How Resilient Are You To Financial Shocks?

Life events happen to us all; anything from falling ill to losing a job, or separating from a partner. Any of these events can have a dramatic impact on our financial positions.

A new report from debt charity StepChange, Life happens: Understanding financial resilience in a world of uncertainty has revealed that people who had experienced a life event in their household within the past two years are three times as likely to be in problem debt when compared with those who have not.

This higher propensity to face problem debt in the years after a significant life event comes despite a range of coping strategies, which in many cases don't appear to be working as planned.

The more coping strategies an individual deploys, the more likely they are to be in problem debt following a life event. This suggests that even seeking help and guidance from different sources isn't sufficient to prevent getting into financial difficulty when things go wrong.

It's worth noting that many people do manage to avoid falling into problem debt following a life event; it's far from inevitable that this will be the outcome.

The report found that many people are trying to cope with their existing budgets and savings, but this isn't enough to keep them out of debt.

A common tactic used by people following a life event was to cut back on expenditure. More than a third of those surveyed tried this approach, with more than a quarter dipping into cash savings.

However, nearly half of the people surveyed who used their cash savings were either in problem debt or showing signs of financial distress. A similar number of those who cut back on their expenditure faced a similar financial position. This is not to say that savings are unimportant in creating financial resilience; they certainly are!

But modest cash savings can be quickly eroded following a significant life event such as the loss of a job. The typical financial planning rule of thumb is to hold the equivalent of three months of expenditure in cash savings as an emergency fund. Those three months can fly by quickly following a life event.

StepChange also found that those who resort to borrowing following a life event are left particularly vulnerable to problem debt.

If savings are spent or didn't exist in the first place, then borrowing money is often the next port of call following a significant life event. The research found that of the one in five people who had to borrow money from family and friends, nearly three-quarters ended up in problem debt.*

Using a credit card or overdraft to borrow resulted in an even higher incidence of problem debt following a life event. StepChange explains in their report that the benefits system is a valuable source of financial support following a life event, but only for a minority of people

Only around 15% of people appear to apply for state benefits following a life event. But nearly half of those who successfully applied for benefits managed to avoid financial difficulties.*

So when benefits work, they work. But eligibility for benefits that can make a positive difference appears to be limited.

Finally, and perhaps unsurprisingly, the research found that people with higher incomes were more likely to rely on credit to cope with shocks in life.

People in households earning more than £30,000 a year were slightly more likely to rely on a credit card or overdraft following a life event, with lower-income households more likely to rely on friends or family to lend money.

This research is interesting because it concludes that unexpected life events trigger most debt problems.

By understanding this issue and putting steps in place to boost financial resilience ahead of a life event - reducing expensive debt, building cash savings, and insuring against significant risks - you improve your chances of avoiding financial difficulty in the future.

*Source: https://www.stepchange.org/policy-and-research/life-happens.aspx