Best Practices: Creating an Emergency Fund

Step 1: Explaining the Need for an Emergency Fund

Everybody knows what an emergency is, but sometimes it helps to explain financial emergencies and the need to prepare for such events. The planner can provide examples of typical emergencies that might occur:

- Unexpected job loss (and possible related loss of benefits such as health insurance)
- Home/Automobile repairs
- Medical expenses not covered by insurance
- Pet emergency
- Unplanned travel
- Skyrocketing home costs (heat, property taxes)

There is no age limit as to who needs an emergency fund – young and old alike should be prepared for life's financial emergencies.

Step 2: How Much to Save

Financial planners agree on the need for an emergency fund, but recommendations for the amount to save vary. Most planners recommend saving at least enough to cover four months of basic living expenses – some planners recommend being able to cover up to six months of such expenses. A good rule of thumb is to provide for three to four months of living expenses if you are single and under age 35, six months if you have a family or are over age 35.

Examples of basic living expenses include:

- Rent/mortgage
- Car payments
- Utilities
- Student Loans
- Estimated taxes
- Food
- Minimum payments on revolving charges

Step 3: Where to Save (and Where Not to Save) the Emergency Fund

The point of having an emergency fund is to handle unexpected crises that come up suddenly. Thus, the money your client is saving to handle these life events must be readily available and easily accessible. Emergency funds should not be invested in the stock market or in a bank CD because there won't be time to wait for the best stock price or for the CD to mature when an emergency arises. Also, the money should not be invested where it is at risk.

Best places to invest include savings accounts and money market accounts. Another alternative is a staggered investment in Treasury Bills so that some are always maturing – that type of investment should be set up so that at least one month's basic expenses can be covered each month with maturing Treasury Bills.

Step 4: Where Will the Emergency Fund Money Come From?

It's great to think about putting money away in an emergency fund, but for people who have not set up such a fund in the past, it might be difficult to pull together the money to stash away four to six months of living expenses. Couple that with a situation where the client is putting extra funds toward paying off debt, and the emergency fund seems completely out of reach.

The answer will vary for different clients, but in general, here are some tips for how to start this fund.

- For the person focused on using extra funds to pay off debt or starting from a point of zero savings, start small with a minimal deposit each month. Even if the amount is small, it will begin the habit of saving.
- An easy way to save is with an automatic withdrawal from paychecks or a regular automatic transfer from checking to savings.
- Stashing a financial windfall such as a tax refund or an inheritance is a great way to fund an emergency account without disrupting the general ebb and flow of everyday income and expenses.
- If funds are already being saved, diverting them to an accessible interest-bearing account and designating them as the emergency fund should be easy.
- A more extreme measure might be to take on a short-term job or some contract work to bring in extra money that is targeted for emergency savings.
- Sell things that are no longer needed but that could bring in some measurable funds to add to savings.

Step 5: What Happens When Emergencies Arise?

The emergency account is available to handle the emergencies that arise so that the person experiencing the emergency can deal with the problems at hand and not worry about where the money is going to come from. Instead of having to use credit cards and incur debt to handle the emergency, the fund is there to ease the financial burden.

Once the emergency has been addressed and funds have been disbursed, it's important to work with the client to ensure that the emergency fund is replenished. Diverting funds each month or using one of the other techniques discussed in Step 4 will put the client on the path of refilling the emergency fund for future use.