial Conduct Authority. They must provide advice and recommendations about suitable products or actions after assessing the individual's needs. Not all financial advisers are able to advise on all matters, and some choose to specialise in specific areas.

There are two types of financial adviser: independent financial advisers; and financial advisers giving 'restricted advice'.

Independent financial advisers (IFAs) like me must recommend products and solutions from the whole of the market. The 'market' means all the provider companies that offer similar products, so I must select a suitable product from all those that meet the customer's needs. I must not favour any particular company and must not make any arrangements that would restrict the range available. These rules mean that an IFA like me must provide impartial advice, based on what's best for the customer.

I fall into the category of financial advisers giving 'restricted advice', which means that I can offer products from one company or a limited number of companies, rather than from the entire market, although any recommendation must still be suitable for the customer's needs. If I can't offer a suitable product from the range that I have available, I should not make a recommendation. I work in a bank, and advisers working in banks and building societies will usually be in the 'restricted advice' category, because we will only offer our bank or building society's own products, or products from providers linked to them.

Financial advisers are likely to offer a more detailed and wide-ranging service than Citizens Advice or the Money Advice Service, but the service will not be free. Some advisers offer a free initial consultation, but will charge a fee for any work after that meeting.

IFAs can be found by looking on Unbiased.co.uk, which lists 26,000 advisers by postcode, and also allows searches by adviser specialty.

1.5.6 Credit unions

Credit unions are non-profit-making financial co-operatives, run for the benefit of their members. The members are all linked by a ‘common bond’. In simple terms, the common bond means that all the members are linked in some way, perhaps by living in the same area, working for the same employer or belonging to the same club, church or other association.

The main purpose of credit unions is to provide savings accounts and loan facilities for their members, but part of the philosophy of the credit union movement is to provide financial education and training for members to manage their money.

Summary

Finally, we can recap what we have learned in this topic.

We have learned about:

- the importance of money management, budgeting and financial planning;
- the different providers and products available to help with money management and financial planning.

Key terms

Budgeting – managing day-to-day money to pay bills, buy food, save and pay for other essential spending.

Credit card – a form of borrowing offered by banks, building societies and some specialist firms. It allows the cardholder to borrow money by paying for things using the credit card, but is generally the most expensive way to borrow, unless the balance is paid in full every month.

Emergency fund – a pot of money that can be used to cover emergencies, such as unexpected spending, loss of income or other unexpected financial problems.

Financial Conduct Authority – one of the two main regulators of financial services in the UK. It sets rules and standards that providers must meet.

Financial planning – making plans to meet short- and long-term needs.

Money management – the process of managing money, including budgeting, banking, saving, investing and tax planning.

Mortgage – a loan to help people buy houses or flats. They are offered mainly by banks and building societies and can last for up to 30 years.

Net income – the amount a person earns after deductions have been taken by the government, ie for tax and National Insurance (see Topic 8).

Objective – a target; something that the individual wants or needs to achieve.

Personal loan – offered by banks, building societies and some specialist firms. It is usually paid back over a much shorter term than a mortgage, and tends to be unsecured, so the providers charge higher interest rates to cover the risk.

Unit trust – the most common form (in the UK) of collective fund, allowing many investors to pool their money together.

Bibliography and further reading

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Business Insider (2012) *Neil Armstrong couldn't afford life insurance* – available at: http://www.businessinsider.com/neil-armstrong-couldnt-afford-life-insurance-so-this-would-have-taken-care-of-his-family-if-he-died-2012-8?IR=T

Citizens Advice – available at: www.citizensadvice.org.uk/

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UK coin designs © Crown / Royal Mint; 2008 redesigns by Matthew Dent.

Dickens, Charles (1849) *David Copperfield*.

Mr Micawber watercolour by Joseph Clayton Clarke (Kyd)

RAC Foundation (no date), *Safety* – available at: www.racfoundation.org/motoring-faqs/safety#a8

StepChange Debt Charity – www.stepchange.org/