CFSi Center for Financial Services Innovation

A Financial Solutions Lab Brief on Household Liquidity

The bills are due today, but payday is a few days away—the lack of funds to make ends meet poses a common challenge. To bridge the gap, some households can tap into a savings account or shift spending to a credit card. However, for the many Americans without an extra savings cushion or access to reliable credit, easy solutions are scarce. These households face a constant juggle that creates inconvenience, stress, and additional expenses such as late fees, overdraft penalties, or higher-cost credit. Further, the demands of short-term money management tax the focus of many households and prevent them from building the savings and assets that they need to improve their financial health in the long run.

By leveraging technology, financial service providers have a significant chance to help consumers improve their ability to manage household cash flow. This brief explores the challenge of household liquidity, its impact on financial health, and the opportunity for innovation.

*The Financial Solutions Lab is a **$30 million, five-year** initiative managed by the Center for Financial Services Innovation with founding partner JPMorgan Chase & Co. to identify, test and bring to scale promising innovations that help consumers increase savings, improve credit, and build assets.*

Cash Flow Management Challenges

Millions of Americans have difficulty managing their household cash flow. Uncertain or volatile income and urgent expenses challenge households across the income spectrum. And it's not just a problem affecting part-time, self-employed, and seasonal workers. Nearly a third of Americans encounter significant variation in their income—over half of these Americans are employed full-time.[1]

An example from the U.S. Financial Diaries, a research project that quantitatively and qualitatively tracked over 200 low- and moderate-income American households, helps illuminate these challenges.[2]

The U.S. Financial Diaries is a joint initiative of NYU Wagner's Financial Access Initiative (FAI) and CFSI. Leadership support is provided by the Ford Foundation and the Citi Foundation, with additional support and guidance from the Omidyar Network.

Sam and Sarah Johnson of Ohio have stable full-time work, hold several part-time jobs, and receive other sources of income. However, within a seven-month observation period, the Johnsons' monthly income ranged from about $4,100 to nearly $9,000. The family's expenses also varied significantly; for instance, they spent $11,000 one month and $4,660 the next. While many of the Johnsons' expenses occurred with a degree of regularity (e.g. mortgage payments and insurance premiums), the timing or amount of other expenses varied enough that they seemed unpredictable (e.g. auto or home repairs and healthcare expenses). Only about 20% of the Johnsons' monthly expenditures were fixed costs. Though the family has a method for managing their budget, in months with heavy expenses from major purchases and ongoing bills, they may experience a shortfall.[3]

Though the Johnsons' household income frequently exceeded expenses, the timing of their regular paychecks and the seemingly constant and unpredictable flow of expenses led to situations where cash on hand was not sufficient to pay all bills in full or on time. In instances of constrained liquidity, families like the Johnsons face a greater risk of incurring late fees and penalties, relying on costly credit, or having utilities shut off.

The Johnsons' story is not unique, 58% of Americans have difficulty covering expenses and paying bills.[4] As a result, 36% of Americans break-even and 19% spend more than they earn in the course of a year.[5]

A Lack of Saving

A lack of savings compounds the challenge of managing a household with a limited margin between income and expenses. In 2012, 45% of Americans did not save any portion of their income and 61% of households did not have a "rainy day fund" to cover three months of expenses.[6] Over half of American households would not be able to cover a $400 emergency expense without selling something or borrowing money.[7] Even macroeconomic indicators point to the difficulty in managing household cash flow; in 2013, the American savings rate was only 4%, showing that in aggregate there is a narrow margin between household income and expenses.[8] Households with depleted income and no money in savings won't have a safety net to cover unexpected costs, weather a personal financial crisis (i.e. job loss or a medical emergency), or prepare for future needs.

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A Lack of High-Quality Credit Options

With volatile income and an inadequate savings buffer, consumers often turn to credit to bridge the gap. A good credit rating—and subsequent access to low-cost, high-quality credit—saves the average borrower an estimated $250,000 in interest over a lifetime.[9] However, more than half of American consumers have subprime credit.[10] Consumers with limited or poor credit history lack access to traditional credit like lower-interest credit cards. Alternatively, these consumers turn to higher-cost products and services to manage their expenses. Nearly a third of small-dollar credit borrowers (5 million consumers) use short-term loans like payday, pawn, installment, auto title, or deposit advance to cover regular expenses when cash flows are misaligned.[11] Though marketed as short-term solutions, these products often carry significant fees and lead to further debt accumulation. For example, the median payday loan borrower spends at least 55% of the year owing money to lenders.[12] Based on CFSI's upcoming report, "2013 Financially Underserved Market Size Study," consumers with liquidity needs as their main motivation for accessing small-dollar credit spent an estimated $7.5 billion dollars on those products.[13] Because of a lack of access to higher-quality credit, many consumers rely on products that are not designed for their success as a borrower.

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Accessing Funds at High Costs

Both traditional and alternative financial services providers offer instant liquidity at high costs. Among consumers who use such products, 46% are paying for basic living expenses and 18% are trying to make up for lost income.[14] For consumers who need immediate access to funds, check cashers offer instant cashing and are available 24 hours a day. For consumers with transactional accounts that have overdraft protection, a check will still clear when an account is overdrawn, but the use of this feature incurs a fee. These products offer speed and convenience, but they carry heavy transaction costs. CFSI estimates that in 2013, underserved consumers spent over $6 billion on transaction products, like money orders and check cashing, and $7 billion on overdraft.[15]

The Financial Health Impact

Cash flow problems relate directly to the ability to manage day-to-day finances. When people can't pay bills on time they face late fees, overdraft penalties, or risk over-indebtedness. Continually prioritizing and making judgments on spending becomes a mentally exhausting exercise for households facing liquidity challenges. These households must try to plan and predict their finances while confronting complicated decisions, like how to access money and how to borrow and save simultaneously. This is more than a financial challenge; it also takes a significant psychological toll. Behavioral economists Sendhil Mullainathan and Eldar Shafir describe this toll as a "tunneling tax," in which tunnel vision on immediate problems impairs the ability of consumers to make longer-term decisions.[16] Liquidity-challenged consumers have limited bandwidth to think about building savings, assets, and good credit.

The challenge of household liquidity is complex and carries many costs, well beyond the dollar amount. Yet there are untapped ways providers can reduce the friction that makes it so difficult to make ends meet.

Opportunities for Solutions

Household liquidity is a solvable problem. Improvements in low-cost data analytics, innovations in payments, and increasingly powerful mobile capabilities can lead to technologies that better address this widespread issue. Sophisticated risk analytics could make lower-cost, higher-quality credit products available to consumers when they need them most. Better designs for decision-making tools could draw on behavioral economics to nudge consumers down a path of increased long-term financial health, not just present consumers with options. There is need for solutions that help consumers track and understand their cash flow, predicatively plan for unexpected expenses, and better evaluate trade-off costs.

In a world where software is regularly used to analyze spending and behavior patterns, financial service providers can harness this same technology to help consumers plan, save, and access credit to build their financial health.

By raising awareness to this issue, providing more detailed consumer understanding, and bringing in leading lessons from behavioral economics and user-centered design, the Financial Solutions Lab at CFSI with founding partner JPMorgan Chase and Co. aims to support a burgeoning landscape of innovative solutions that help consumers better manage their day-to-day income and expenses, build an emergency fund, and open access to lower-cost, higher-quality credit options. In the process, we will be looking for technology solutions that have the potential to disrupt inefficient industries and business processes and improve the lives of tens of millions of Americans. The first Financial Solutions Lab Innovation Challenge will focus on household liquidity—stay tuned for more information.

The Financial Solutions Lab is a $25M, 5-year initiative managed by the Center for Financial Services Innovation with founding partner JPMorgan Chase & Co.

Bringing together innovators from the fields of technology, behavioral economics, nonprofit services and design to provide guidance, share best practices and develop scalable financial product solutions, the Financial Solutions Lab is launching a series of competitions for entrepreneurs to identify and enhance tech-enabled innovations that address consumer needs. Winning ideas will be supported with capital, technical assistance and third-party evaluation. Learn more at www.cfsinnovationlabs.com

CFSI Center for Financial Services Innovation

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The Center for Financial Services Innovation (CFSI) is the nation's authority on consumer financial health. CFSI leads a network of financial services innovators committed to building a more robust financial services marketplace with higher quality products and services. Through its Compass Principles and a lineup of proprietary research, insights and events, CFSI informs, advises, and connects members of its network to seed the innovation that will transform the financial services landscape.

For more on CFSI, go to cfsinnovation.com and follow on Twitter at @CFSInnovation.

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2 The U.S. Financial Diaries is a research project that tracks more than 200 low- and moderate-income households over the course of a year and collects highly detailed data on household financial activity. The U.S. Financial Diaries were created jointly by the NYU Financial Access Initiative and the Center for Financial Services Innovation. Leadership support for the project is provided by the Ford Foundation and the Citi Foundation, with additional support and guidance from the Omidyar Network. For more information, visit http://www.usfinancialdiaries.org/

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