

## Coming Up with Cash in a Pinch: Emergency Savings and Its Alternatives

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### Introduction

It is widely recognized that a significant proportion of U.S. households would benefit from spending less and saving more. Important household financial decisions such as paying down debt, investing in a home or an education, and setting aside sufficient funds for retirement have garnered a great deal of attention among researchers and policymakers. However, another key financial reality for many U.S. households—their ability, or lack thereof, to access liquid assets quickly in order to meet unexpected expenses—has not been rigorously studied despite the fact that the lack of an emergency savings cushion leaves families vulnerable to financial hardship. Emergency savings serves as a form of insurance against non-routine expenditures such as a medical emergency or car repair. Many households, especially those with lower incomes, struggle to generate and maintain adequate savings. In the absence of readily accessible savings to cover unexpected expenses, people delay paying bills, sell possessions, and turn to other alternatives including

short-term credit products, friends and family, or public subsidy programs. Short-term credit alternatives often come at a high cost to the borrower. Thus, emergency savings can help individuals avoid high cost borrowing.

This brief summarizes a paper that reviews 80 articles about savings and households' ability to access cash quickly to meet unexpected expenses (see Chase, Gjertson, & Collins, 2011). Numerous articles have modeled household savings behavior and developed general theories of savings; far fewer focus on emergency savings and expenditure shocks specifically. Studies about savings that include race, income, or education as explanatory variables generally find that savings levels are lower among lower-income, minority, and less-educated households. Overall, households' ability to deal with expenditure shocks has not been widely studied, but at least two studies conclude that lower-income and minority households are less prepared to manage short-term demands for cash.

### Emergency vs. Precautionary Savings

Ideally, families would save in anticipation of both *income shocks* (e.g. job loss) and *expenditure shocks* (e.g. medical expenses or car repairs). We distinguish emergency savings from precautionary savings based on whether the funds are set aside for expenditure versus income shocks. However, the mechanisms for saving (or not saving) are probably quite similar across these two types of savings.

#### **Emergency Savings versus Precautionary Savings**

Neither of these types of savings has been consistently defined across the existing literature. In this brief, we use these terms to distinguish two types of savings:

**Emergency savings** is used in response to expenditure shocks such as a car repair or medical expense

**Precautionary savings** is used in response to income shocks such as a pay cut or job loss

**Precautionary savings** refers to savings undertaken by individuals who expect that they face some risk of experiencing an income shortfall in the future (an “income shock”). Research on whether income uncertainty or a predicted income drop lead to greater precautionary savings is inconclusive. In contrast, **emergency savings** refers to savings for expenditure shocks. Expenditure shocks that require emergency savings in the form of liquid assets include both predictable “lumpy” expenses such as seasonal heating bills and school clothing for children and less predictable expenses (e.g. those

resulting from a change in family size or a relative in need of financial support). Because precautionary savings has been widely studied (and emergency savings has not), this brief relies upon the precautionary savings literature to draw inferences about emergency savings.

### Barriers to Saving for Emergencies

People may fail to save enough because they lack financial literacy, underestimate the risk of events requiring such funds, or procrastinate and delay initiating a savings practice. If families are living beyond their means, they have nothing left to set aside. It may be especially difficult for lower-income households to acquire and maintain savings because they spend a greater proportion of their economic resources meeting basic needs. Other barriers to savings for lower-income households include public programs’ eligibility restrictions, which often limit the amount of savings benefit recipients can have. Additionally, savings mechanisms at financial institutions may be difficult for lower-income households to navigate due to account minimums, terms, and conditions. It is estimated that over one quarter of U.S. households are unbanked (i.e. without a transaction account) or underbanked (i.e. have an account but still utilize alternative services such as check-cashers or payday lenders) (Fellowes & Mabanta, 2008; Ryan et al., 2009).

### Meeting the Need for Liquid Assets

A significant body of research has explored payday lending and other alternative credit mechanisms for consumers. A number of these studies address the need for low cost alternative credit among consumers who lack emergency savings. The costs of these types of financial products may appear to be high, especially when they are compared to more traditional savings or checking accounts. However, the continued demand for these products suggests that they help a certain segment of consumers meet liquidity needs. In a liquidity emergency, families face many trade-offs, and more research is needed to aid in the development of financial products that benefit families in need of short-term funds to deal with a crisis.

The demand for alternative financial products has grown over the last several decades due in part to the decline in the savings rate and the recent financial crisis. A 2009 survey found that between 6 and 13 percent of U.S. families used the following alternative financial services in the past five years: a payday loan, a pawnshop, a refund anticipation loan, a rent-to-own store, or an auto title loan (McKernan, Ratcliffe, & Kuehn, 2010). Each type of liquidity mechanism has specific costs and benefits, the highlights of which are summarized in **Table 1**. Some traditional strategies for accessing liquidity such as family loans and pawnshops have been utilized for centuries.

**Table 1. Summary of Liquidity Mechanisms**

| Type                                       | Pro (+)   | Con (-)  |
|--|---|--|
| Checking Account                           | Convenient  | Overdraft fees costly if more than account balance withdrawn               |
| Savings Account                            | Convenient  | Minimum balance required; Limits on withdrawals                            |
| a) Informal Lending                        | Convenient; Underwriting and collections efficiencies         | Relationship based   |
| b) Late or Skipped Payment                 | Convenient  | Undermines credit history; May lose other accounts                         |
| c) Payday Loan                             | Convenient advance of short run income                        | Requires bank account; Costly if used repeatedly                           |
| d) Pawnshop                                | Can liquidate durable goods or personal property              | May be costly; May lose property   |
| e) Auto Title Loan                         | Convert equity in auto to current consumption; Collateralized | May be costly; May lose vehicle  |
| f) Refund Anticipation Loan                | Can convert tax refund to consumption                         | Short term loan once per year; May be costly                               |
| g) Credit Card                             | Convenient  | Terms vary; Qualification standards vary                                   |
| h) Retirement/401(k) Loan/<br>Liquidation  | Low cost loan; May have significant assets                    | Access varies; Nonpayment carries tax penalty; Loss of retirement security |
| i) Whole Life Insurance Cash<br>Value Loan | Low cost loan   | Access varies  |

Payday loans are an increasingly common way for consumers to meet their short-term liquidity needs. A payday loan is a small, single-payment loan made over a short period of time. These loans are typically accompanied by high fees and finance charges. Considered by some to be a form of predatory lending, payday loans have been limited or banned in many jurisdictions across the country. A growing body of empirical literature on payday lending confirms that these loans do in fact provide a mechanism for meeting pressing expenses, but that this benefit often comes at a great expense to the borrower (Wilson et al., 2010; Flannery & Samolyk, 2005). For example, taking out a payday loan has been linked to employment problems among Air Force service members and may increase the likelihood of filing for bankruptcy (Carrell & Zinman, 2008; Skiba & Tobacman, 2008).

Auto title loans are another contemporary method for accessing liquidity. These loans are used more often by males than females and by consumers with higher incomes than those who use payday loans (Feltner, 2007). Although many states have limited or outlawed auto title loans, they are also available online.

Early withdrawals from retirement or pension accounts and loans against life insurance policies can also serve as sources of funds for households

experiencing income or expenditure shocks. Assets borrowed from retirement accounts and life insurance policies can smooth consumption, but borrowing from these sources may have markedly negative effects on account balances or death benefits.

Refund anticipation loans (RALs) are short-term loans based on a borrower's expected income tax refund. RALs are administered by financial institutions but are typically facilitated by tax preparers during the tax preparation process. Although almost 10 million taxpayers took out a RAL in 2008, the availability of these loans has declined dramatically in the last few years due in part to legislation at the state level and changes in IRS practices (Wu & Fox, 2009; Douglas, 2011).

Finally, credit cards remain an option for covering emergency expenses, provided consumers have a sufficient credit line available to them.

### Discussion

The costs of some alternative credit products appear to be high on an absolute level. However, households' continued demand for these products indicates a strong underlying need for liquidity among many U.S. households. All people face some probability of experiencing an income shortfall in the future, yet preparedness for such events is uneven across demographic subgroups.

Behavioral economics and psychology suggest that households may fail to save for a rainy day due to forecasting errors. Thus, even families that have sufficient resources to start saving may fail to do so at adequate levels. Households may underestimate the probability of future expenses, or even procrastinate and defer the act of saving indefinitely into the future. Given these behavioral tendencies and the challenging economic environment, the demand for liquidity to meet short-term emergency needs will continue to be a pressing need among a large proportion of consumers.

#### Future Directions

The findings from this project lend themselves to future directions for research, policy, and product development in the realm of emergency savings and liquidity mechanisms. More research is needed on the predictors and correlates of expenditure shocks and emergency savings as well as on interventions that ameliorate risk and promote savings. An adapted version of an Individual Development Account (IDA) matched savings program for survivors of domestic violence is one example of a promising intervention for promoting savings. The IDA program was adapted for survivors of domestic violence by expanding the allowable use of matched funds to include the purchase of a reliable vehicle and emergency expenses

(Sanders, 2010). Unlike prior models, the IDA program explicitly allowed for and encouraged women to save for emergencies. About two-thirds of program participants reached their savings goals. Future research could evaluate this model with other populations.

Furthermore, both researchers and policymakers should work to better understand the implications of asset tests used to determine eligibility for some public benefits. Eligibility requirements may act as disincentives to saving when a family that saves risks losing access to benefits. Finally, there is an enduring need for the development of credible financial products that provide liquidity at a reasonable cost while remaining accessible to those unable to utilize more traditional mechanisms.

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