Paying for the Unexpected: Making the Case for a New Generation of Emergency Savings, Affording Contingencies and Liquid Resources for Low Income Consumers

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October 1, 2012

1 Introduction

This case statement begins an 'innovation dialog' about financial strategies designed to help low-income people/households to meet immediate non-recurring expenses with a project supported by the Charles Stewart Mott Foundation. These funds might be characterized as 'emergency savings' or even 'contingency savings'. These resources are not intended to meet regularly budgeted items like rent or food, but rather unexpected expenses and/or *opportunities*. Examples of opportunities include fees for a certification or training that could boost income, or an enrichment activity for children. These sort of discretionary upward economic mobility investments, while small in scale, are hard to foresee and cannot be acted upon without access to a liquid form of savings or credit. The costs of such expenses are immediate but the rewards may continue for years onward. Likewise unexpected emergencies can arise and contingency savings can provide protection from downward economic mobility. *Emergency* savings serve as a form of insurance against lumpy, non-routine expenditures such as a car repair or unforeseen medical expense. These funds can also serve as a rainy day fund available for unexpected income shocks.

The failure to amass sufficient savings is common, especially among low- and moderate-income households. Without easy access to liquid savings, people turn to alternatives including short-term credit or friends and family. Over a time, most families are certain to experience an unplanned expense. Because the exact timing of such expenses is uncertain, putting off the accumulation of contingency funds is predictable. Individual factors that may discourage savings include a lack of knowledge to adequately to assess the risk of an emergency, procrastination biases, failures to plan, legal problems (such as garnishment) and recurring expenses that exceed typical income. Institutional factors include a limited or nonexistent market offering affordable financial services and policies that restrict savings by way of asset tests in public benefit programs.

Recent surveys indicate that low-income households are worried about how their ability to manage economic resources can negatively impact their families (Lusardi et al., 2011). Families unable to acquire liquid assets may experience economic and material hardships and/or miss upward economic mobility opportunities. Housing instability, food insecurity or failure to access needed medical care can be symptoms of not being able to address unanticipated short-term expenses. For low-income households even relatively small shocks can have significant impacts on long term financial stability (Abbi, 2012).

Recent Federal Reserve data show that the Great Recession has significantly reduced household wealth and thus increased the financial fragility of families. With the exception of the top 10 percent of earners, all households saw their net worth decline meaningfully since 2007. While median net worth declined between 2007-2010 nearly 40 percent across all households, younger, non-college educated, and non-white households lost the greatest proportion of their wealth. Meanwhile, the number of families reporting having at least $3,000 in liquid savings has declined from nearly 53 percent in 2007 to around 48 percent in 2010 – despite the fact that households reported in 2010 that liquid savings, instead of retirement savings, is now their top savings priority.[1]

2 The Emergency Savings Project

The Emergency Savings Project launched in the fall of 2012 with the goal of exploring new avenues to promote emergency or contingency savings. The concept is a response to a request from the Charles Stewart Mott Foundation, which is also the financial sponsor of the project. The foundation is exploring new ways to support asset building and savings beyond traditional strategies. This project is guided by an Advisory Committee and over the next year we will document innovative ways to address emergency savings issues, as well as inform the foundation's strategic priorities. This case statement serves as the foundation of the project, communicating the evidence of the need and proposing a framework to spur further program or product innovations. The additional phases of the project include:

Case Statement This document; designed to layout the concept of contingency savings and need for new approaches.

Advisory Board Review the Case Statement, review selected innovation proposals and attend Salon.

Call for Proposals Invitation to submit two-page strategy proposals to be considered for Salon.

Salon May 7, 2013 meeting in Chicago, IL to present 8-12 fully-developed strategies as conference papers.

Edited Volume A book that presents the need for new strategies and includes Salon papers as chapters.

[1] See `http://www.stlouisfed.org/household-financial-stability/`

Foundation Report A report to the Charles Stewart Mott Foundation, as well as complementary media tools.

3 Financial Fragility: Coming Up With Cash in a Pinch

About half of U.S. households cannot come up with $2,000 in 30 days (Lusardi et al., 2011). Just over 23 percent of people with incomes below $20,000 could do so, and 33 percent of people with incomes between $20,000 and $30,000. Among those who could find $2,000, 50 percent suggest a savings account as the source, 30 percent suggested borrowing from family/friends and 21 percent suggested a credit card and about 12 percent suggested a payday or pawn loan.

Families typically respond to unanticipated income shocks or unplanned expenses by consuming less. They may reduce consumption beforehand to accumulate savings or they reduce consumption after in order to pay back the debt. In the absence of adequate savings, households must turn to other mechanisms for credit. Here the low-income households are more likely to rely on alternative sources of liquidity that typically come at higher costs than conventional credit (Rawlings, 2008). The following liquidity mechanisms are commonly used and have features that are instructive in the design of new approaches:

Overdrafts Overdrafts are easy to use—just write a check and let it bounce (if the consumer is banked); the transparency of the costs vary but with experience (individually or though social networks), the fees involved are relatively predictable.

Borrowing from Peers or Kin Lending is based on the idea that someone who knows a borrower socially may benefit from having information about the borrower's ability to repay, as well as have additional influence to collect payments that may not be available to formal lenders. The non-monetary costs for this type of lending can be steep, however, and people with peers and kin of lower socio-economic status will have less capacity to borrow.

Late or Skipped Payments One simple way for an individual to deal with an unexpected expense is to delay or skip a payment for another bill. This will likely result in additional fees, may result in service/utility shut-offs or repossession, could threaten housing stability, and could undermine an individual's credit history.

Payday Loans Payday lenders are often conveniently located and offer extended hours and simple application procedures. Costs are transparent and may cost less than missed payments, but can become very expensive if the borrower extends the loan by rolling it over at the end of the loan period for additional fees.

Pawnshops One of the oldest forms of household liquidity, pawn shops are relatively convenient for smaller loans if the consumer has something of value to pawn. The borrower risks losing their possession.

Auto Title Pawn Is a form of pawn with the benefit that the borrower can still use their automobile during the loan term. Often convenient and transparently priced, but if the borrower fails to repay the loan they risk losing their vehicle, which may be their transportation to work and other household functions.

Income Tax Refund Loan Refund anticipation checks can be sizable (and costly) but are only available once per year and as such more likely to be used to 'catch up' from a recent unexpected expense.

Credit Cards A convenient option if the borrower is qualified to have a credit card. The costs and terms of credit cards vary. Some people choose not to own any credit cards due to the temptation to use for regular expenses or frivolous purchases.

Retirement Savings Loan or Liquidation Withdrawals are only available to workers that have accumulated assets in a retirement account and can be costly in terms of taxes and lost returns when retirement assets are needed later.

Life Insurance Loans A loan against a whole (or permanent) life insurance policy will incur low interest rates, but also reduces the amount of the death benefit available. Few lower income households have these policies.

4 Shifting from Assets for a Purpose to Creating Liquidity for Unplanned Needs

Much of the literature in economics regarding household savings levels emphasizes the importance of long-term savings for goals including home ownership, education, and most prominently retirement. Having savings increases the likelihood of low-income individuals and their children moving up the economic ladder (Cramer et al., 2009). Less is known about saving for short-term needs and unexpected expenses. The accumulation of savings or assets allows the current storage of resources for future consumption. Many prior asset building efforts focused on savings for a home, small business or education. These are important goals, but also imply planning and well developed expectations. Most programs have paternalistic restrictions which prevent using savings for a non-approved purpose. Yet, even with penalties participants in matched savings programs forfeit matches in order to access savings early highlighting the need for liquidity. Smaller, unplanned discretionary spending may prove to be as valuable over the life course.

4.1 Barriers to Contingency Savings

There are a range of barriers that discourage the accumulation of savings among low- and moderate-income households. Barriers include economic constraints, policy restrictions and psychological/behavioral biases.

4.1.1 Structural Barriers

Saving poses an exceptionally difficult challenge to the low-income because basic living expenses comprise a large portion of available resources leaving little or nothing left over to save (Schreiner and Sherraden, 2007). Income often fluctuates month to month making planning a budget very difficult. The necessary focus on economic survival may shorten the time horizon of people living at or near poverty in a way that makes saving a low priority (Schreiner and Sherraden, 2007). In addition, the savings product market is underdeveloped because the financial industry has been reluctant to offer savings products the for the low-and moderate-income population. There may simply be insufficient incentives for firms to enter markets catering to underserved consumers (Hachikian, 2009).

Governmental programs are another barrier. Some means-tested public benefit programs have asset limits as part of the eligibility criteria that act to discourage savings for households that depend on the benefits. For example, SSI (Supplemental Social Security) benefits restrict a single person to a savings balance below $2,000 and a married couple below $3,000. Some SNAP (Supplemental Nutrition Assistance Program) and TANF (Temporary Assistance for Needy Families) also have similar restrictions. Even beliefs and myths about the asset restrictions of benefit programs may discourage saving (Cramer et al., 2009). There is an opportunity for innovations that allow seniors on public benefits, veterans with disabilities, and other recipients of means-tested benefits to save and not lose benefits for a period of time.

Lastly, the government currently has no specific policy or program that supports the development of emergency savings (Lusardi et al., 2011). This is not an area of vigorous policy research or discussion. Policy innovations that fill the void may be an opportunity for leveraged impact.

4.1.2 Financial Literacy/Financial Knowledge

Many people—at all income levels—lack basic knowledge related to financial management and planning (Lusardi and Mitchelli, 2007). A lack of financial knowledge may lead people to underestimate the need to set aside resources for unexpected expenses. It may also lead people to not seek out beneficial financial products or services because they fail to know about them or how to use them.

4.1.3 Psychological/Behavioral Biases

Any new strategies being developed around emergency savings goals should be thoughtfully designed to incorporate evidence from the social sciences. Psychologists and behavioral economists suggest a variety of reasons that cause households to inadequately save for future liquidity shortfalls, including the inability to forecast future earnings or economic circumstances accurately. At least one study suggests that among the lowest income quintile households, people perceive their annual emergency savings needs at about $1,500, yet these households typically spend around $2,000 annually on unexpected expenses (Brobeck, 2008). Behavioral studies show unrealistic optimism is associated with less prudent financial behaviors such as short planning horizons and saving less (Puri and Robinson, 2007).

Many people are present-biased, meaning they prefer rewards now, such as the instant gratification of spending, and push off difficult tasks with delayed rewards, like saving (Laibson, 1997). People actually prefer to save more, but fail to predict that they will not follow-through with their own stated preferences. Self-aware consumers realize their self-control problems and correct for it using commitment devices, such as promising today to save more tomorrow (O'Donoghue and Rabin, 1999). The naive consumer does not recognize their shortcoming and will forever continue to push off saving into future with an end result of never saving (O'Donoghue and Rabin, 1999). A commitment device like an automatic deposit into a savings account works only if people are self-aware enough to enroll in it, or are funneled into the account automatically (Ashraf et al., 2006).

Related to the idea of impatience is the idea of self-control—that not spending money takes effort. Behavioral researchers suggest self-control is in many ways like a muscle in that it can be exhausted after repeated exertions within a period of time (Baumeister et al., 2007). It can also be strengthened over time with experience.

Perception of time and money are prone to other biases. For example, studies show people have problems predicting their ability to manage money in the future. When a consumer borrows money, she can acquire more liquidity–or financial 'slack'—today, at the expense of facing a tighter resources in the future when faced with debt repayment. People generally fail to predict how hard that repayment process will be and end up over-committing future resources as a result. Another bias is that people only have a limited supply of attention that can be feasibly applied to household financial management (Stango and Zinman, 2011). Essentially people neglect to pay attention in the absence of reminders or other mechanisms.

Behavior change is difficult, it requires that people be informed, motivated, and have an opportunity to act. Ongoing studies of behavior in a variety of domains, including health and nutrition, suggest that focusing people on concrete goals and then helping them form implementation intentions can serve as powerful incentives or reinforcements for behaviors. A lack of goals can leave people unfocused and with little accountability for failing to take planned actions (Gollwitzer et al., 2011).

Ideal innovations should systematically encourage adequate savings with these strategies:

- Help people form realistic expectations regarding regular and unexpected expenses as well as income limits for the near future;
- Address present-bias (or impatience) through commitment devices;
- Limit the need to exert excessive self-control to save or restrain spending with features such as automatic transfers;
- Targets specific types of expenses or contingencies that households typically under estimate, including occasional large items and/or frequent but smaller ones;

- Recognize behavioral biases and over-optimism about future resources, and
- Focus on goals and implementation intentions, as well as create a way to systematically encourage adequate savings for an emergency.

5 New Frontiers in Emergency Liquidity: A Framework for Innovation

This project seeks to inspire 8 to 12 strategy proposals for mechanisms which will serve to facilitate lower-income households to have greater access to contingency funds. These concept proposals might incorporate policy strategies, program innovations, traditional savings accounts, or new vehicles which combine credit and savings features, insurance, technology or any array of relevant approaches. Strategies may be completely novel, describe an emerging approach, or expand upon existing models. Several innovative programs and products have been developed that facilitate accessible savings in low-income households, findings are promising but there is room for improvement.[2] The ultimate outcome is identified categories of promising mechanisms to facilitate the development of pilot projects worthy of support from philanthropy, private industry and the public sector.

Proposals should have well defined objectives clearly focused on the needs of low-income households and addressing the barriers described in this document. The primary question to address is:

How does this approach overcome barriers to saving, support the accumulation of contingency funds and/or promote access to reasonably priced liquidity mechanisms?

Describe the approximate amount of liquid assets the innovation provides and the anticipated purpose (e.g. small unexpected expenses vs. mortgage payment after a drop in income), and any anticipated sources of funds. Any proposal should also directly address six key factors, including: (1) scale, (2) institutional capacity, (3) political/regulatory leeway, (4) costs, (5) accessibility, and (6) evidence of effectiveness.

Scale How many people could be served? Does the innovation have the capacity to impact household saving or access to liquidity over time? What will it take for this proposal to go beyond a pilot and be launched nationally or widely adopted by existing programs?

Institutional Capacity Are there existing organizations/markets in place to launch this strategy? What will it take for implementation to be accomplished? How long would it take for the innovation to be available to consumers?

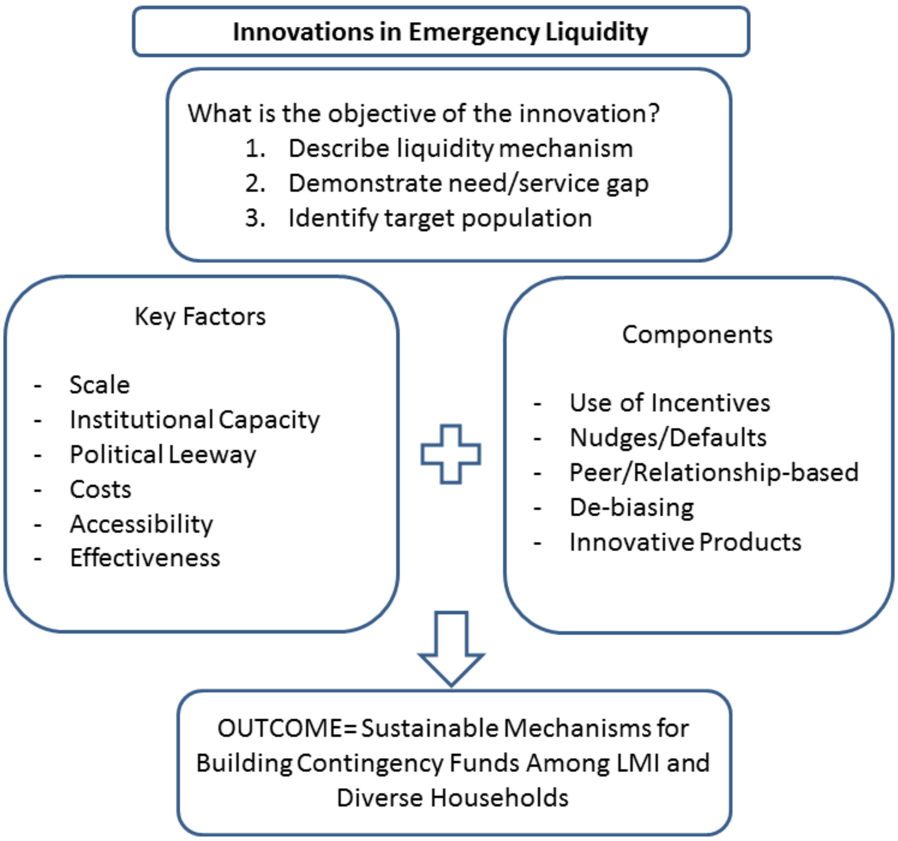
[2]Examples include: AutoSave: an automatic payroll deduction initiative by the New America Foundation and MDRC; 'Rainy Day Reserve': savings stored on a prepaid card, a partnership between D2D and Plastyc, Inc.; SaveUSA: tax-time matched savings program in New York City. See `http://assets.newamerica.net/events/2012/building_better_savings_products` for additional information.

Political Leeway Is the proposed innovation feasible based on existing regulations and policies? What kind of changes, if any, would be required and from what agencies?

Costs and Sustainability How much will the innovation cost to implement? What are the potential sources of funds initially and in the long term?

Accessibility Does the innovation target an underserved community? Is it accessible to a diverse population? This is especially relevant for innovations involving online or mobile technology. For example, could a person with a vision or hearing challenge, cognitive impairment, physical disability, or health or mental health condition access the tool? To what extent is it available to those with limited English proficiency? Does the innovation consider the impact of savings for recipients of means-tested benefits?

Evidence of Effectiveness What existing evidence from prior pilots or social science research offers empirical support that this strategy will be effective? How will this pilot be evaluated?



5.1 Research-Informed Components

Finally, any new innovation in developing contingency funds for low income households should be grounded in one more more of the following components:

I. Incentives A long standing strategy in asset building is matching savings. Typically individual development accounts (IDAs) have not been designed for discretionary spending, but new models might be feasible if the matching and payout process can be efficiently administered. Other approaches might include gift-based savings or even non-monetary incentives for savings. Ideally such innovations will be applicable not only to the sophisticated consumer who recognizes the value of systematic savings (and is most likely to enroll) but also the less aware consumer who often fails to sign up for such programs.

II. Behaviorally-informed 'Nudges' There are a wide range of approaches using choice architecture, defaults, automatic deposits and targeted timing to encourage various financial behaviors on the margin. Technology is often part and parcel to these approaches, as is process design, administrative procedure and the use of well-designed forms. Of particular interest are mechanisms that are integrated into existing programs as well as 'just in time' interventions that coincide with the receipt of a lump sum payment designed to take advantage of the tendency to mentally account for lump sums differently from regular income. These approaches might also take advantage of variations in the intra-month timing of bill payments and income/payroll systems.

III. Peer/relationship-based models Peer lending has a long history in many communities. The sou sou (or 'susu') model common among immigrants is rare in many parts of the country. New strategies could carefully build on the behavioral and economic benefits of social lending, with a focus on sustainability and scale.

IV. De-biasing Mechanisms Programs might target overcoming unrealistic expectations, better assessment of risks, using commitment devices, using reminders to overcome limited attention, engaging in coaching, counseling or education, and/or focusing on the implementation of specific goals. New innovations might simply implement exiting strategies with enhancements which overcome biases. For example, new systems to help people with existing accounts to better form expectations and become more aware of their own biases with the goal of saving more.

V. Innovative Products There is a wide range of innovative financial products that could be developed. Examples include accessible and attractive savings products, quasi-liquid accounts, hybrid savings and loan products that allow consumers to accumulate savings and when an expense arises to borrow from that savings in combination with a loan product, savings vehicles for underbanked via savings pockets on prepaid cards, insurance-related vehicles and other products. Not every innovation will require the development of new financial products, although most will require some form of financial vehicle to acquire liquid funds. Most stand alone products, however, will require a supportive program to facilitate implementation and adoption.

5.2 Planning for Impact

Before an innovation can be expanded or brought to scale on a state regional, or national level, there needs to be evidence of effectiveness. Innovation proposals should begin with this end in mind, including the design of an evaluation which can show the impact of the approach relative to existing approaches. Evaluation designs should utilize randomized controlled experimental trails as appropriate, and include measurement of intended behaviors, overall economic well-being and cost-effectiveness.

6 From Ideas to Implementation

6.1 Facilitating Innovation: Call for Proposals

A call for proposals will be released in October 2012. The goal is to generate a broad set of ideas for strategies that can serve to expand savings mechanisms, vehicles, programs, or financial products. The call will include—but not be limited to—specific categories of products, such as workplace-based savings accounts, mobile phone or technology enhanced savings, peer savings models, insurance-oriented approaches, social service or public program based models, mandatory savings programs, savings related to income taxes and tax refunds, debit card savings mechanisms, hybrid savings and credit products. The call will request a two page concept proposal.

Proposals will be selected for further development and then to be part of a 'salon' and eventual inclusion in a published volume. Proposals will be evaluated based on the criteria described above, including a focus on vulnerable or targeted populations and overcoming savings barriers using current research related to asset building and behavioral economics.

Because the topic of developing contingency funds for low-income families cuts across a variety of fields, an explicit goal of this call for proposals is to encourage collaborations between and among organizations and sectors. Broader strategies which combine approaches to enhance existing programs/products in new ways are of particular interest.

The Call for Proposals will be distributed through the Advisory Committee (Committee members are not prohibited from submitting proposals but will not evaluate or rank their own submissions). Selected proposals will be asked to develop longer concept papers that fully address the details of the proposed strategy, including the framework and components discussed in this paper.

6.2 Discussion and Promotion of Models: Salon

The next phase of this project will be convening an invitation only salon organized around a series of up to 12 innovation proposals. These proposals will each explore a new approach to emergency savings, including federal, state, or local public policies, improved administrative processes, public or nonprofit programs, demonstrations of reforms in public programs treatment of savings, and new financial products.

6.3 Translation and Dissemination: Edited Volume

The final phase of the project will be a published edited volume of the salon papers. The book will include the case statement, policy proposals, discussants' written comments, and the proposers' counterpoints, and a rapporteurs report and conclusion. The volume will serve both as a guide for the Charles Stewart Mott Foundation and salon participants, but also as a useful publication for policymakers and the asset-building field more generally.

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