Cost of Cash ISAs

A commissioned report by Cebr for Scottish Friendly

October 2018

Scottish Friendly has provided a unique insight into the financial health of the UK population with its quarterly disposable income index survey since 2014. Now, in this specially commissioned report, Cebr, the Centre for Economics and Business Research, look at that most popular of investment vehicles, individual savings accounts (ISAs) and how they have shaped our finances. In particular we look at the nation's ongoing love affair with saving in cash accounts in preference to shares and the attitudes surrounding this.

Authorship and acknowledgements

This report has been produced by Cebr, an independent economics and business research consultancy established in 1992. The views expressed herein are those of the authors only and are based upon independent research by them.

The report does not necessarily reflect the views of Scottish Friendly, October 2018

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Executive Summary

Individual savings accounts (ISAs) were introduced in April 1999, and allow UK savers to accrue tax-free interest or investment returns. There are a variety of different types of ISAs, the most common of which are cash ISAs and stocks & shares ISAs. Historically, cash ISAs have offered interest rates well-above the rate of inflation, meaning that users of this savings vehicle can enjoy meaningful real-terms returns on their deposits. However, since the Bank of England slashed its base rate in the aftermath of the financial crisis, the typical interest rate on cash ISAs has steadily fallen, eating into savers' returns. Meanwhile, despite a high degree of volatility, stock market returns have tended to outperform the interest rates offered on cash ISAs, particularly in recent years.

In this report, we examine the returns that typical cash ISA savers will have seen for a range of different scenarios, and compare these with the returns that could have been realised had the equivalent sums been invested in stocks & shares ISAs. From this, we find:

- A sum of £3,000 deposited in a cash ISA in April 1999 will be worth £5,735 as of October 1st 2018, assuming that the interest rates received were in line with the national average. Meanwhile, if the same amount was deposited in a stocks & shares ISA tracking the FTSE All-Share Index, the value of the savings would have stood at around £6,435 as of October 1st 2018;
- If an individual utilised their full ISA allowance each year from 1999 to the present, a total of £20,628 of tax-free interest will have been accrued if the money were invested solely in cash ISAs. This is less than a third of the estimated £70,987 that will have been accrued had the same money been invested in stocks & shares ISAs tracking the FTSE All-Share Index;
- If an individual deposited their full annual allowance in an average cash ISA in September 2016 (£15,240), they will have accrued just over £225 in interest over the following two years. This is a 4% real terms decline in the value of savings. By contrast, had the same amount been deposited in a stocks & shares ISA tracking the FTSE All-Share Index, savers will have made a gain of £2,344 by September 2018. Even after adjusting for inflation, this represents a 9% positive return on investment.

We also estimate that at a national level since 1999, savers in the UK have missed out on £127 billion in additional returns by depositing their money in cash ISAs rather than stocks & shares ISAs.

The report goes on to analyse how rates of saving and investment vary across the country, by looking at the amount average households have available to put aside for saving each week as well as the amount that is actually put away. We find:

- Households in Northern Ireland and Yorkshire & the Humber spend on average 32% of their weekly income on non-essentials – the highest share in the UK. This likely reflects lower costs of non-essential goods & services, and implies that households in these regions have the greatest potential to save. Meanwhile, households in Wales and the West Midlands spend 28% and 27% of their respective weekly incomes on non-essential goods and services;
- In absolute terms, households in the South East spend the most in the UK both on pensions and other savings and investments. The lowest levels of saving are found in Northern Ireland and the North East, reflecting the lower levels of average income in these areas;
- When including pension contributions, households in the South East and the East of England allocate the largest share of their weekly discretionary income to saving. When excluding pension contributions, households in the South West and the South East allocate the largest share of their weekly discretionary income to saving.

A consumer survey of 2,000 UK adults carried out to support this research reveals that current and savings accounts remain by far the most common savings vehicles. Meanwhile, 40% of survey respondents indicated that they use a cash ISA, compared with 18% who use a stocks & shares ISA. Among those that do not have a stocks & shares ISA, the most commonly listed reasons for this are a lack of understanding of this savings vehicle (cited by 23%) and a fear of losing money (cited by 22%).

1 Cash ISA savers see 4% decline in real value of savings in last two years

Individual savings accounts (ISAs) provide UK residents with the opportunity to enjoy tax-free interest from their savings. There are a variety of different types of ISA, including a standard cash ISA and stocks & shares ISAs, which invest savings into various possible portfolios of assets. The annual individual allowance for ISAs has risen from £3,000 in the 1999/2000 financial year to £20,000 in the 2017/18 financial year.

1.1 Cash ISAs

Since their inception in April 1999, the average interest rate offered on savings deposited in cash ISAs has moved broadly in line with the Bank of England's (BoE) base rate – typically diverging by less than 0.5 percentage points from the BoE rate. Following the 2008 global financial crisis and the series of drastic BoE rate cuts that followed, the average rate offered on cash ISAs has declined steadily, although it has recovered marginally in recent months.

Figure 1 Cash ISA interest rates, BoE base rate and CPI inflation rate since introduction of ISAs in April 1999

Source: Bank of England, Office for National Statistics, Cebr analysis

In the months and years immediately following the introduction of ISAs in April 1999, annual rates of interest paid on cash ISAs were frequently more than 6 percentage points above the rate of inflation, making them a highly attractive option for savers. While the gap between cash ISA rates and inflation did narrow somewhat, annual real returns (the return after accounting for inflation) still averaged 3.2% between 1999 and 2007.

Since 2010, inflation has more often than not exceeded the average interest rate paid on cash ISAs, meaning that users of this savings vehicle have in fact been witnessing a real terms decline in the value of their savings. This issue has become particularly pronounced following the EU referendum in June 2016, as the consequent depreciation of the pound led to a sharp increase in inflation via rising import costs.

Meanwhile, cash ISA returns have remained stubbornly low, meaning that over the last two years, cash ISA savers have faced negative annual real returns averaging 1.6%.

1.2 Stocks and shares ISAs

While the average interest rate on cash ISAs has been languishing at or below 1% over the past two years, stock market returns both in the UK and internationally have been considerably higher. As of October 15th 2018, the FTSE All-Share Index, which includes over 600 companies listed on the London Stock Exchange, will have delivered effective annual returns of 5.1% over the last two years, 5.8% over the last five years and 5.2% over the last 19 years going back to 1999. Meanwhile, the annual rate of CPI inflation has averaged just over 2% during this period. Unlike most cash ISAs, providers of stocks & shares ISAs typically charge fees to manage the account. A review of the current market shows that these fees vary significantly between different providers, but on average are around 1.4% per year.

It is worth noting that despite offering significantly higher real returns on average, the volatility of returns from stocks and shares ISAs is also far greater. For instance, the FTSE All-Share Index lost over a third (37%) of its value between October 2007 and October 2008. That being said, the bulk of these losses were clawed back over the subsequent two years.

1.3 Stylised case studies

To examine the typical returns that individuals using cash ISAs or stocks & shares ISAs may have seen in recent years, we have developed a range of stylised case studies[1]:

1. An individual who deposited £3,000 in a cash ISA in 1999 at the average available interest rate for that year, and then 12 months later reinvests the full amount (including the interest accrued) in another account that pays the average interest rate offered for that particular year. It is assumed that this pattern continues uninterrupted until 2018.
2. The same as case study 1, but assuming that the money is invested in a stocks & shares ISA which tracks the FTSE All-Share Index, with an annual fee of 1.4%.
3. An individual who saves the maximum permitted amount in a cash ISA each year at the average available interest rate for that year.
4. The same as case study 3, but assuming that the money is invested in a stocks & shares ISA which tracks the FTSE All-Share Index, with an annual fee of 1.4%.
5. An individual who saves £15,240 in a cash ISA in September 2016 at the average available interest rate for that year, and then 12 months later reinvests the full amount (including the interest accrued) in another account that pays the average interest rate offered at that point in time.
6. The same as case study 5, but assuming that the money is invested in a stocks & shares ISA which tracks the FTSE All-Share Index, with an annual fee of 1.4%.

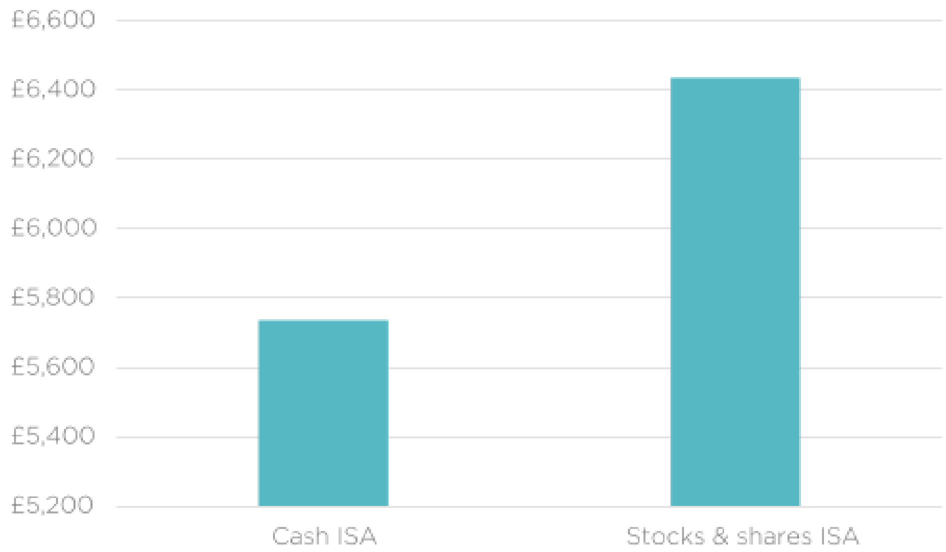
1 In calculating savings returns for each case study, we have used data running from 1st April 1999 to October 1st 2018. Data on average annual interest rates on cash ISAs are published by the Bank of England. Data on total returns from the FTSE All-Share Index are published by the Financial Times Stock Exchange.

Case studies 1 & 2

A sum of £3,000 deposited in a cash ISA in April 1999 will be worth £5,735 as of October 1st 2018, assuming that the interest rates received were in line with the national average. This represents a nominal gain of £2,735. However adjusting for inflation, the gain diminishes to just £881 in 1999 prices, equating to a real annual interest rate of 1.3%.

Meanwhile, if the same amount was deposited in a stocks & shares ISA tracking the FTSE All-Share Index, the value of the savings would have stood at around £6,435 as of October 1st 2018 – a gain of £3,435.
After adjusting for inflation, the gain falls to £1,354 in 1999 prices, equating to a real annual interest rate of 1.9%.

Figure 2 Current value of a £3,000 investment made in April 1999 into a cash ISA vs a stocks & shares ISA

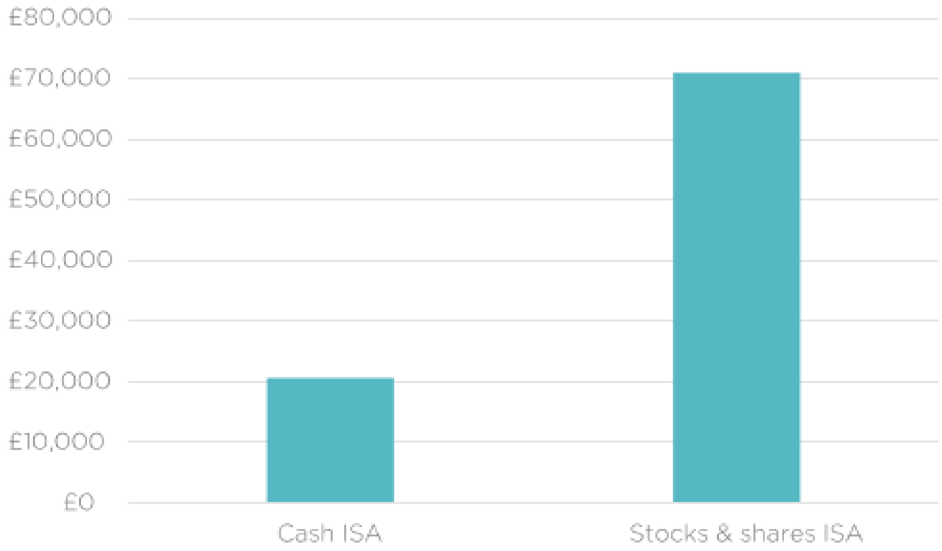


Source: Bank of England, Office for National Statistics, Financial Times Stock Exchange, Cebr analysis

Case studies 3 & 4

Case studies 3 and 4 examine a case in which an individual utilises their full ISA allowance each year from 1999 to the present. In total, this would equate to £131,860 being invested in cash ISAs over the last twenty years. Assuming that the interest rate received on these savings corresponded to the national average each year, a total of £20,628 of tax-free interest will have been accrued. This is less than a third of the estimated £70,987 that will have been accrued had the same money been invested in stocks & shares ISAs tracking the FTSE All-Share Index.

Figure 3 Gains from investing maximum annual ISA allowance into cash ISAs since 1999 vs gains from investing in stocks & shares ISAs



Source: Bank of England, Office for National Statistics, Financial Times Stock Exchange, Cebr analysis

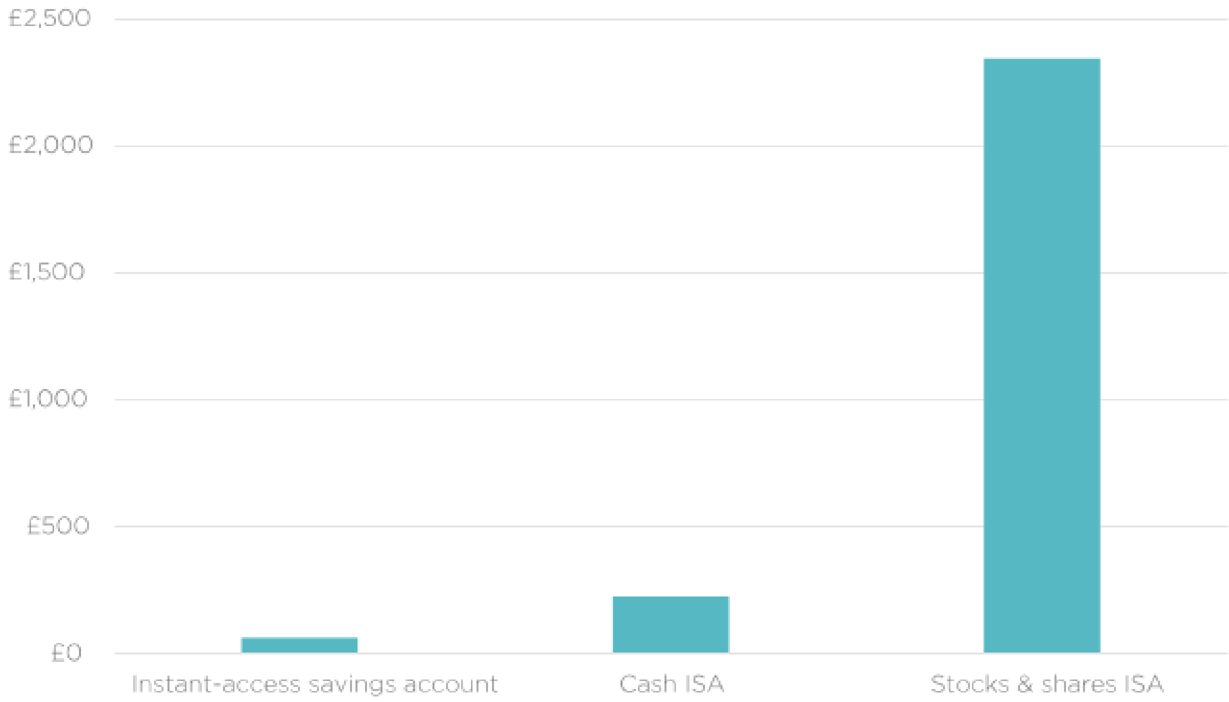
Case studies 5 & 6

Case study 5 examines a case in which an individual deposited their full annual allowance in a cash ISA in September 2016 (£15,240). Such an investment will have led to an accrual of just £225 in interest over the following two years. This figure is even less impressive when considering that inflation has risen considerably since 2016, eating into the real value of savings. Indeed, individuals who deposited £15,240 in a cash ISA in September 2016 will have seen this diminish to £14,620, in September 2016 prices. This is a 4% real terms decline in the value of savings, equating to a real annual interest rate of -2.1%.

By contrast, had the same amount been deposited in a stocks & shares ISA tracking the FTSE All-Share Index, savers will have made a gain of £2,344 by September 2018. Even after adjusting for inflation, the value of savings in September 2018 would stand at £16,623 in September 2016 prices. This represents a 9% positive return on investment (equating to a real annual interest rate of 4.4%).

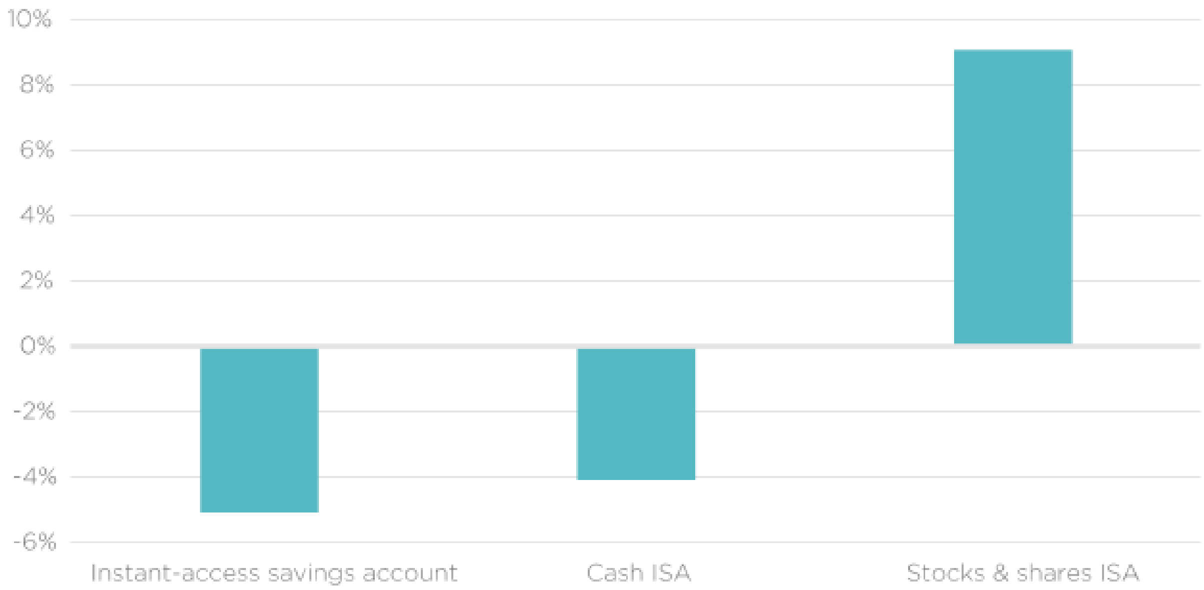
While the returns from cash ISAs over the past two years have been meagre, they are slightly higher than those yielded by instant-access savings accounts. A sum of £15,240 deposited in an average instant- access savings account in September 2016 will have accrued just £64 in interest over the following two years, leading to a real terms decline of 5%.

Figure 4 Nominal gains from investing £15,240 in a cash ISA in September 2016 vs gains from investing in a stocks & shares ISA



Source: Bank of England, Office for National Statistics, Financial Times Stock Exchange, Cebr analysis

Figure 5 Inflation adjusted returns from investing £15,240 in a cash ISA in September 2016 vs gains from investing in a stocks & shares ISA



Source: Bank of England, Office for National Statistics, Financial Times Stock Exchange, Cebr analysis

1.4 National level analysis

According to the latest data from HMRC, at the start of the 2018/19 financial year there was over £270 billion in savings deposited in cash ISAs in the UK. This compares to £337 billion deposited in stocks and shares ISAs.[2] Figure 6 shows that the value of savings held in cash ISAs has flatlined in recent years. This can be attributed to a number of factors. Firstly, interest rates on cash ISAs have remained highly suppressed, incentivising savers to opt either for the convenience of instant-access savings accounts or the higher returns offered by stocks & shares ISAs or fixed-rate accounts. Another factor is the introduction of the Personal Savings Allowance in 2016, which allows basic rate taxpayers to earn up to £1,000 in savings income tax-free. This has nullified one of the primary advantages that cash ISAs previously offered over other savings vehicles.

Figure 6 Value of savings held in cash ISAs and stocks & shares ISAs in the UK, between 1999 - present

Source: HM Revenue and Customs

Since ISAs were introduced in 1999, the annual interest rate offered on cash ISAs has averaged around 3.2%. Meanwhile, the annual return on a stocks & shares ISA tracking the FTSE All-Share Index (assuming a 1.4% annual account fee) has averaged roughly 5.6%. This discrepancy means that the decision to deposit savings in cash ISAs instead of investing in the stock market has had a significant impact on the aggregate level of savings for UK households. Based on the average annual interest rates on cash ISAs, we estimate that UK households have accrued nearly £75 billion in tax free interest from this savings vehicle. However, were all the money deposited in cash ISAs between 1999 and 2018 placed into stocks & shares ISAs instead, UK savers would have enjoyed an estimated £127 billion in additional investment returns.

[2] In April 2008, all Personal Equity Plan accounts automatically became stocks & shares ISAs.

2 South East leads the way in saving

Saving and investment patterns are determined not only by household preferences and behaviours but also to a large extent by the amount of income households have available to put aside. In this section, we examine how saving and investment varies across the UK, using data from the Office for National Statistics' (ONS) most recent Living Costs and Food Survey.

2.1 Spending on essentials and non-essentials

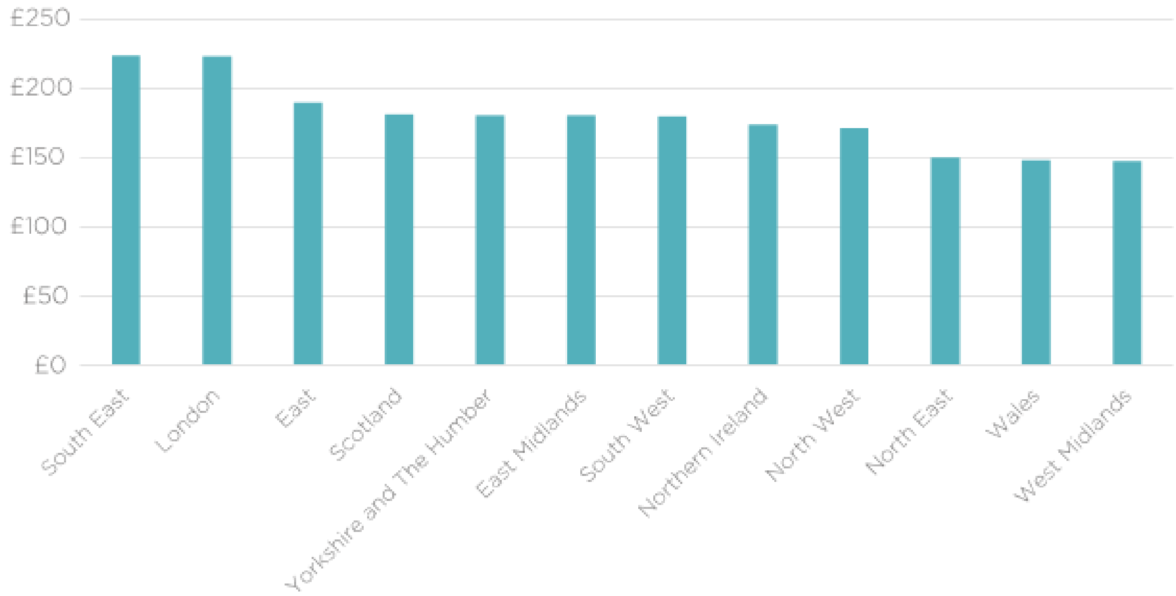
For the purposes of our analysis, we have defined essential spending as all expenditures on:

- Food & non-alcoholic drinks;
- Clothing & footwear;
- Housing, fuel & power;
- Household goods & services;
- Health;
- Transport;
- Communications;
- Insurance; and
- Loan servicing.

Whatever post-tax income is left-over from this essential spending is categorised as non-essential spending. The level of non-essential spending represents the upper bound limit on the amount an average household can in theory put aside for saving or investing each week.

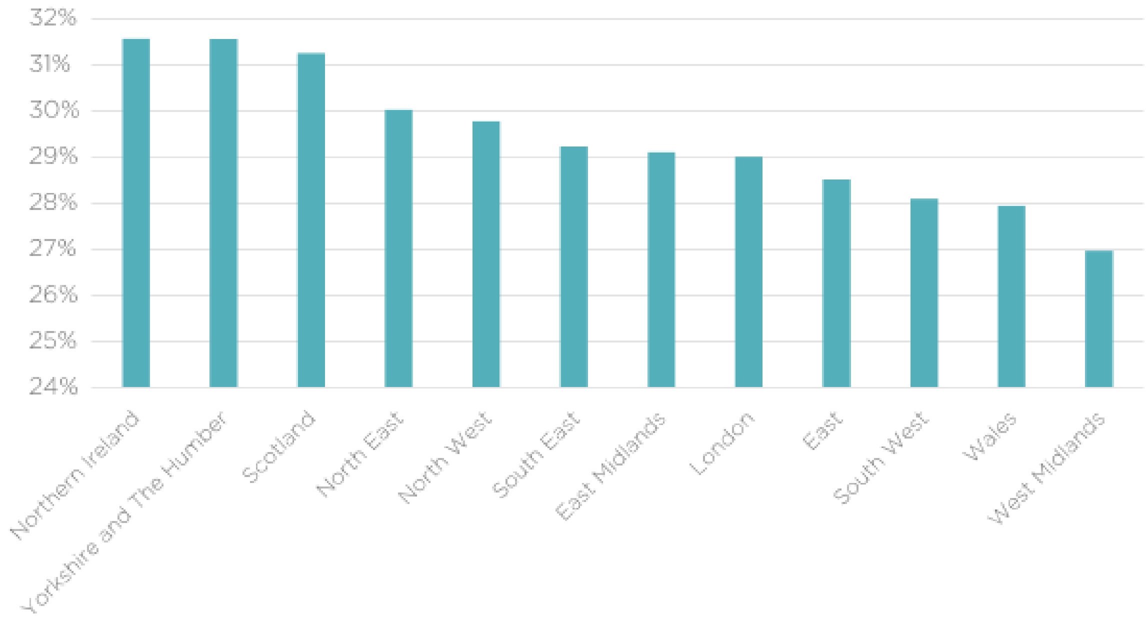
The weekly level of non-essential spending is significantly higher in London and the South East than elsewhere in the UK, which reflects above average incomes as well as higher costs of goods and services. However, when looking at non-essential spending as a share of total spending, these two regions fall below the UK average as a result of the high cost of essentials such as housing and food. Households in Northern Ireland and Yorkshire & the Humber both spend on average 32% of their weekly income on non-essentials – the highest share in the UK. This implies that households in these regions have the greatest potential to save. Meanwhile, households in Wales and the West Midlands spend only 28% and 27% of their respective weekly incomes on non-essential goods and services. These regions also have the lowest level of non-essential spending in absolute terms.

Figure 7 Average weekly household expenditure on non-essential goods and services, by region



Source: Office for National Statistics, Cebr analysis

Figure 8 Share of post-tax income diverted to non-essential spending, by region

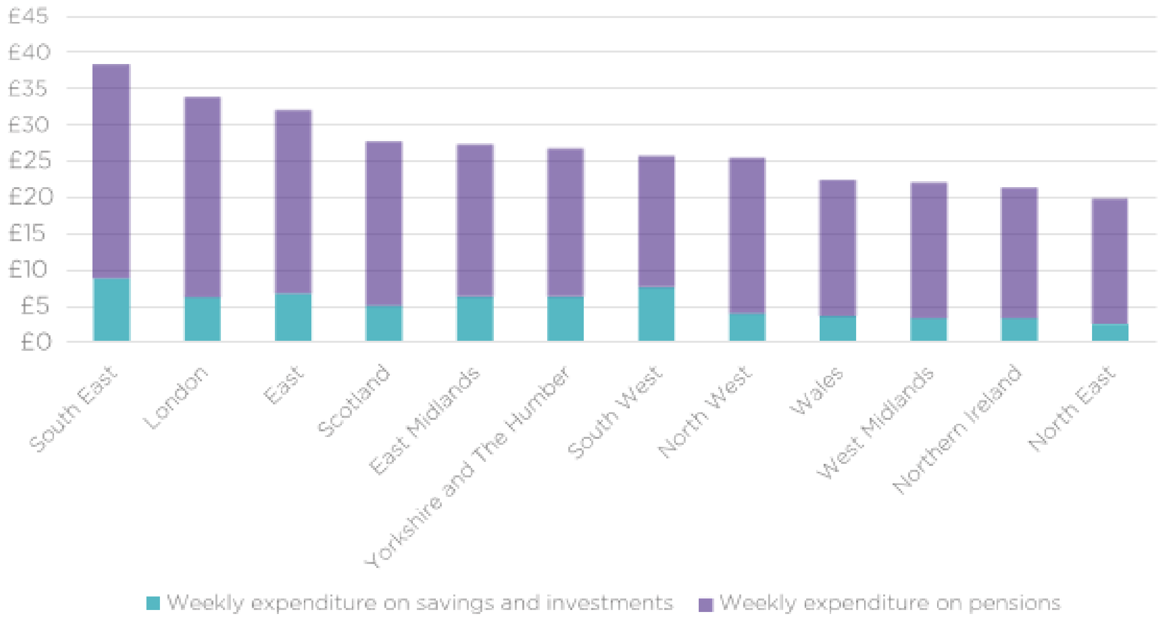


Source: Office for National Statistics, Cebr analysis

2.2 Expenditures on savings and investments

The Living Costs and Food Survey also details the average weekly amount allocated to savings and investments in each region. In absolute terms, households in the South East spend the most in the UK both on pensions and other savings and investments. Following the South East is London, where households spend on average £27.60 per week on pension contributions and £6.30 per week on other savings and investments. The lowest levels of saving are found in Northern Ireland and the North East, reflecting the lower levels of average income in these areas.

Figure 9 Average weekly household expenditures on pensions, savings & investments, by region



Source: Office for National Statistics, Cebr analysis

When including pension contributions, households in the South East and the East of England allocate the largest share of their weekly discretionary income to saving. When excluding pension contributions, households in the South West and the South East allocate the largest share of their weekly discretionary income to saving. Interestingly, there is no obvious correlation between the share of weekly income dedicated to pensions and the share dedicated to other savings and investments. On the one hand, households that put away more money towards their pension could be perceived as more forward-looking with a higher tendency towards saving in general. On the other hand however, directing more money towards a pension would divert it away from other savings vehicles. It appears from the regional data that these two effects broadly balance each other out.

Figure 10 Share of savings & investments and pensions contributions in non-essential spending, by region

Source: Office for National Statistics, Cebr analysis

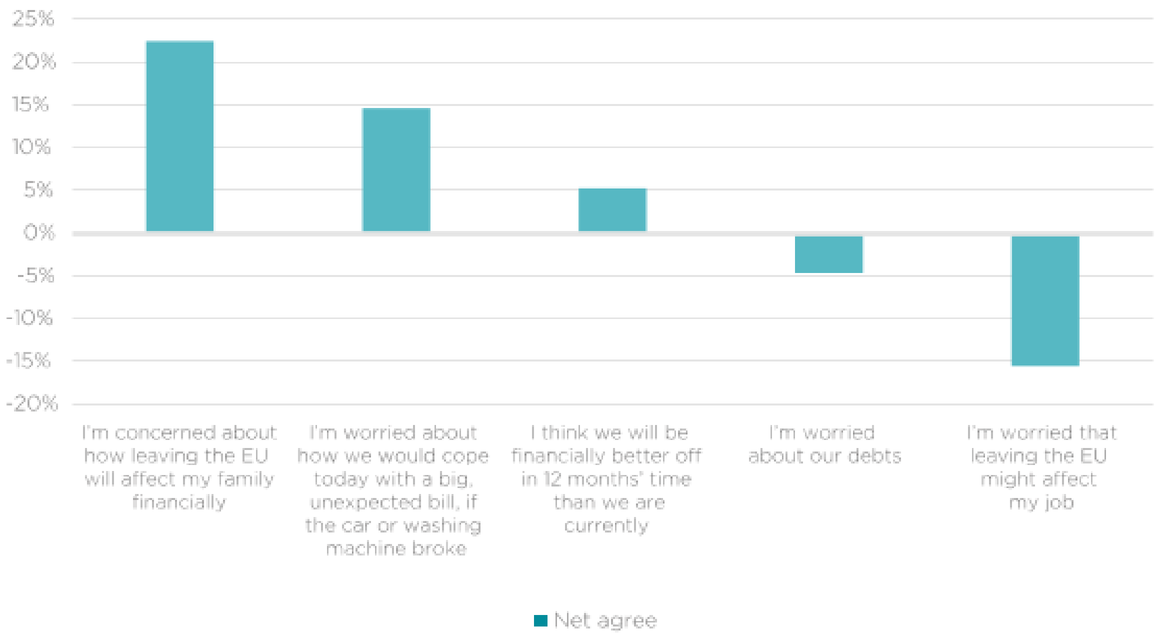
3 Cash ISAs remain more than twice as popular as stocks & shares ISAs despite weak returns

To supplement the preceding research, we commissioned a survey of 2,000 adults, which shines a light on saving behaviours and attitudes in the UK.

3.1 Financial concerns

The survey first looks at individuals' financial worries and concerns. The results show that the financial impact of Brexit is the largest concern, with a net of 22% stating that this is a worry. More than a third (37%) of respondents said that they were worried about their debts, highlighting how the rapid growth in consumer credit in recent years has left its mark on household finances. However, this share is admittedly outweighed by the 41% of survey respondents who said that their debts were not a concern. Meanwhile, more than a quarter (26%) of individuals in our survey feel that they have less money left at the end of the month after paying for essentials than they did 12 months ago, compared to one in five (20%) who feel they have more left over. This reflects the squeeze in living standards that many households have experienced given persistently weak growth in average real earnings.

Figure 11 Individuals' main financial concerns

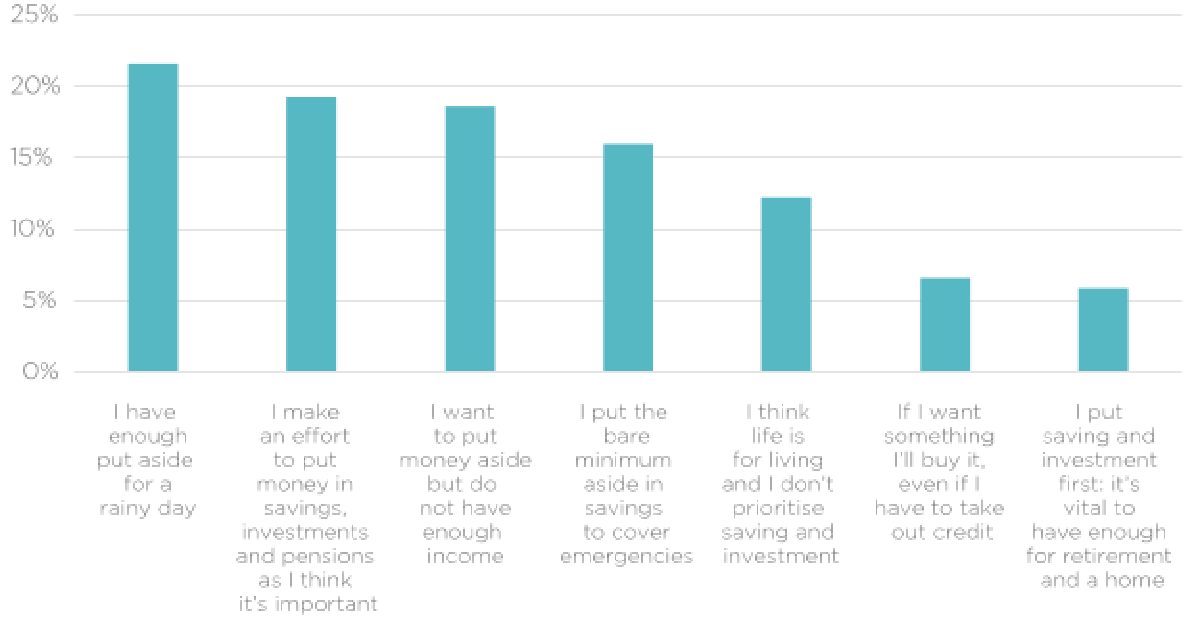


Source: 3Gem, Cebr analysis

3.2 Attitudes and behaviours towards saving/investment

Less than half (47%) of individuals in our survey decide to or are able to allocate a significant amount of their income to savings. One in five (19%) would like to put money aside but do not have sufficient income for this, while 35% choose not to dedicate a large amount of their income to savings or investments.

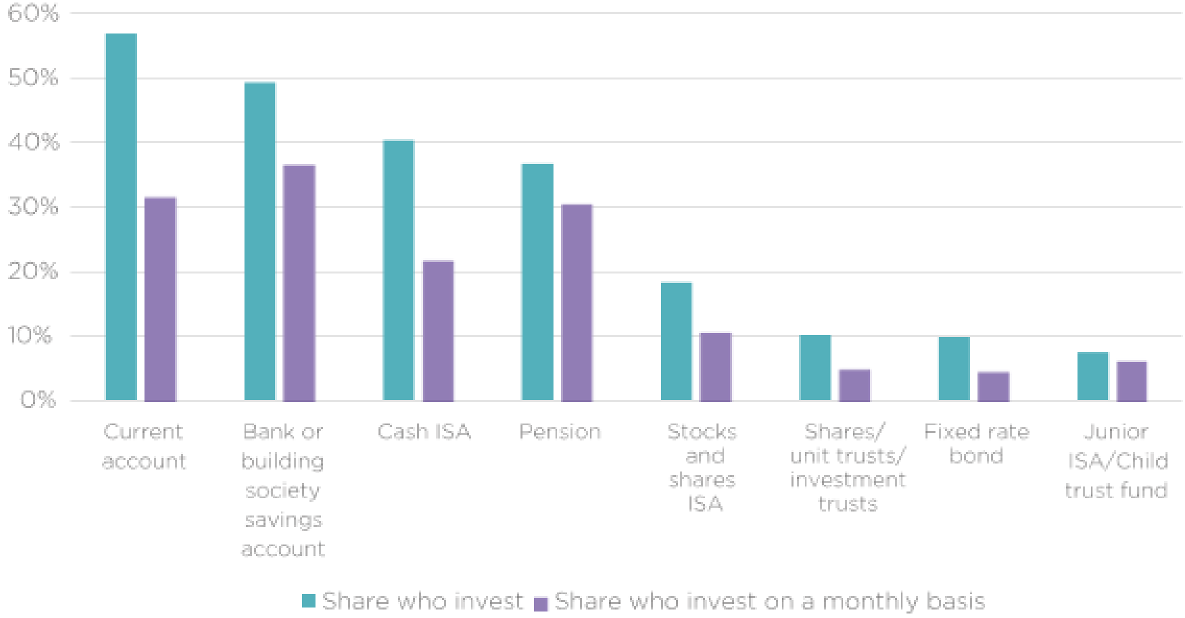
Figure 12 Attitudes to money in life



Source: 3Gem, Cebr analysis

Current and savings accounts stand out as the primary vehicles through which individuals save, with the former utilised by 57% of survey respondents. 40% of survey respondents save into a cash ISA, with more than half (54%) of these doing so on a monthly basis. Meanwhile, less than a fifth (18%) pay into a stocks & shares ISA, with just one in ten (11%) doing so on a monthly basis.

Figure 13 Popularity of different savings vehicles

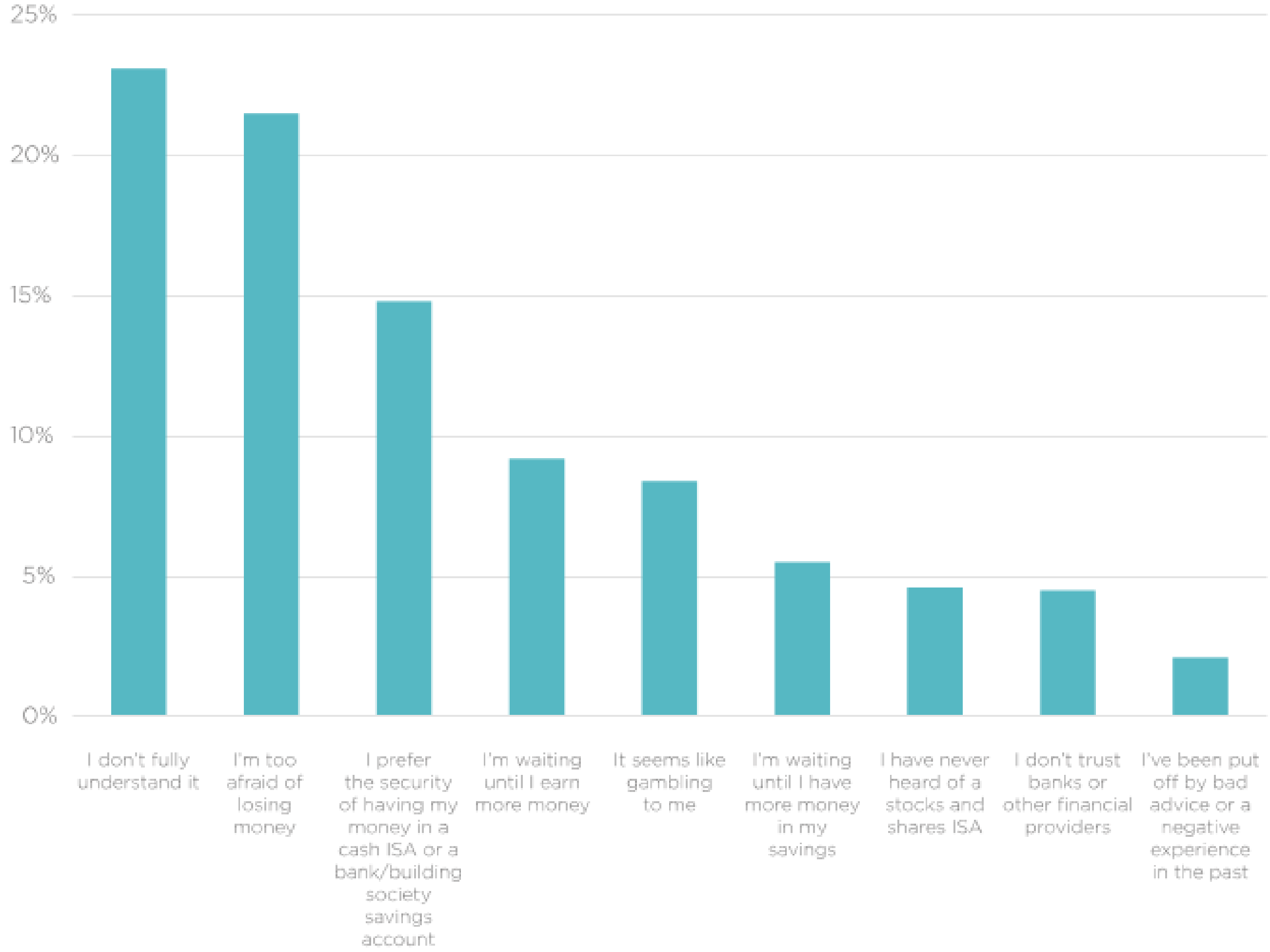


Source: 3Gem, Cebr analysis

Among those that do not have a stocks & shares ISA, the most commonly listed reasons for this are a lack of understanding of this savings vehicle (cited by 23%) and a fear of losing money (cited by 22%). Just one in twenty (5%) have never heard of a stocks & shares ISA, highlighting that a vast majority of individuals are aware of this savings option, but have chosen not to utilise it due to the perceived risks and/or complexity.

According to our survey, individuals feel confident about money matters generally, with 85% saying they are at least fairly confident in this respect. However when it comes to investing specifically, half of respondents say that they are not confident. This finding is likely to be a factor underlying the low uptake rates for stocks & shares ISAs discussed above.

Figure 14 Reasons for not having a stocks & shares ISA

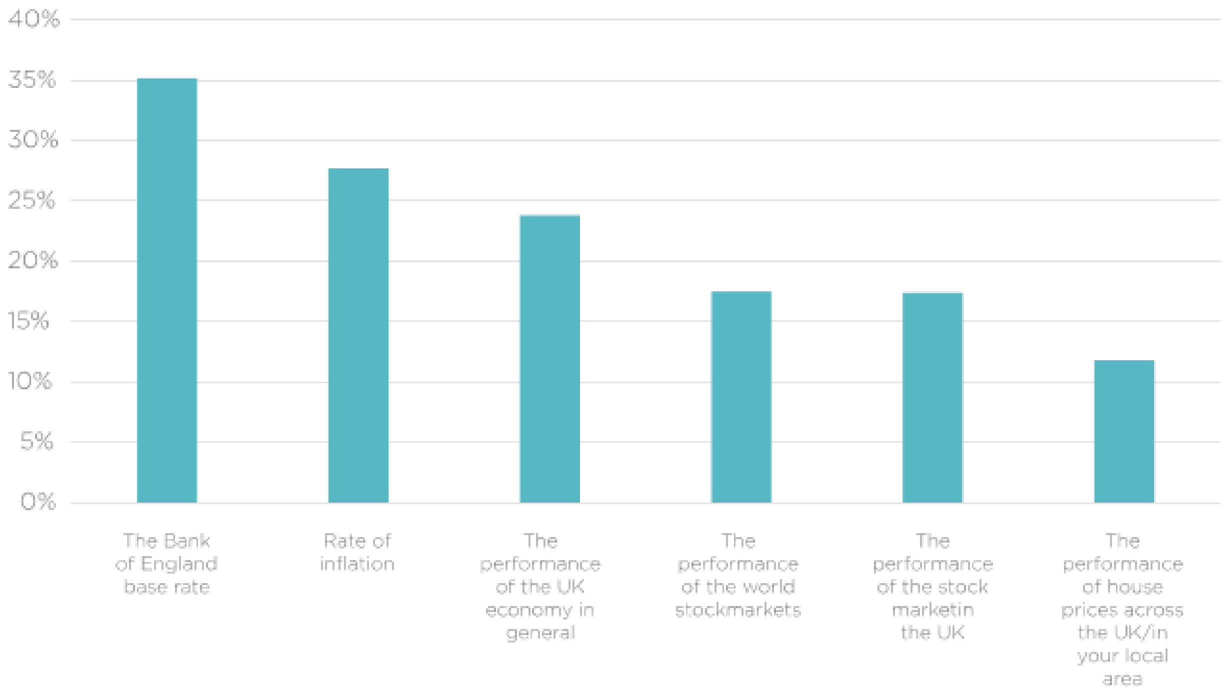


Source: 3Gem, Cebr analysis

More than two fifths (43%) of survey respondents said that the rate of interest on cash savings accounts did not have an impact on their saving / investment decisions over the past 12 months. Among the third (34%) of individuals who were impacted, 44% of these said that they were less willing to invest at all, while a majority (56%) either moved their existing cash savings into stocks & shares investments (30%) or invested in stocks & shares instead of cash savings (26%). Only a quarter of adults in our survey stated that they would be likely to invest in a product that offers the potential to grow their money by more than they may get from a cash deposit account. This suggests that individuals are aware of the trade-off between risk and returns, and also take into consideration convenience and complexity when choosing their savings vehicles.

In terms of the wider economic and political factors that influence saving / investing decisions, 35% of survey respondents pay attention to the BoE base rate, while 28% look at the rate of inflation. This highlights the fact that current accounts and savings accounts are the most widely used savings vehicles, the real returns from which are closely linked to the BoE base rate and inflation. Just 17% take into account stock market performance while more than a quarter (27%) do not consider any wider economic factors.

Figure 15 Economic and political factors considered when making savings/investment decisions

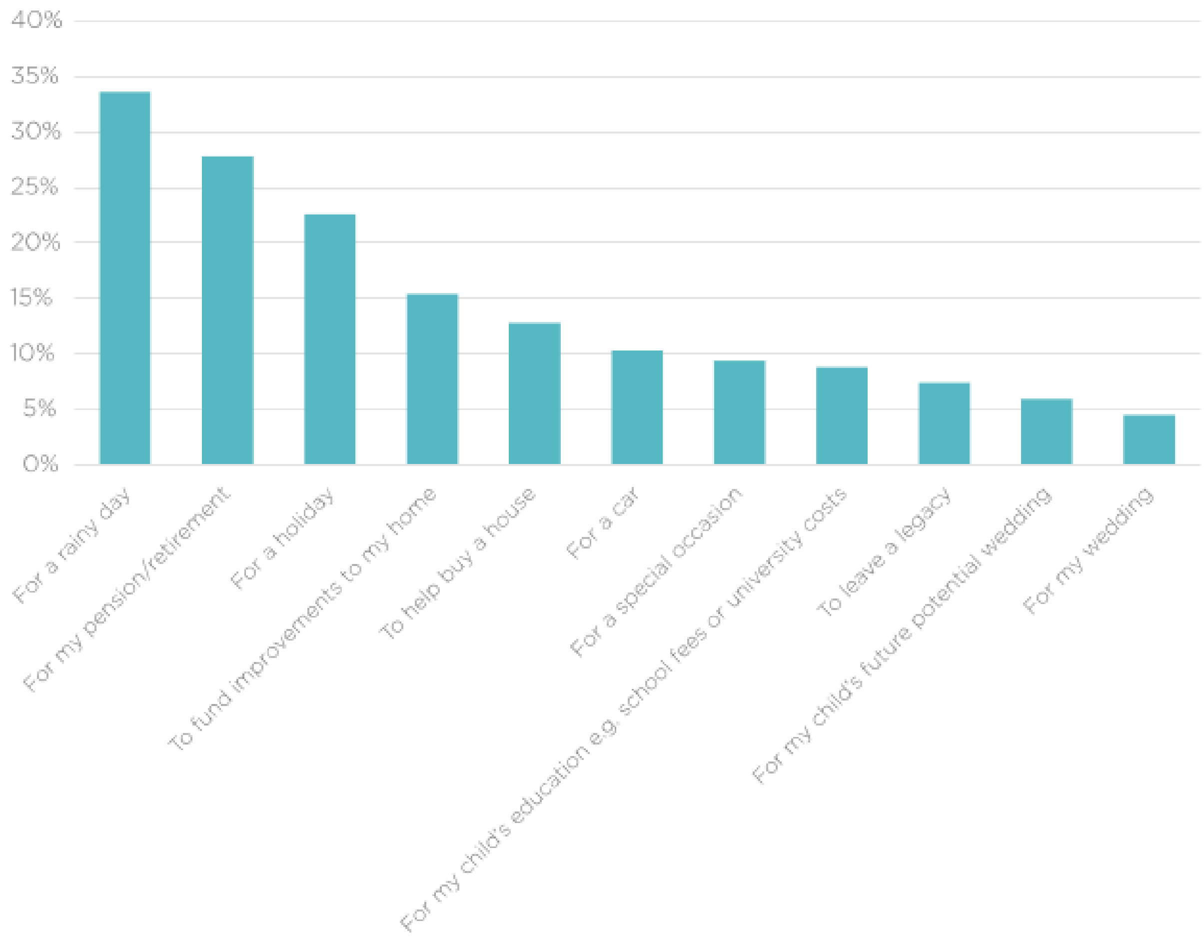


Source: 3Gem, Cebr analysis

3.3 Savings goals

Next, the survey looks at respondents' main savings goals. More than a third (34%) are saving as a precautionary measure in order to provide a cushion against financial hardship in the future. Meanwhile, 28% are saving towards their retirement. Significant numbers are also saving towards shorter term goals, such as a holiday (23%), home improvements (15%), and buying a home (13%).

Figure 16 Individuals' saving objectives



Source: 3Gem, Cebr analysis

4 Conclusions

Based on historical interest rate and stock market data, UK savers have foregone considerable potential returns by opting to save their money in cash ISAs rather than in stocks & shares ISAs. This is particularly true in recent years, as average interest rates on cash ISAs have languished at around 1% while UK equities have registered strong gains. Moreover, cash ISA savers have seen a real terms decline in the value of their savings over the last two years, due to the rise in inflation that followed the EU referendum in 2016. The results of our consumer survey highlight that returns are far from the only factor that individuals consider when making saving/investment decisions. Nearly half (45%) of those who do not currently have a stocks & shares ISA cited concerns surrounding the risks associated with investing in the stock market. Meanwhile, 28% indicated that they were deterred by an incomplete understanding of this savings vehicle. This suggests that an opportunity exists to boost savings in stocks & shares ISAs through providing more support and assistance to consumers who may be interested in this savings vehicle.

The UK's withdrawal from the European Union tops the list of financial concerns among those in our survey, followed by the occurrence of major unexpected expenses. While around half (47%) of survey respondents are endeavouring to save a significant portion of their income, one in five (19%) would like to do so but do not have the necessary income. This points to a concerningly high number of households who either cannot or choose not to divert a significant share of their income towards their savings. This issue is exacerbated by low interest rates – which make saving less attractive – as well as weak income growth, meaning that many have little left to put aside at the end of the month. A regional breakdown shows that the South East is the region that saves the most, both in absolute terms and as a share of discretionary income. Meanwhile households in Northern Ireland and Yorkshire & the Humber have the highest potential to save, based on the share of income directed to non-essential expenditure.

Visit Scottish Friendly's Insights Hub where you can find out more about our research into the nation's disposable income and investing.

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