Fleshing out the vision a better model

It's an emergency- Why emergency savings are key

South Africa | 06 June 2016 | Insight

Authors and contributers

Alexander Forbes Research Institute

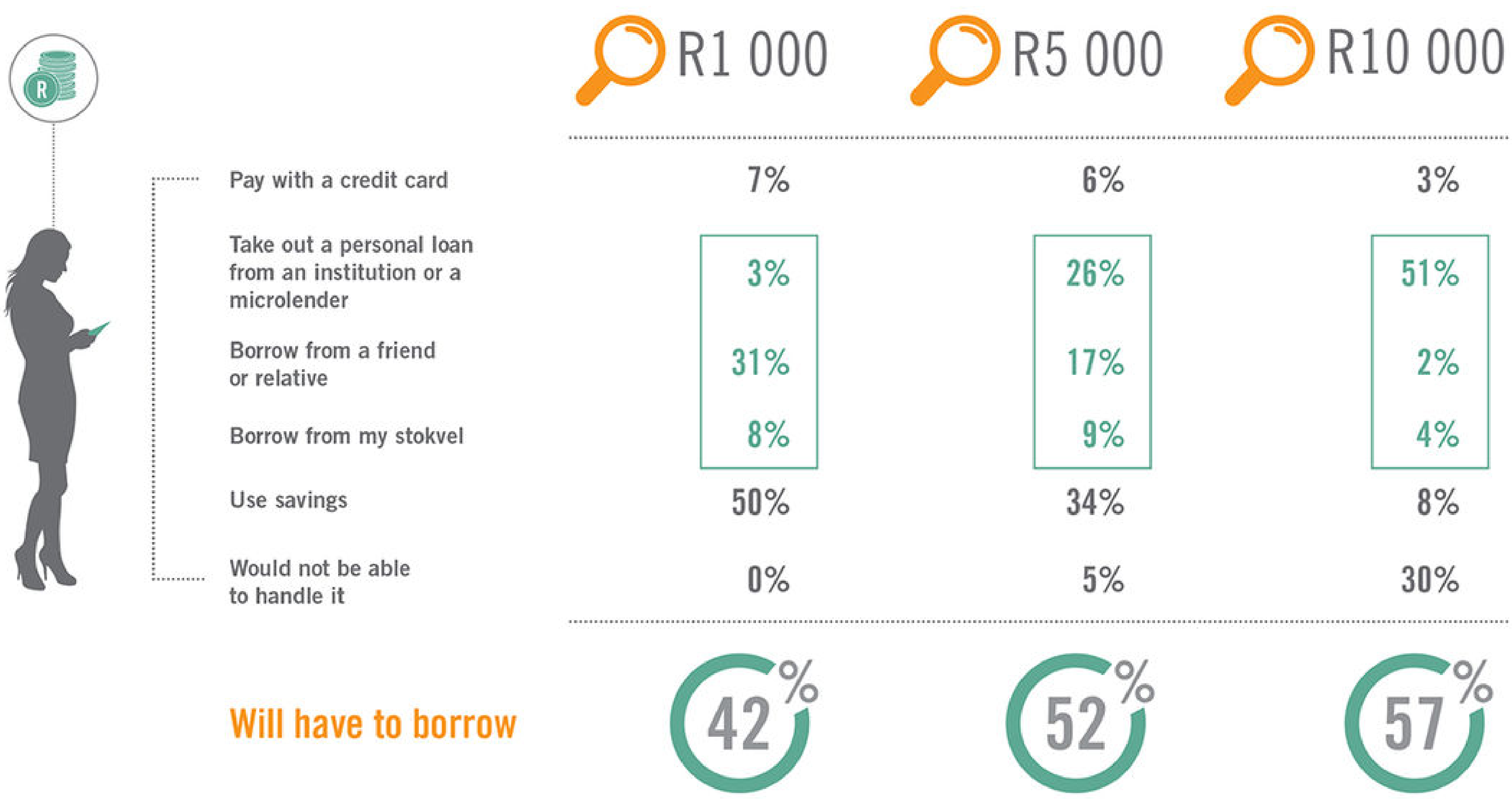
In financial planning, the starting point for any conversation around an individual's financial well-being is whether they have an emergency savings fund. In other words: how well can your wallet withstand a short-term fi nancial crisis? This is something we're encouraged to set up just after that fi rst budgeting exercise – and long before considering any long-term savings programme. Still, we think nothing of propelling employees into a retirement funding programme without even attempting to understand how well they can weather a short-term financial shock. The price we pay for this oversight is high.

Consider the simple problem of why there has been such an adverse reaction to any proposals for mandatory preservation or annuitisation in the retirement reform discussion. Or consider why it is that so many members will willingly quit their jobs to access their savings. Or appreciate why there is such a low rate of preservation when individuals change employers. More often than not these issues point to a lack of an emergency savings safety net. Should it come as any surprise that when a fi nancial crisis looms the fi rst port of call is to raid one's employee benefits?

How resilient are South Africans to financial crisis?

As the following charts highlight, if suddenly asked to cover a R10 000 financial shock, 57% of employees earning between R6 000 and R19 999 per month would need to borrow the funds. And 30% of the same group would be unable to meet the demand **by any means**. Of those employees with salaries between R20 000 and R39 999 per month, 48% would need to borrow the funds and 11% would be unable to meet the demands **by any means**[1]. What these numbers suggest is that there's a disturbing number of South African employees that are "just one destabilising shock from hardship.[2]" The lower the income, the more pronounced the shock is likely to be.

Ability to handle unforeseen expenditure (R6 000 to R19 999 monthly household income)



Ability to handle unforeseen expenditure (R20 000 to R39 999 monthly household income)

	R1 000	R5 000	R10 000
Pay with a credit card	25%	27%	13%
Take out a personal loan from an institution or a microlender	1%	11%	34%
Borrow from a friend or relative	12%	12%	9%
Borrow from my stokvel	5%	8%	5%
Use savings	51%	39%	25%
Would not be able to handle it	0%	2%	11%
Will have to borrow	18%	31%	48%

Source: Old Mutual Savings and Investment Monitor, July 2015

> **The harsh reality is that financial shocks are without prejudice – they can strike any one of us at any time.**

This is something we all need – no matter how wealthy we are

Emergency savings serve all of our interests, no matter what socio-economic group we belong to. As a point of contrast, a 2013 US Federal Reserve Board study found that 47% of Americans would be unable to pay for a $400 emergency without borrowing or selling something. The harsh reality is that financial shocks are without prejudice – they can strike any one of us at any time.

But the rise of a credit mindset has also created a sea-change in the way individuals make their financial decisions. Gone are the days of constraints that could limit the number of financial commitments an individual could make.

A paper by Lusardi, Tufano and Schneider[3] argues that the more sophisticated a country's credit and financial markets, the more difficult it is for its population to maintain a level of financial literacy. South Africa's formal financial markets are renowned for their first-world sophistication. But our financial woes are complicated further by the fact that there's another whole world of borrowing and savings, the informal sector, which rarely gets included in the total picture for the individual.

Emergency savings do more than just prevent a financial maelstrom. They also can provide individuals with the first tentative step towards asset accumulation and management[4]. Emergency savings "enable people to achieve other goals and avoid other hardships". **It's as much about being able to meet unexpected expenses as it is about being able to take advantage of unexpected opportunities (such as an unexpected training or educational opportunity)[5].**

But perhaps the most powerful attribute of emergency savings is the psychological impact they have on the saver. We know, for example, **that people's perceptions of their financial well-being are typically more influenced by their assessments of their current cash balances than by any valuation of their long-term asset accumulation potential[6].** We tend to focus on how well we could deal with a sudden financial crisis, rather than absolute levels of wealth.

An emergency savings habit addresses two important issues. Firstly, should a financial crisis occur, it allows the individual to deal with it without destabilising any long-term savings strategies. And secondly, it has an impact on time-frame tolerance: the greater the financial cushion, the more willing investors are to adopt longer-term time horizons for other savings goals. Research also tells us that there's a strong relationship between establishing an emergency savings habit and economic mobility, intergenerational wealth transfer and family stability[7].

> **Perhaps the most powerful attribute of emergency savings is the psychological impact they have on the saver.**

What makes a good saver?

Case study/Lesson

Is saving something that belongs to the realm of nature, or nurture? Will individuals who are innately inclined to save become economically successful, or can individuals achieve economic mobility simply by adopting good habits around saving and money management skills?

Findings from joint Swedish and American research on identical twins suggest that **individuals are indeed born with a propensity to a specific saving behaviour**[8]. **Genetic differences can account for around 33% of the variation.** This genetic influence, according to the study, seems to persist throughout an individual's life. But socioeconomic circumstances and parenting influences can interact to temper that genetic predisposition. That said, parenting influences (good or bad) tend to dissipate when the individual becomes an adult. In the long run, current socio-economic circumstances trump upbringing, meaning that we can potentially nurture a savings habit.

A further insight from the same study is that **"behaviours regarding savings appear to be genetically correlated with one's predispositions towards self-control or time preferences"** – in other words, one's level of tolerance for delayed gratification. You may be familiar with the famous marshmallow test conducted at Stanford University in the 1960s, where Walter Mischel made a direct connection between a child's willingness to postpone eating a marshmallow in order to gain an extra one and their professional success later on in life[9].

Perhaps the more intriguing aspect of the Swedish-American study is their finding that, while there appears to be no correlation between savings and education, there does appear to be a significantly positive correlation between an individual's savings rate and income growth. Slightly more disturbing, though, was their observation that there also appears to be significant negative correlations between obesity or smoking and savings[10].

None of this suggests that social dynamics are not an important factor. What the research doesn't tell us is how life experiences might factor in here. Nor does it give us any insight into when genetic predisposition might be the dominant influence or when environment might be the dominant factor. What we can conclude though is still important. Any number of factors are at play when it comes to an individual's propensity to save. On top of that, household members are often at very different phases of their financial cycles when it comes to accumulating, spending and rebuilding savings. This suggests that it is unlikely that any single approach will resolve the problem of getting people to save.

Perhaps we're missing an important opportunity by not understanding the critical role emergency savings play alongside long-term savings. Policymakers globally are generally silent on the point of emergency savings[11]. They have their attention firmly focused on the importance of long-term savings, particularly when it comes to such goals as retirement, housing and education. Or, if they focus on emergencies at all, it's for the government to be the last port of call – after every other source of income: pension fund, insurance cover, job. In fact, where countries use means testing to determine whether individuals or families warrant financial assistance, this requirement can act as a strong disincentive to creating an emergency savings fund. The very existence of such a fund disqualifies an individual for assistance.

> **Any number of factors are at play when it comes to an individual's propensity to save.**

By introducing a framework that allows us to accommodate both short-term and long-term savings from one controlled environment, we think we can go a long way to defusing some of the tensions around compulsory long-term savings. This demands that we get individuals and their families to think differently about short-term and long-term savings, and to recognise that these two investments need to be managed differently. Finally, we need to create an enabling framework in the workplace that provides individuals with ways to manage these two imperatives simultaneously as part of a more holistic financial well-being programme.

Emergency Savings

Case study/lesson

Looking for the answer

We know from our survey covered in 'What do our members want?' and from our discourse on the effectiveness of the informal financial sector in 'Learning from the informal sector' that creating some emergency savings is top of mind for all levels of South Africans. The question is how to address this efficiently. For a large portion of the South African population, the community, with its informal financial savings forums, offers any number of saving vehicles for crises in the form of stokvels or burial societies. In the workplace, employers who allow their employees to borrow against future earnings in the event of an emergency provide another potential resource.

But neither solution is optimal. To begin with, for individuals to make meaningful trade-off decisions, they need to be able to have an aggregate picture of their financial health. And they need to be able to seamlessly and efficiently shift money around as needed. This is one of the drawbacks of splitting resources between the informal and formal savings environments. Additionally, borrowing from an employer against future income creates another bad precedent. Reducing future earnings distribution during a time of financial crisis has the potential of placing even greater financial strain on the family.

The better solution might be one where the savings cushion is already in place – but out of sight and out of mind to discourage impulse withdrawals. An emergency savings fund might work best as a commitment device: get the individual to pre-commit to maintaining this balance and ensure that what's required is deducted directly off payroll before the individual is able to use the funds for immediate consumption. It should become a 'set-and-forget' solution – until, of course, they need it.

Unlike long-term savings where people tend to save once to meet a goal, emergency savings are perpetual, something individuals need to be able to access immediately, spend down to cover a crisis, and then repeat the process of replenishing – over a lifetime. As important as it is to have these surplus funds on tap, it's equally important that there isn't **too** much surplus capital sitting idle. This means that an automated system linking payroll to account should be employed.

Creating a framework like this now means that it is the employer who is driving a shortterm savings culture for their employees. This may initially appear to be paternalistic but at some level this may be one of the methods we could devise to make the process effective. From the employees' perspective, it's particularly helpful to have money channelled directly from the payroll to a commitment device before one is tempted to reconsider. From the perspective of the employer, providing a savings model to cope with the inevitable employee financial crisis ensures that a bad situation doesn't become a worse debt spiral. Helping employees cope with debt spirals goes to a root cause of productivity declines, absenteeism, fraud ... the litany goes on. **If employees are an employer's most valuable asset, then emergency saving funds will provide an important foundation for keeping those employees financially stable.**

Creating an enabling environment

Setting up emergency saving funds as part of a holistic employee benefits package is straightforward.

We need five conditions to make this work effectively:

- Members must pre-commit to the programme – after which all processes should run nearly automatically (except for withdrawals).
- Payroll must channel after-tax funds directly into low-risk, money-market type investment portfolios, preferably an institutionally-priced unit trust, before paying salaries to employees.
- Members must have ongoing sight of their aggregate short-term and long-term savings pictures.
- Members need to have easy access to their funds in case of an emergency.
- Members should be able to access financial guidance in relation to the emergency to ensure that they can get back on track.

Because short-term savings are not tax-incentivised, employing a tax-free savings vehicle might not be optimal. Contributions would be capped at R30 000 per year and R500 000 overall and if money is withdrawn from the fund and if these limits have been reached, it cannot be replaced. The risk here is that, because individuals are not allowed to top up their funds in the event of a withdrawal from a tax-free savings vehicle, individuals might end up depleting their tax savings over time.

The significant advantage of setting this up through an employee benefits platform is that it offers flexibility to structure this double-barrelled approach to savings in a way that would be most effective. Irrespective of how the solution is structured though, five decisions are central to the whole process:

- Who would determine what the funding process should look like?
- What would constitute an adequate emergency savings reserve?
- What is the most effective way to accumulate it?
- What sort of controls or nudges should be put in place to make sure these funds are used effectively?
- What vehicle should be used?

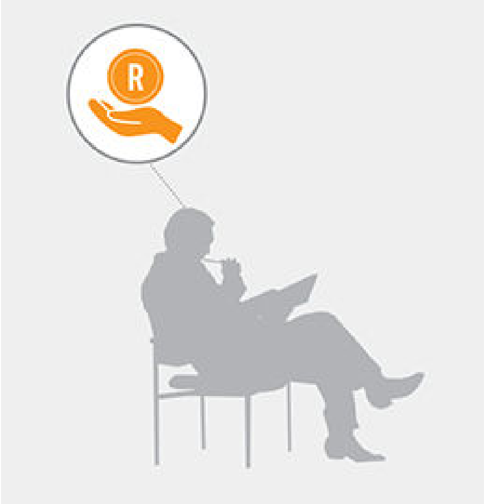
You could consider using one or a combination of the following:

Employer-driven, where the employer:

- provides the solution as a default (employees could potentially opt out) •
- determines what level of savings is optimal
- offers incentives to make sure employees apply these emergency savings optimally.

This might be in the form of matching funding to an employee's

existing savings level in the event of a genuine emergency.



Member-driven, where the member determines:

- the level of savings they want
- the conditions under which they can withdraw the money
- how they can replenish funds and what kind of incentives would keep them on the programme.

Stokvel-type model for the workplace, where members:

- determine contribution rates to pool emergency funding
- offer ongoing support to monitor each other's progress
- determine conditions for withdrawal and replenishing the pool.

This could either be structured as an actual workplace stokvel, or it could simply be a workplace support group.

HOW COULD SUCH A SOLUTION LOOK FOR A MEMBER?

There are two options for them to follow: they can either specify the length of time over which they would like to build up the fund to cover three months' salary, or they can specify the amount that they would like to contribute.

Option 1: Specifying the saving period

Assuming the employer and the individual both contribute the same amount towards the goal, but the employer contribution is paid over and above the individual's current pay (so that the employee's take-home pay is only reduced by the amount of their contribution), then the required contribution rates for a specified length of savings period would be as follows:

Length of contribution period	Total required contribution
One year	12.9%
One and a half years	8.2%
Two years	5.9%
Two and a half years	4.6%
Three years	3.7%

We calculated these required contribution rates assuming real investment returns of 1.8% per year compounded monthly, and applying a merit scale to the individual's earnings. This return corresponds to the anticipated return on a portfolio made up of 67% cash investments and 33% bonds, which is simply a proxy for a low-risk, liquid fixed income portfolio. Without investment earnings, both the individual and the employer would need to contribute 6.3% of salary for 24 months, but investment returns have reduced this required contribution rate by just under 0.4%.

Option 2: Specifying the contribution rate

The individual and the employer can also specify the amount that they would each like to contribute and let the savings period vary. Employer and employee contributions might not be the same, but there needs to be a restriction on how low and high the contributions can go. If the employer would like to limit their liability to just one and a half month's salary, then they will need to select their contribution rate carefully.

The following table summarises the projected savings period if the employer and employee both have choice over the value of the contribution rate:

Employee contribution rate	Employer contribution rate	Savings period
2.5%	2.5%	Four years and three months
5.0%	5.0%	Two years and four months
7.5%	7.5%	One year and eight months

In this model, depending on how much the employer and employee are willing to contribute, it could take over four years and three months to accumulate the required amount of three months' salary. This may just not be viable. Employers might need to set higher minimum contribution rates as one solution. At an employee contribution rate of 5% and matching employer contribution rate of 5%, it would take just over two years to save the required amount. This seems like a much more reasonable amount of time.

The success of this method relies on how generous employers are willing to be. Securing the employee's peace of mind could be an easy investment decision for many employers. Structured correctly, an employer could even justify funding the exercise from employee engagement resources.'Why South Africans can't meet their funding needs now' takes a closer look at how we can solve for an emergency savings fund while addressing the member's other long-term savings objectives.

CUTTING THE CLOTH TO FIT THE COMPANY

To illustrate how broadly different the optimal solution for a given company could look, let's examine how two different employers have implemented this at two very different set-ups.

Model 1: Consciously rewarding prudent savings behaviour

In this example, the employer determined that a reasonable emergency savings cushion would be approximately three months' after-tax salary. They also recognised that accumulating such an amount without putting significant pressure on the family would take too long. Given this constraint, the employer stipulated that the employee only had to save up to one and a half month's salary by making monthly contributions over two years. In turn, the employer agreed to make an up-front contribution of one and a half month's salary into the savings pool every time a new employee came on board.

As the employee contribution would come out of employees' after-tax income, the employee would be free to withdraw the funds at any time, for whatever personal reason they might have. But, should a real financial crisis emerge, the employer would only release their contribution pot if they receive a legitimate emergency claim.

One challenge here might be determining what constitutes a genuine financial emergency. Again options will be necessary. If there was indeed a financial crisis and the employee had demonstrated a responsible commitment to saving, the employer could release the matching amount. Clearly such a crisis would have to pass a qualifying test, which could be vetted through a set of pre-existing rules.

The claim of a financial emergency could also trigger a session with a Financial Well-Being Consultant. This would ensure that any employee experiencing a financial crisis receives help as to how to get their financial affairs back on track.

Model 2: Helping employees help themselves

The thinking behind this model is to have as little employer intervention as possible and to capitalise on the ways that peer groups with a common purpose and common needs provide some of the most effective policing and coaching support.

In this case, the employee joins a workplace stokvel specially designated for their employer, but controlled exclusively by the members. Payroll would still automatically collect monthly contributions to this stokvel, but these funds would then be channelled into a single pool and invested into a unit trust specially designed to service stokveltype savings clubs.

A stokvel is an informal rotating credit union or saving scheme where members contribute fixed amounts of money regularly to a central fund. What makes them particularly effective is that members generally know each other and ensure that each participant fulfils their obligation to the savings club. Stokvels are exempt from the Banks Act. For further discussion, please see 'What do our members want?'.

Like many stokvels, this fund would function yearly. Contribution rates could be determined in advance by the individual for the year and apportioned into monthly deductions. Should an individual require access to emergency funding, they would be entitled to their full year's contribution at any point, but there would be a nominal interest charge on that loan and the borrower would forgo any capital gains or interest accumulation that their investments would have earned. The great power of the stokvel model is that regular monthly meetings offer all-important peer-group support where tips and insights become a real bonus for the participant.

> **The great power of the stokvel model is that regular monthly meetings offer all-important peer-group support where tips and insights become a real bonus for the participant.**

CONCLUDING THOUGHTS

Both of these models use strategies that have been shown to be effective behaviour modifiers. In the first model, the primary driver is a matching strategy and in the second model, the peer pressure of the stokvel structure. But neither of these strategies alone can cope with the wave of behaviour biases that invariably undermine the best thought-out savings plans. For both of these models to be truly effective, we would have to bolster them with other effective behavioural change strategies:

- Auto-enrolment (where members could opt out)
- Commitment devices (once you've reached your short-term savings goal, those contributions would be reallocated to your long-term savings plans)
- Simplification
- Nudges and reminders (should you fall below your emergency savings target, you would receive notices that you need to fill it up)[12].

The kind of benefits platform we're describing should be able to provide all of that. But what's probably the most important feature of our parallel savings structure is that it gives members a mental accounting framework and helps individuals appreciate that short-term and long-term savings involve different considerations and demands. **By accommodating both in a single environment that's easy to access and to stress-test, individuals and their families can understand how to balance their two savings imperatives.**

References

1 Old Mutual Savings and Investment Monitor, 2015
2 Collins and Gjertson, 2015
3 Lusardi, Schneider & Tufano, 2011
4 Ibid
5 The Pew Charitable Trusts, 2016
6 Ibid
7 Collins and Gjertson, 2015
8 Cronqvist and Siegel, 2013
9 Mischel, 2014
10 Cronqvist and Siegel, 2013
11 Lusardi, Schneider & Tufano, 2011
12 Madrian, 2012