Financial Solutions Lab

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Helping Americans Weather Financial Shocks

Laura Cummings

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.

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The Financial Solutions Lab (FinLab) is a $30 million, five-year initiative managed by CFSI with founding partner JPMorgan Chase & Co. The Lab seeks to identify, test and bring to scale promising innovations that help Americans increase savings, improve credit, and build assets. Lab participants share a relentless focus on building products that will improve the financial health of Americans. The Lab provides capital, national partnership opportunities, industry expertise, mentorship, and cutting-edge consumer and design insights necessary to build the next generation of leading financial products and services.

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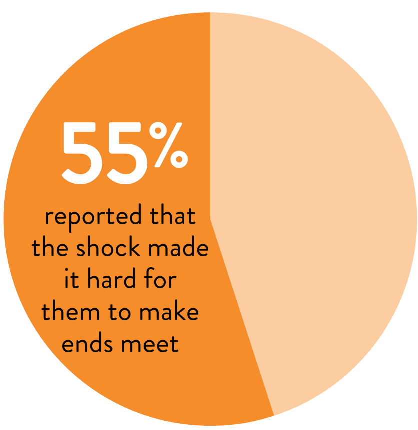
“**Financial shocks” may sound like a stroke of bad luck that happens to the unfortunate few, taking them from comfort to despair, and wiping out hard-earned savings. But financial shocks are not limited to a hapless minority. *In fact, sixty percent of Americans experienced a financial shock in the past year.*[1]**

Financial shocks are unexpected expenses and drops in income, and for Americans they are all too common. There are numerous causes of financial shocks. For one family, it may be a car accident or unscheduled car repairs. For another, it may be back surgery, requiring time off work and endless medical appointments and co-pays. Yet not all causes of financial shocks are negative. The birth or adoption of a child, though a welcome addition to the family, often brings unexpected expenses and a reduction in income that can overwhelm even the most diligent planners.



Why are so many families experiencing life’s surprises, big and small, as financial shocks? One big reason is that these Americans lack access to quality products that could help them withstand financial shocks. While unexpected expenses and drops in income are a part of life, few financial products are designed with that reality in mind.

The statistics around financial shocks are staggering. Fifty-five percent of those experiencing financial shocks reported that the shock made it hard for them to make ends meet.[2] Without products to help weather financial shocks, the effects reverberate throughout a household’s finances, often causing long-term damage. In addition to creating financial strain, shocks cause personal stress that can lead to household discord and even detrimental effects for the children of these households.[3]

In an effort to direct technology, innovation, and talent toward addressing this important issue, the 2016 Financial Solutions Lab (FinLab) is dedicated to supporting entrepreneurs and non-profit innovators who are helping Americans weather the financial shocks that all of us experience in life. This issue brief will outline why the Center for Financial Services Innovation (CFSI) and its partners selected this challenge, identify some of the ways that Americans are affected by financial shocks, and review the current tools Americans turn to — along with their shortcomings. From affordable, transparent insurance products to new approaches to savings, to quality credit options, the Financial Solutions Lab seeks innovative solutions that will help Americans weather financial shocks.

Using This Issue Brief

The 2016 Challenge topic of the Financial Solutions Lab is Helping Americans Weather Financial Shocks. This issue brief introduces the topic, the reasons it is an important problem to solve, and some innovative approaches to doing so. The examples and ideas included are not prescriptive, but rather a handful among thousands of potential solutions we would welcome from applicants.

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[1] The Pew Charitable Trusts. “Americans’ Financial Security: Perception and Reality,” March 2015. **http://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2015/02/americans-financial-security-perceptions-and-reality.**

[2] The Pew Charitable Trusts. “How Do Families Cope with Financial Shocks?” October 2015. **http://www.pewtrusts.org/~/media/assets/2015/10/emergency-savings-report-1_artfinal.pdf?la=en/**.

[3] CFSI. “Leveraging Innovation to Support the Financial Health of LMI Families with Children,” November 2015. **http://bit.ly/1XFq2W4**

What Are Financial Shocks?

Financial shocks can come from all angles, whether life changes such as divorce, changes in employment and income, car or home repair expenses, or health events. These financial strains may be unexpected but they are not uncommon.

In fact, CFSI's Consumer Financial Health Survey found 65 percent of households experienced at least one major life event in the past five years. The top three most common were: 1. A reduction in work hours and/or pay by head of household or spouse (23 percent), 2. A health emergency (22 percent), and 3. The loss of a job by head of household or spouse (20 percent).[4] Financial shocks can also come from the more predictable changes in life, such as buying a house or sending a child to college. It can be hard to estimate all of the seemingly never-ending costs of such things, despite knowing that a large outlay is coming.

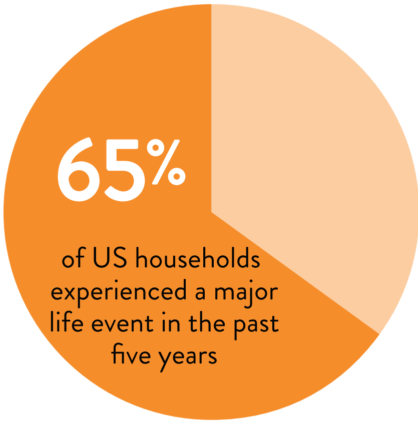
Households with children have a greater risk of financial shocks; the needs of children require parents to take unscheduled time off of work and bring their own healthcare costs, along with other unplanned expenses. CFSI's survey found 45 percent of households with children reported using savings to pay for bills and expenses versus 38 percent of households without children.[5] However, there is a great diversity in the causes of financial shocks — which is why this challenge is so compelling. FinLab seeks products and solutions that are as diverse in approach as the Americans who stand to benefit from them.

How Are Financial Shocks Experienced?

Research from the U.S. Financial Diaries[6] and the JPMorgan Chase Institute[7] demonstrate that spikes and dips in income and expenses are the norm. Our first FinLab challenge addressed the issue of household liquidity, the mismatch of income and expenses. These spikes and dips stress the finances of families that may look balanced when their annual income and expenses are compared — but the timing of their income and expenses create good times and bad, requiring complex financial maneuvering to keep everything in check. Financial shocks often occur on top of this day-to-day and month-to-month volatility — and often are compounded by this volatility. They upset any precarious balance that may have been achieved. Financial shocks disrupt already messy household finances.

Income Disruptions Bring Financial Shocks

The Hossains are a family of four who emigrated from Bangladesh to Queens, New York in 2010. Both parents work, but neither receives paid sick leave from their employer. When Mr. Hossain suffered an injury to his hand, he lost two weeks of income. In the same year, Ms. Hossain started a new job that required two weeks of up-front unpaid training. Those two unexpected financial shocks resulted in a month's loss of income. The Hossains borrowed money from friends to cover their rent and expenses as a result of those shocks—but for many, this lifeline may not be available. (US Financial Diaries, "*Adjusting to a New Life in the US: The Hossains*," 2014. **http://www.usfinancialdiaries.org/house3-ny**)



Most common major life events

1. Reduction in hours or pay at work (23%)
2. A health emergency (22%)
3. Loss of a job (20%)

Source: CFSI Consumer Financial Health Study, 2014

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[4] CFSI. "Consumer Financial Health Study," 2014. **http://www.cfsinnovation.com/Find-your-topic/More-Topics/Consumer-Study**

[5] Ibid.

[6] The U.S. Financial Diaries is a research project that tracked 235 low-and moderate-income households over the course of a year and collected highly detailed data on household financial activity. The U.S. Financial Diaries were created jointly by the Financial Access Initiative at NYU-Wagner, Bankable Frontier Associates 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/**

[7] Farrell, Diana and Greig, Fiona. "Weathering Volatility: Big Data on the Financial Ups and Downs of U.S. Individuals," May 2015. JPMorgan Chase Institute. **https://www.jpmorganchase.com/content/dam/jpmorganchase/en/legacy/corporate/institute/document/54918-jpmc-institute-report-2015-aw5.pdf**

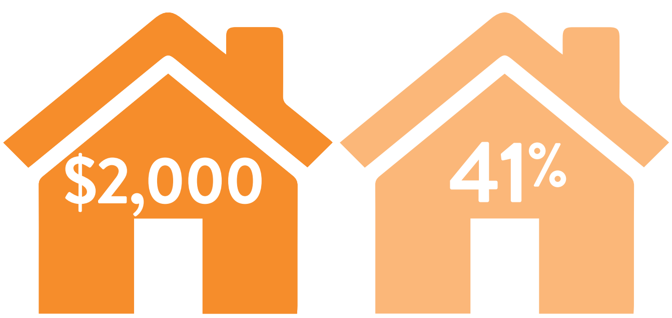
The Pew Charitable Trusts (Pew) recently surveyed American households regarding financial shocks and found the typical household's most expensive financial shock cost $2,000.[8] But financial shocks do not limit themselves to an annual event. A job layoff may cause a drop in income, followed by an offer for employment that requires a move to a new state. Looking to the "rainy day fund" is not an option for many; Pew found just six in ten (59 percent) households had enough liquid savings to cover a $2,000 expense.[9] Once the rainy day fund is raided, families have limited options when the next financial shock occurs. The prevalent lack of savings removes the financial shock absorber and leaves consumers scrambling for funds.

What is Financial Health?

Financial health isn't only about wealth—it's about how financial products and behaviors make life work: your ability to spend, save, borrow and plan for life. Financial health is when your daily financial system helps you build resilience and take advantage of opportunities. Just as people who eat balanced diets and have good health insurance today are more likely to avoid disease and be more physically active later in life, people with good savings habits and access to affordable credit today are more likely to avoid bankruptcy, handle unexpected expenses, and be prepared for retirement.

The "Wealth Gap" Makes It Worse

The racial wealth gap makes financial shocks especially detrimental for non-white households that do not have assets such as a home, savings, or a potential network of friends and family with available funds to loan. The median wealth gap between white and non-white households is more than $100,000.[10] According to CFED, households of color are twice as vulnerable to a financial crisis, such as becoming homeless, as compared to white households.[11] Pew's research specifically found that the typical white household has slightly more than one month's worth of income in liquid savings, compared with just 12 days for the typical Hispanic household and five days for the typical African-American household. The disparity in wealth, assets, and access between white and non-white Americans needs more attention from innovators and policymakers.



The typical household's most expensive financial shock cost $2,000

41% of households don't have enough liquid savings to pay for an expense of this magnitude

Addressing Financial Shocks to Improve Financial Health

Most financial products do not accommodate, let alone facilitate, Americans' financial lives. Volatile income, unexpected expenses, and life changes, both good and bad, are a fact of life. Innovative financial products meet customers where they are and assist in improving their financial health by providing daily financial systems that help to build resilience and take advantage of opportunities.

The 2016 Financial Solutions Lab challenge is "Helping Americans Weather Financial Shocks" because so many Americans experience not only financial shocks, but also their detrimental long-term negative impacts. Americans typically turn to savings, insurance, and credit when faced with a financial shock – so it is these very tools that present opportunities for innovation to better meet the needs of consumers, especially the 138 million "financially unhealthy" Americans.[12]

[8] The Pew Charitable Trusts. "What Resources Do Families Have for Financial Emergencies?" November 2015. **http://www.pewtrusts.org/~/media/assets/2015/11/emergency-savings-report-2_artfinal.pdf?la=en**

[9] Ibid.

[10] Wolff, Sarah D. "The Cumulative Cost of Predatory Practices," The Center for Responsible Lending. June 2015. **http://www.responsiblelending.org/state-of-lending/reports/13-Cumulative-Impact.pdf**

[11] Thomas, Marlysa. "The Racial Wealth Gap: A Systematic Barrier to Households of Color," CFED. June 2015. **http://cfed.org/blog/inclusiveeconomy/the_racial_wealth_gap_a_systemic_barrier_to_households_of_color**.

[12] Garon, Thea and Gutman, Aliza and Hogarth, Jeanne and Schneider, Rachel. "Understanding and Improving Consumer Financial Health in America," March 2015. Center for Financial Services Innovation. **http://bit.ly/ConsumerFinHealth**.

Emergency Savings Goals Go Unmet

Building resilience for financial shocks is a challenge for Americans from across the income spectrum. Even as household incomes rise, savings rates for the all-too-common shocks remain dismal. Saving for an emergency fund is one of the top three financial goals for over half of Americans.[13] The aspiration to build a savings cushion is prevalent but we are coming up short. The U.S. Financial Diaries found that the median household goal for emergency savings was $5,000, or 1.7 months of income, surprisingly less than the standard rule of thumb of at least three to six months' of income or expenses. However, only seven percent of households were even meeting their own emergency savings goal.[14] The JPMorgan Chase Institute found similar results when analyzing JPMorgan Chase customer data:

> *"Except for top earners, households across the income spectrum did not have sufficient liquid assets in place to weather 90% of financial fluctuations observed in our data."*[15]

Instead of lamenting a crisis of savings, financial product and service providers can do more to help consumers prepare for the unexpected. One of the Lab winners, Digit, automates savings by monitoring spending and income patterns to set aside small amounts of money that won't be missed. Digit's goal is to help users achieve long-term financial health, and two of the most popular reasons people use the service are to build a financial cushion and pay off debt. Ethan Bloch, CEO of Digit, explains, "We want this generation to have confidence in their relationship with money, and to do that we need to provide modern services that fit into the everyday busy lives of millennials so they can achieve financial health with minimal effort."

Planning and savings behavior are key to financial health. In fact, CFSI found that more than income, planning behavior is the most predictive attribute of an individual's financial health. Households that plan ahead for large, irregular expenses are ten times as likely to be financially healthy as those that do not plan ahead. Those with a savings habit are four times as likely to be financially healthy than those that do not.[16] Products that encourage savings behavior can get Americans in the habit of saving, setting them up for greater resilience to financial shocks.

Insurance Would Have Been Nice

Insurance has an important role to play in protecting consumers from catastrophic losses and providing peace of mind. For many life changes and significant financial events, there are insurance products available — including health insurance, auto insurance, and homeowner's insurance. However, the most vulnerable — those without savings and secure employment — often lack the insurance coverage needed to minimize the financial hardship of financial shocks. Only 34 percent of renters have renters insurance and half (52 percent) cited affordability as the reason to not purchase coverage.[17] Perceived cost is also the reason only fifty-seven percent of Americans have life insurance.[18] In addition, in order to receive an affordable premium, the coverage may require a deductible that allows the financial shock to wipe out any savings. Even the most comprehensive coverage can take too long to reach the hands of those trying to recover from a financial shock, causing undue stress and a scramble to plug the gap.

Expert Perspective

"Our data show that the majority of Americans face significant volatility, undermining their ability to plan for the future. As a result, many lack the financial cushion to withstand unexpected emergencies. There's a tremendous opportunity for new solutions that help consumers smooth income and consumption volatility, leverage the spikes in income to create a cushion for future dips, access affordable loans, and build emergency savings cushions."

– Diana Farrell, President and CEO of the JPMorgan Chase Institute

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[13] CFSI. "Consumer Financial Health Study," 2014. **http://www.cfsinnovation.com/Find-your-topic/More-Topics/Consumer-Study**

[14] U.S. Financial Diaries, "Emergency Savings." June 2015. **http://www.usfinancialdiaries.org/issue4-emersav**

[15] JPMorgan Chase Institute. "Weathering Volatility Big Data on the Financial Ups and Downs of U.S. Individuals." May 2015. **http://www.jpmorganchase.com/content/dam/jpmorganchase/en/legacy/corporate/institute/document/54918-jpmc-institute-report-2015-aw5.pdf**

[16] Garon, Thea and Gutman, Aliza and Hogarth, Jeanne and Schneider, Rachel. "Understanding and Improving Consumer Financial Health in America," March 2015. Center for Financial Services Innovation. **http://bit.ly/ConsumerFinHealth**.

[17] Johnson, Allie, "insuranceQuotes.com survey: Myths cause many renters to go without renter's insurance." August 28, 2013. **http://www.insurancequotes.com/home/insurance-for-renters**.

[18] "2015 Insurance Barometer Study Finds Americans Continue to Overestimate Cost of Life Insurance." LIMRA. April 14, 2015. **http://www.limra.com/Posts/PR/News_Releases/2015_Insurance_Barometer_Study_Finds_Americans_Continue_to_Overestimate__Cost_of_Life_Insurance.aspx** and MacDonald, Jay. "Survey: How many of us have life insurance? And how many have enough of it?" Bankrate.com. July 8, 2015. **http://www.bankrate.com/finance/insurance/money-pulse-0715.aspx**

Innovation in insurance has been a long time coming, but new models are changing the way customer premiums are calculated. In the case of Progressive's Snapshot Program, premiums are based on driving behavior and miles driven instead of demographic factors. Insurance is also a market in which looking overseas can inspire innovation at home. In many developing countries, micro-insurance can be paid for via mobile phone using mobile money or even airtime minutes. [19] Bundling insurance and other products may also present an opportunity for innovation. For example, one monthly payment could go toward both building a rainy day fund and paying an insurance premium.

Credit Can Create A New Calamity

For many, borrowing money may be the only option available to stay afloat after a financial shock. When CFSI asked where a household would get $600 for an emergency expense that had to be paid within one week, half of the respondents answered with borrowing.[20] Respondents selected credit cards, friends and family members, a payday loan, pawning an item, and trying to arrange to pay in installments as potential sources of funds.

Credit is an important option — allowing the consumer to spread the expense over time — but high-quality credit is not an option for the more than 108 million Americans who lack access to credit cards or online lending.[21] CFSI found that 32 percent of consumers who use small dollar credit – through products such as payday loans, direct deposit advances, auto title and installment loans — do so for unexpected expenses.[22] While accessible regardless of credit profile, small dollar credit products are typically more costly than mainstream credit because of fees and high interest rates.

Expert Perspective

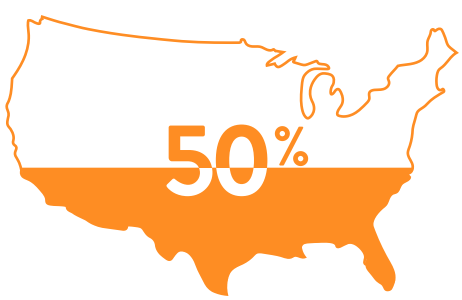
"Armed with better data and deeper consumer insights, we must build the next generation of financial products and services with the same degree of sophistication and nuance as we see in consumers' financial lives and management strategies."

– **Jonathan Mintz, President and CEO of the Cities for Financial Empowerment Fund**

Credit specific to the consumer's need, such as financing for a new refrigerator or car, can be a helpful solution when faced with a financial shock. However, the transparency and quality of these products varies, presenting the opportunity for new entrants to offer durable goods warranties, insurance, and financing that help consumers get the products they need and minimize disruption to their lives, both in the short-term and the long-term.

Short Term Shocks, Long Term Impacts

Financial shocks can cause both immediate and long-term damage. For the estimated 38 million households that suffered acute financial hardship due to financial shocks in 2015, it will likely be years before many recover.[23] The burden of financial shocks can cause families to draw upon their long-term and retirement savings, sell assets, or default on their existing debts.



Half of Americans would rely on borrowing to cover a $600 expense that had to be paid within one week.

[19] Tappendorf, Tyler and Saunders, David. "Designing Mobile Microinsurance Products: Premium, Payment Methods." February 12, 2014. **http://www.cgap.org/blog/designing-mobile-microinsurance-products-premium-payment-methods**.

[20] CFSI. "Consumer Financial Health Study," 2014. **http://www.cfsinnovation.com/Find-your-topic/More-Topics/Consumer-Study**

[21] Experian, "VantageScore® Credit Score Ranges," 2015; VantageScore, "Credit Scores: The gateway to credit and how the scoring landscape is changing," July 2014; United States Census Bureau, "State and County Quick Facts," 2014

[22] CFSI, "Why Consumers Turn to Small-Dollar Credit." **http://www.cfsinnovation.com/CMSPages/GetFile.aspx?guid=fe3b2339-a899-4c88-afc8-98b465fa65b4**

[23] For this analysis, CFSI calculated 38 million households using the US Census Bureau's 117 million US households figure and Pew's findings that 60 percent of US households experienced a financial shock and 55 percent of those households reported that the financial shock made it hard for them to make ends meet. United States Census Bureau, "Housing Vacancies and Homeownership, Table 8," 2015. **https://www.census.gov/housing/hvs/data/histtabs.html**; The Pew Charitable Trusts. "How Do Families Cope with Financial Shocks?" October 2015. **http://www.pewtrusts.org/~/media/assets/2015/10/emergency-savings-report-1_artfinal.pdf?la=en/**.

Financial shocks can rob individuals of their future financial well-being by forcing them to access their retirement savings early — or prevent them from saving for retirement in the first place. In 2014 alone, 13 percent of Americans dipped into their retirement funds to pay for an emergency.[24] The Federal Reserve's Survey of Consumer Finances suggests that since the recession, families making above the median income are increasing their savings for retirement but failing to allocate funds for emergency savings.[25] Tax-advantaged retirement savings—such as 401(k) and IRA plans — are difficult to access and charge fees and penalties for most withdrawals. The time it takes to get to retirement funds alone may cause an individual to go elsewhere, despite having the funds saved. There is an opportunity to create products that promote long-term savings behavior and accommodate the need for accessibility and flexibility.

The dreaded outcomes of financial shocks—bankruptcy, foreclosure, eviction, repossession, and liens—occur when shocks are too strong or too frequent for a household to sustain. These outcomes are not only stressful and disruptive to families and communities, but they follow an individual for years, making it difficult to recover. Adverse credit items remain on an individual's credit history for up to seven years, lowering their credit score and raising their personal cost of credit. Credit scores also affect the cost of insurance: those with poor credit pay 91 percent more than homeowners with excellent credit. [26] Americans need financial products that help prevent such negative outcomes and their long-term damage.

Provider Opportunity: What's Possible?

Recognizing that financial shocks are varied, personal, and all too common, the Financial Solutions Lab seeks bold, innovative solutions to help consumers better weather life's ups and downs, especially those who are most vulnerable.

The savings, insurance and credit options available today are far from perfect. In fact, financially under-served Americans spent $138 billion in fees and interest to access financial products in 2014.[27] Notably, the $138 billion spent doesn't even include insurance. Thus, there is a huge opportunity for providers of all types to chip away at this market by offering products that help consumers build resilience and withstand life's surprises.

As data collection and analytics improve, we expect more innovators will find ways to prevent financial shocks before they occur. Providers will be able to better predict and mitigate risk for the various causes of financial shocks — from sensors that shut off water to prevent a flood in the basement to car insurance that rewards safe-driving behaviors.[28] Narrowing the causes and frequency of unplanned expenses can help all Americans.

The Financial Solutions Lab seeks more creativity, talent, and technical expertise directed towards this challenge. We are committed to supporting entrepreneurs and non-profit innovators who are working to help consumers build resilience and better weather financial shocks, ultimately allowing them to pursue opportunities and enjoy improved financial health.

Expert Perspective

"The increased risk we have transferred to individuals in terms of income instability, eroding employer benefits, and limited social safety nets puts even more emphasis on the need for financial products that can help households weather financial shocks. As I showed in *No Slack* (Brookings Press 2012), most households lack the financial stability they so sorely need. Innovative financial products can help these household to manage their finances, save, and build a better future for themselves and their families."
– **Michael Barr, Professor of Law and Public Policy at the University of Michigan**

"I would like to see products that help prepare individuals and families both mentally and financially for the shocks that will happen. I would like to see products that promote savings and access to fair and reasonable short- and medium-term credit that promote a sense of financial security while also helping consumers improve their financial health."
– **Andrea Levere, President of the Corporation for Enterprise Development (CFED)**

[24] Kahn, Chris. "After 2 month slump, financial security swings higher in September". Posted: Sept. 23, 2015. **http://www.bankrate.com /finance/consumer-index/financial-security-charts-0915.aspx**

[25] Schrager, Allison. "America is full of high-earning poor people." November 3, 2015. **http://qz.com/520414/the-high-earning-poor/**

[26] DiUlio, Nick. "If you have poor credit, you may pay nearly double for home insurance." August 14, 2014. **http://www.insurancequotes.com/home/home-insurance-and-credit**. Note: MD, MA and CA prohibit the use of credit scoring in pricing premiums.

[27] Wolkowitz, Eva and Schmall, Theresa. "2014 Underserved Market Size: Financial Health Opportunity in Dollars and Cents", Center for Financial Services Innovation. December 2015. **http://bitly.com/marketsize14**

[28] Core Innovation Capital. "Slicing Up the Gecko." May 2015. **http://corevc.com/wisdom/Slicing%20Up%20the%20Gecko%20-%20CoreEMC.pdf**