Issue Briefs

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Family Financial Education

Emergency Savings: New Approaches to Save for a Rainy Day

More than 62% of people in Wisconsin report not having enough savings to cover 3 months' of living expenses, according to the 2012 Financial Industry Regulatory Authority (FINRA) Financial Capability survey. While 3 months of expenses is a lot, many families would find it hard to even come up with $1,000 for an unexpected expense. This also means families do not have savings available if an unexpected opportunity arises, such as job training or a credential that could boost income. Recent research by the U.S. Financial Diaries project shows just how fragile family finances can be. Even having $500 in a coffee can could improve family financial stability. That $500 puts a household in better position to make a car or home repair, address a medical emergency or visit a sick relative.

The reality for many people is that finding liquid financial assets for unexpected expenses is stressful. Families may set aside modest amounts of savings, but such saving is difficult, especially for low-income families, so most do not do so. But having money for the unexpected as a contingency or emergency fund may be one of the most important personal financial tasks families can work on in the short run. This brief provides an overview of this topic and strategies for educators.

Saving and Financial Stability

There are multiple forms of shocks that family budgets can experience:

- Unexpected expense (sudden car repair) or a lumpy expense (elevated utility bill)
- Unexpected drop in income (cut in pay, hours or work options)
- Unexpected opportunity (a trip, training or an opportunity to invest in the future)

Some of these are more unexpected than others. For example, winter usually brings higher heating bills. Some people anticipate this and try to smooth their spending over the course of the year. Or, knowing that car tires wear out, families save for replacements over time. Other events are more unexpected—perhaps they are something families know could happen, but they see it as unlikely and far off in the future. We all tend to underestimate these kinds of events, and generally the only "insurance" we have is having a rainy day fund, or accessing emergency forms of credit such as a credit card (if available) or pay day loans, pawn loans or other short term forms of borrowing—all of which can be costly.

CONTENTS

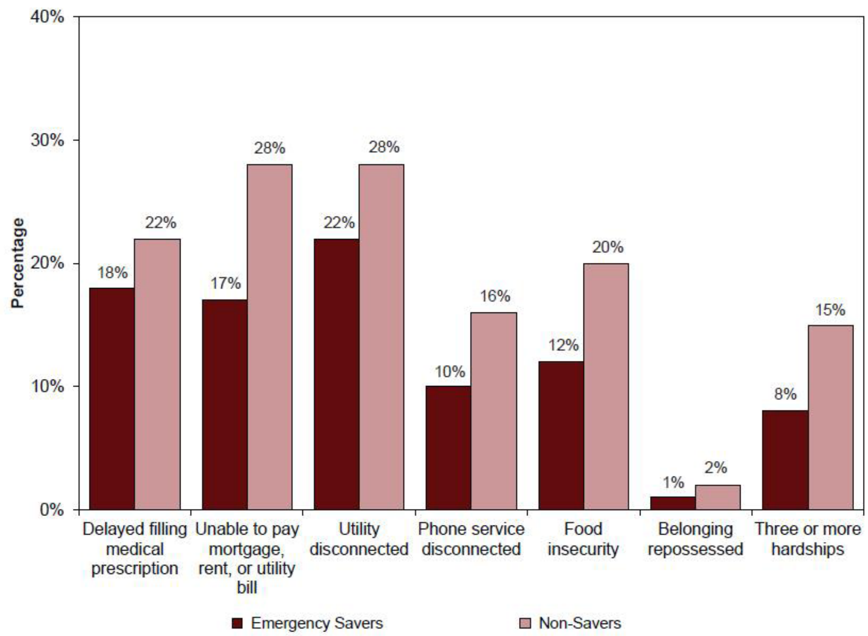
Additional Resources

America Saves – Saving for Emergencies.
Emergency Savings (Center for Financial Security and Charles Stewart Mott Foundation).
SaveUSA: New York City.
Financial Diaries
FINRA Financial Capability Survey
Online Budgeting Tool

Families typically have to respond to unanticipated expenses or drops income by spending less. They may reduce expenditures before an income shock by accumulating savings, or they reduce expenditures after the shock in order to pay back debt incurred during the crisis. Without adequate savings, households must turn to other mechanisms for credit that may come at a high cost. They may also be unable to meet necessary expenses. Food insecurity, failure to access needed medical care, and missed housing or utility payments can be symptoms of not being able to address unexpected short term expenses (Figure 1).[1]

Figure 1: Emergency savers report fewer hardships than households not saving for emergencies

Source: Annie E. Casey Foundation's Making Connections Survey



Saving Even While Paying Back Loans

Economists often argue there is a better return on investment to pay back a loan at 25% interest than to save at 2% interest. While this is true from an interest rate perspective, having liquid assets that can be accessed quickly and cheaply maybe worth while, even if that means not accelerating debt repayment. Of course this does not mean people should default on loans or fail to make minimum payments. Simply, that all else equal, paying off credit cards at the expense of your emergency fund may not always be the best option. Once an emergency fund is established, paying off debt can become a priority.

Budget Smoothing

The reality is while some expenses are predictable—rent or food, for example—others are always variable. Utilities, transportation, clothing, taxes and health care costs are just a few examples. It is important for people to think about fixed and variable expenses in their budget, and consider "what if" scenarios where expenses or income go wrong—or both. Some emergencies are actually quite predictable. In effect, careful budgeting is a form of smoothing lumpy income and expenses over time. Savings in this case is simply next month's expense. This can help families to avoid late fees, especially if they are living paycheck-to-paycheck or regularly using bank overdrafts.

Getting Started

Staring savings of any kind requires overcoming procrastination to get started. It is too easy to put off saving until "tomorrow" and then tomorrow, repeating that logic. Financial inertia can set in and no fund is ever created.

Having a goal to build an emergency savings fund is often desired, and may feel more accessible than a goal like retirement. However, the goal needs to be supported by a reasonable plan with specific steps such as how often and how much will be saved and where the money will be stored. Small frequent deposits, such as a few dollars on a weekly basis, may work better for those with tight budgets or irregular incomes. Because emergency savings are meant to be spent there also needs to be plan for rebuilding the fund when it is used.

Goal-setting research confirms that people are more successful when they set moderately challenging and reasonably attainable goals. One goal is by trying to save $20 per week, or $1,040 per year. According to the National Foundation for Credit Counseling this will address the majority of short-term emergencies.

Make a Commitment and Stick to It

Creating a feeling of commitment can be an important tool for sticking with a plan to build emergency

1 Collins, M., & Gjertson, L. (2013). Emergency Savings for Low-Income Consumers. (2013). Institute for Research on Poverty Focus (30)1.

savings.[2 3] Making the commitment public by saving with a group, or just telling family friends about your savings plan, can create additional pressure to stick to your savings goal. Another effective strategy is to commit to a regular automatic withdrawal to a savings vehicle. The automation removes the need to repeatedly make the decision to save. Scheduling automatic deposits to an emergency fund is one way to "pay yourself first." Often emergency savings can become a regular line item in a budget, just like a utility bill.

Find a Safe Place: Liquidity vs. Constraints

Savings need to be safe from others and safe from you. Emergency savings should be readily accessible, but no too accessible such that it is tempting to spend the funds for a non-emergency purpose. Having emergency savings stored as accessible cash or in a checking account, means it is on hand and easy to spend. The extra step of having to retrieve funds or transfer money from savings to checking can act as a protective barrier.

Opening a savings account with a bank or credit union is a traditional place for storing savings. But there are other options. Prepaid cards are an alternative to financial institution accounts that may be a better fit for some individuals removes the risk of building overdraft fees. Several prepaid cards even have "savings pockets" attached to the debit account. This is a feature that allows you to automatically save your "left over" cents when you swipe your debit card. Prepaid card fee structures can vary dramatically and not all cards are FDIC insured so it is important to review options before selecting a prepaid card.

2 Ashraf, N., Karlan, D., & Yin, W. (2006). Tying Odysseus to the Mast: Evidence from a Commitment Savings Product in the Philippines. Quarterly Journal of Economics, 121(2), 635-672.
3 Fiorillo, A., Potok, L., & Wright, J. (2014). Applying Behavioral Economics to Improve Microsavings Outcomes. Ideas42.

Unexpected Income as a Target

A tax refund, rebate, pay raise, bonus, cost-of-living adjustment or other extra income can all be used to fund an emergency fund. Depending on family circumstances there may be other opportune moments for starting or building an emergency savings fund especially capitalizing off of lump sum payments which can seem different and be perceived as a windfall. For many households a tax refund is one of the largest lump sums they receive in a year. Tax time may be an opportunity start an emergency savings fund by setting aside a small portion of the refund in a savings account or other savings product. A streamlined process for splitting a tax refund and directly depositing a portion into a savings account is a potential strategy for encouraging saving.[4] Programs offering a funds match to low-income tax filers at Volunteer Income Tax Assistance (VITA) sites may act as an incentive to save a part of their tax refund.[5]

Implications for Educators

Families may prepare for financial emergencies by setting aside funds, but saving is difficult for families with limited income and many are not saving for an emergency. Exploring options to start or build a modest emergency fund can provide financial security and peace of mind. Often a key strategy is to help families diagnose what has happened in the past, including shocks to income and expenses. Help families see that some of this is predictable and can become part of a budget. Also use simple case studies or budgets and then do a "what if?" exercise with drops in income or jumps in expenses. Simulating these events can help families realize the likelihood of needing savings. It is also important to be able to connect people to savings vehicles, including stored value cards, savings accounts, U.S. savings bonds and other mechanisms that offer safety and (limited) liquidity.

4 Grinstein-Weiss, M., Ariely, D., Key, C., & Holub, K. (2013). Creating Contingency Savings at Tax Time.
5 Mintz, J. (2013). The SaveUSA Coalition.

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The University of Wisconsin-Extension (UWEX) Cooperative Extension's mission extends the knowledge and resources of the University of Wisconsin to people where they live and work. Issue Briefs are an ongoing series of the Family Financial Education Team. This brief was drafted by J. Michael Collins, Associate Professor in Consumer Finance and Extension State Specialist, Center for Financial Security