

Savings You Can Do It!

CONTENT NOTE



Definition of Saving

Savings is money put aside by an individual or household for use in the future. A key to good money management, savings help individuals and households manage risk, deal with emergencies, smooth income, build assets, and meet financial goals. People save by putting money aside when it comes in and by spending less when it goes out.

Reasons to Save

"... there are many times when poor people need sums of money that are bigger than what they have in hand. The need for these 'usefully large lump sums' arises from life cycle events such as birth, education, marriage and death, from emergency situations, and from the discovery of opportunities to make investments in assets or businesses. The only reliable and sustainable way they can obtain these sums is to build them, somehow or other, from their savings..."¹

You can use savings to meet both expected and unexpected needs. They help to smooth cash flow, allow for optional expenditures, and invest in assets and businesses. In case of emergencies and crises, savings enable you to respond immediately and, over time, recover from related loss of income or property.

Savings play a key role in meeting financial goals. These can include short-term goals (weeks or months) such as buying stock for a business or paying school fees; medium-term goals (1–3 years) such as home improvement expenses or a visit to the family; or long-term goals (over three years), such as to buy a house or save for retirement.

¹Rutherford, Stuart, *The Poor and Their Money*, Oxford University Press: New Delhi, India, 2000, p.1.

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Ways to Save

“Managing money well begins with hanging on to what you have. This means avoiding unnecessary expenditure and then finding a safe place to store whatever money is left over. Making that choice—the choice to save rather than to consume—is the foundation of money management.”²

You can choose to save through formal, semi-formal or informal institutions, and in the form of cash or non-cash.

Non-cash forms of saving are assets, such as jewelry, consumer durables, or livestock that can quickly and easily be converted to cash and generally retain their value. Land is also an asset in which you can invest and hold your savings; it retains its value but is less liquid than livestock.

Informal savings include saving cash at home, which keeps your cash very accessible and allows you to avoid the transaction costs associated with saving at formal savings institutions. This form of informal savings has two significant disadvantages: the temptation to spend the money and the risk of theft. You need strong discipline to both avoid spending these savings yourself and deny the pleas of other family members. Furthermore, money saved at home does not earn any interest, and thus may lose value over time. Saving in-kind (gold, livestock or land) is another form of informal savings.

Semi-Formal savings encompass deposit collectors and group savings mechanisms, including rotating credit and savings associations (ROSCAs), village banks, solidarity groups and self-help groups. Familiar and simple, the group mechanism encourages discipline, scrutiny and support among members. The advantage of ROSCAs is that each member receives a lump sum of money at one time, with no loan or interest payments. However, a corresponding limitation is that members typically do not earn interest on money they have saved. Members of self-help groups borrow from their collective savings with the obligation to repay with interest, but they also receive periodic dividends. Limitations of group savings include instability of the groups, disagreements among members, and limited access to funds.

Formal savings involve financial institutions, including banks, credit unions, cooperatives, post offices or microfinance institutions, and offer another widely used option for saving cash. Savings in these financial institutions are generally safe and earn interest. They offer a range of savings accounts tailored to different financial needs. However, the requirements for opening and maintaining an account such as minimum deposits, user fees, and

²Rutherford, Stuart, *The Poor and Their Money*, Oxford University Press: New Delhi, India, 2000, p.2.

withdrawal requirements can be costly. These requirements are challenging if you make small, frequent deposits or withdrawals. Limited bank hours may make it difficult for you to access your money quickly in the case of emergency. Finally, where banks have failed, people tend to lack confidence in them.

Savings Options at Formal Financial Institutions

Formal financial institutions offer a wide variety of savings products. *Regular or passbook savings* is the most widely used type of account for regular transactions because the timing and amount of deposits and withdrawals are flexible. Typically, you are allowed a set number of “free” transactions each month, and will be charged a fee for any additional ones. In exchange for the right to make frequent transactions, the bank pays very low interest on passbook savings accounts. Account transactions are tracked through a passbook, and a minimum deposit is usually required in order to open the account. This account is appropriate when you need to make regular deposits and withdrawals, and require easy access to your savings.

Contractual savings are an alternative form of savings that require you to deposit a fixed amount on a regular basis over a pre-determined period of time. Although contractual savings can be structured in many ways, access to savings often is restricted until the contract is fulfilled, and you will be charged a penalty for withdrawing your funds early. This type of account will be useful if you have a regular source of income that enables you to meet a commitment to save at regular intervals for future goals.

Time deposits require a fixed sum to be deposited for a pre-determined amount of time and interest rate. They are not accessible during this period of time, but generally yield a higher interest rate than regular or contractual savings. You may be interested in this account if you receive a lump sum of money that you do not need immediately. To save for a future goal and earn maximum interest, you can use this account to place that money out of reach for a pre-determined amount of time. You choose how long that period will be based on your estimation of when you might need the money. Time deposits vary from six months to five years, and typically, the longer the time period you choose, the higher the interest rate will be.

Important Factors for Deciding Where to Save

When deciding where to save, you should consider the following:

- **Deposit requirements for the savings account.** Is there a minimum deposit required to open the account? Is there a minimum balance required to keep the account open? Are small deposits accepted? Can variable sums be deposited? Can deposits be made frequently? What paperwork is required?
- **Terms of use.** Is the saving program compulsory or voluntary? Do you have to commit to saving a set amount at regular intervals or over a certain time period? Are there rules about how much you must deposit and when? Are there rules about how much you are allowed to withdraw and when? Can you withdraw the money at any time without penalty?
- **Cost.** What fees are charged for deposits, withdrawals, or passbooks? Some forms of saving may lose value during times of inflation or economic instability. You need to consider such costs even though they do not involve payment of actual fees.
- **Access/Ease of use.** Is the account convenient? What are the institution's hours of operation? Is it open at convenient times? How far is the institution from your home or workplace? Are transactions quick and confidential? What is the quality of customer service? Is the atmosphere comfortable and friendly? Are there long lines at the teller windows? Is information on the account easily available? Does it provide statements? Are they easy to understand? Are the application procedures easy to follow? Does it have an ATM network?
- **Safety.** What is the reputation of the institution? Does it have insurance or other guarantees to safeguard funds? Are the telephone or electronic transactions safe? Is the bank or its branch located in a safe neighborhood location?
- **Liquidity.** How easy is it to withdraw funds from the account? Will the full amount be available? Are fees charged if the funds are withdrawn before a specified date?
- **Interest.** Will your savings earn interest? If so, how much? How and when is the interest paid? What is the difference in interest rates earned across different types of savings products or plans?

How to Make a Savings Plan

A savings plan is a critical tool for managing money to meet short-, medium-, or long-term financial goals. To make a savings plan, follow the steps outlined below:

1. Set savings goals.
2. Figure out how much you need to save over what period of time to meet your savings goals. Set a savings target.
3. Figure out how much you are earning over this period of time, the regularity (or irregularity) of your earnings, and how much you can expect to save on a regular basis.
4. Identify which expense you can cut back (for example, video rental, cigarettes, or tea breaks) and reallocate this amount to your savings.
5. Decide where you will save. Identify places to save, available savings products, and their pros and cons.
6. Plan how much and how often you will save. For example, you could put a specified amount aside in an envelope when you are paid or at the end of each business day and keep it in a safe place until you are able to take it to the bank. Go to the bank on a set day of the week or month. If you are a wage earner and your employer is linked to a bank, consider a deduction from your paycheck that is automatically deposited into your savings account.
7. Keep track of your savings. Monitor progress towards your savings target on a regular basis by checking the amount you have saved and how close you are to your goal. Check bank statements, passbooks, or other sources of information on your savings.

Rules of Thumb for Savings

While basic principles of money management can apply to everyone, decisions to save or consume depend very much on your level of income, access to loans, access to appropriate savings products, and personal discipline. Nevertheless, there are a number of rules of thumb that you can use to guide decisions about savings and consumption.³

- Save as much as you can as soon as you can. The more you save, the better off you'll be.
- Save as you earn.
- Try to save 10% of your income even if you don't have a specific purchase or investment for which you are saving.
- Pay yourself first—put 10% of your earnings aside for savings before you do anything else. If you can't afford 10% right away, start with less, but save something.
- Calculate how your money can grow over time if you save regularly in an account that earns interest.
- Don't carry a lot of cash—avoid temptation to spend it!
- Spend carefully. If you purchase big items, consider how much you could resell them for. Look for opportunities to save money by bulk buying of non-perishables.
- Pay off your debts. Some people recommend paying down your debt before you start to save; others recommend saving even while paying down debt because it is important to begin building assets as soon as possible. This choice will depend on individual priorities, situation, and means. Total household debt should not exceed 36% of household income.
- Keep three to six months of living expenses in an emergency fund at all times. It can be used in case of job loss, unexpected illness, and to meet other emergency needs. An emergency fund will reduce your anxiety.
- Keep emergency funds in a separate account. Open two savings accounts—one for emergencies that is easy to access and doesn't have any penalties for withdrawal, and one for savings for other goals that is harder to access (and therefore less tempting to withdraw the money). Keeping some savings "out of reach" is important.
- Find savings products that match your savings goals.

Good savings behavior requires discipline; discipline is learned through practice!

³Researchers have shown that many rules of thumb about life-cycle savings are as effective in "optimizing the utility" of those decisions as sophisticated financial models (Rodepeter and Winter, 1999).

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