Emergency Funds

by Sophia

WHAT'S COVERED

In this lesson, you will learn why an emergency fund is critical for financial well-being. You will explore how your technology and agility skills can help you plan and adapt as needed. Specifically, this lesson will cover:

1. Overview of Emergency Funds

Whenever you see the word *emergency*, you should instinctively be thinking about your agility skill . Whether the emergency is financial or otherwise, emergencies are a time where you'll need to adapt.

1a. Protecting Against Pure Risks

Lack of preparation for what are called pure risks can be a serious problem.

- A pure risk is one that results only in an economic loss, such as needing to repair a car or replace a major appliance (see Hint).
- It is essential that you prepare for and anticipate these types of pure risks by establishing an emergency fund.
- An **emergency fund** holds money that is specifically set aside, in an easily accessible account, for the purpose of being available to address unexpected financial needs.

HINT

Unfortunately, only about one in four individuals have sufficient funds to handle pure risks.

If you need more convincing about the value of an emergency fund, consider that no one ever plans to be in a car accident. Most people, if choosing between two similar cars, will prefer the one that has better safety features just in case of a wreck. The same logic holds true when thinking about your financial journey. Although no one expects to lose her or his job or need expensive medical care, these things occasionally happen (see the illustration below). This is the reason why the best financial plans always include an emergency fund – to protect against the unexpected and ensure a safe arrival at the desired financial destination.

Even the most careful plans might not protect you against unexpected emergencies!

TERM TO KNOW

Emergency Fund

Holds money that is specifically set aside, in an easily accessible account, for the purpose of being available to address unexpected financial needs.

1b. Determining the Amount of an Emergency Fund

Just like the number of safety features incorporated into an automobile, the appropriate amount of money that should be held in an emergency fund varies from one person to the next, based on his or her own life circumstances and tolerance for risk. For example, there are some people who are comfortable living with the possibility of a financial setback, meaning that they prefer spending all their income now rather than setting any aside for an emergency. Their tolerance for risk is likely higher than someone who wants to make sure that he or she can pay for a sizable emergency expense.

KEY CONCEPT

It is generally recommended that three to six months of expenses be set aside in an emergency fund.

You can determine your **emergency fund ratio**, which indicates whether you have sufficient resources in case of an emergency, such as losing your job or becoming seriously ill. This ratio, shown below, is calculated using data from your balance sheet and your income and expense statement as follows:

STEP BY STEP

1. Estimate your monthly living expenses, which is the minimum monthly dollar amount you would need to replace in case of an emergency by adding all your expenses and then subtracting nonessential expenses. Most fixed expenses – things like mortgage or rent, insurance, and loan payments – tend to fall into the emergency-need category. Other necessities would also be in this category, such as food, transportation, and utilities. Reviewing your personal budget will be the best way to determine this amount.
2. Determine how much you have in monetary assets, which includes cash, savings, and checking accounts.
3. Calculate your emergency fund ratio by dividing the amount of your monetary assets by your monthly living expenses.

FORMULA TO KNOW

Emergency Fund Ratio

$$\text{Emergency Fund Ratio} = \frac{\text{Monetary Assets}}{\text{Monthly Living Expenses}}$$

The result from the calculation should be between three and six months. Those who have a very low risk tolerance will want to have six months of emergency savings in place. For example, say that in the case of a major emergency you would need $3,000 per month to live. You will need to have at least $9,000 in your emergency fund to meet the benchmark ($9,000 ÷ $3,000 = 3). If you have a very low tolerance for risk, you would want to have six months’ worth of emergency savings in place, which would be $18,000 ($18,000 ÷ $3,000 = 6).

SKILLS 10

Agility: Why Employers Care

Employers seek workers with an agile mindset, as many types of collaboration require openness and optimism to be successful. In fact, you might even encounter an agility question in a job interview. If a potential employer asks you how well you adapt to “fast-paced” or “shifting” workplace conditions, you’ll know that they are really asking about your agility skill!

TERM TO KNOW

Emergency Fund Ratio

Indicates whether you have sufficient resources in case of an emergency, such as losing your job or becoming seriously ill.

2. Creating Your Own Emergency Fund

Technology: Skill Tip

Spreadsheets are an efficient technology tool to help you calculate your emergency fund ratio automatically. If you already have a monthly budget and a balance sheet, you can use your technology skills to build a simple formula for your emergency fund ratio.

2a. Considering Common Financial Emergencies

Although these calculations are helpful in determining how much you need in an emergency fund, you should consider your individual situation very carefully.

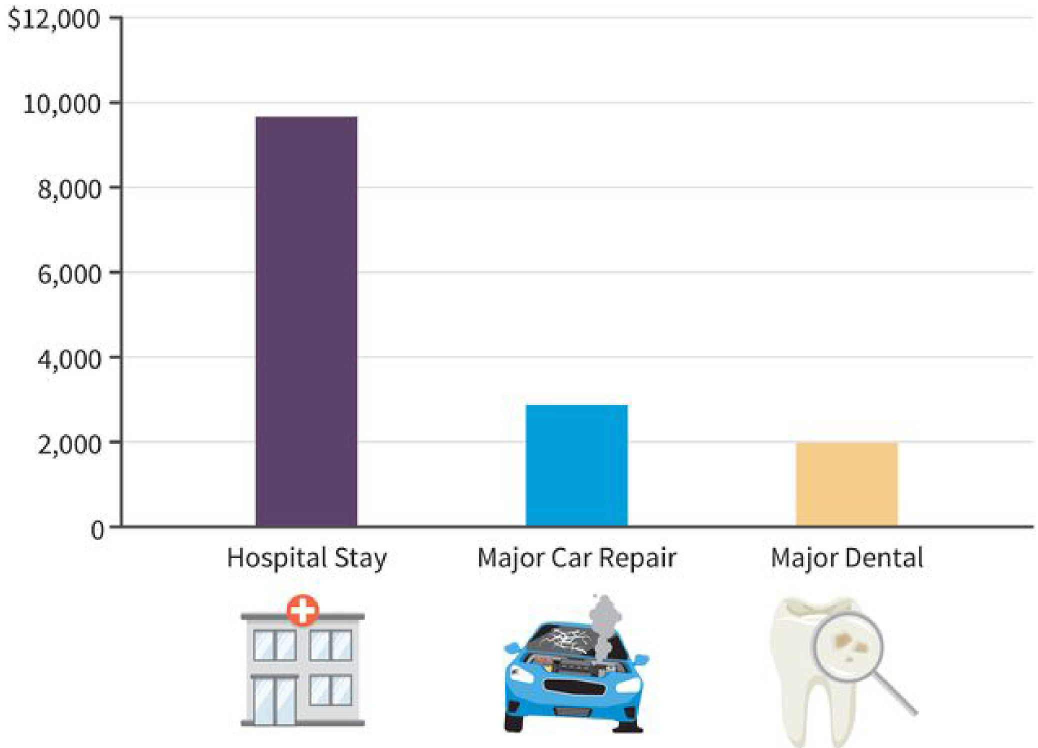
THINK ABOUT IT

For example, what if you lost your job? Did you know that for working adults who become unemployed, the median length of time it takes to find another job is about 20 weeks, or five months? You may qualify for unemployment benefits during this time, but these benefits tend to be very small and too low to sustain you financially. How much money would you need on hand to live for five months until you could find a new job?

Aside from job loss, some other financial emergencies include:

- Major car repairs (especially for older vehicles).
- Major medical expenses (such as unforeseen surgeries and dental work).
- Major home repairs (not a problem if you are renting).
- Emergency travel (expect to pay about 50% more for last-minute airline tickets).

When thinking about your own emergency fund, it is important to be realistic about the cost of emergencies. Consider the expenses shown in the following column chart. The figure shows the average costs for a hospital stay and the median costs for a major car repair and major dental work. Just one of these may be enough to throw you off your financial course.



Sources: A. Pfunter, L. Wier, and C. Steiner, "Statistical Brief #146: Costs for Hospital Stays in the United States, 2010," *Healthcare Cost and Utilization Project* (Washington Agency for Healthcare Research and Quality, 2013); and CarMD, "The 15 Most Expensive 'Check Engine' Related Vehicle Repairs in the U.S.," *2013 Vehicle Health Index: Detailed Tabulated Data* (California Healthcare Foundation, 2014).

2b. Using an Emergency Fund to Fill Budget Gaps

You have already learned about the importance of having and following a budget.

Essentially, a budget helps you to manage income and expenses.

- If you have been using a budget, you will also know that amounts can and often do change from one month to the next.
- You want to be able to pay for things, rather than borrow money, during those months when expenses are greater than income.
- An emergency fund can be used for just this purpose – as a way to address unexpected gaps in your budget.
- If using an emergency fund to fill budget gaps, then try to replenish the emergency fund as quickly as possible.

2c. Building Your Emergency Fund

When it comes to building an emergency fund, you have two main options:

1. Deposit money each month or pay period into a savings account.

HINT

You might earn a higher interest rate through an online savings account; just be sure that it is FDIC-insured.

2. Maintain a combination of savings and low-cost access to credit to protect against unexpected events. For example, if your monthly income is $2,000, then you should have access to about $6,000 in emergency sources of income. The money could consist of $3,000 in savings, plus an unused $3,000 credit line.

HINT

When calculating your emergency fund ratio, only use the money you have set aside for an emergency without regard to any available credit.

Holding highly liquid cash assets tends to be the best form of emergency savings because cash can be accessed quickly and inexpensively. However, having access to affordable credit (a low-interest-rate credit card without a balance) can provide the needed liquidity when sufficient cash is unavailable. Keep the following in mind:

- This is not an optimal strategy because the money you borrow must be paid back, usually at a high interest rate.
- Further, this approach does not work well if you need to borrow money to pay for expenses due to unemployment. In this case, you, at least temporarily, will not be earning a salary to repay the loan, which can easily lead to more debt.
- Ultimately, an approach that is based on borrowing, rather than saving, completely fails if you do not have access to credit.

SUMMARY

In this lesson, you received an **overview of emergency funds**. Since life is full of unexpected events, it's important to be agile and have cash on hand that's readily available, or liquid, and enough to cover your needs. Emergency funds **protect against life's pure risks**. **Determining the amount of an emergency fund** is straightforward: divide your monetary assets (dollars) by your monthly expenses (dollars per month). The result should be between three and six months. If it isn't, then you should adjust your emergency fund.

Before **creating your own emergency fund**, you need to **consider the common financial emergencies** that might occur in your life. Could car repairs set you back? What about a major medical situation? Beware of **using an emergency fund to fill budget gaps** from month to month. If you do, be sure to **build that emergency fund** back up to its original amount. You can use your technology skills to track budget adjustments using a tool like a spreadsheet.

ATTRIBUTIONS

- Statistical Brief #146: Costs for Hospital Stays in the United States, 2010 | **Author:** Anne Pfunter, Lauren M. Wier, and Claudia Steiner | **License:** Public Domain
- The 15 Most Expensive 'Check Engine' Related Vehicle Repairs in the U.S. | **Author:** California Healthcare Foundation, 2014

TERMS TO KNOW

Emergency Fund
Holds money that is specifically set aside, in an easily accessible account, for the purpose of being available to address unexpected financial needs.

Emergency Fund Ratio
Indicates whether you have sufficient resources in case of an emergency, such as losing your job or becoming seriously ill.