How to Build an Emergency Fund

Some advisors might tell you to not worry about building an emergency fund as long as you have debt to pay off. That advice comes from a perspective that you're paying more interest on that debt than you can earn on a savings account and if an emergency comes up, you can just borrow that money again. While that may make sense from a numbers standpoint, not all good decisions boil down to simple math, especially when people are involved. The goal isn't just to get debt-free as quickly as possible. The goal is to get debt-free and stay that way permanently. In order to do that, we need to change what got us there in the first place. An emergency fund is a crucial element in that process and shouldn't be downplayed or ignored simply because we still have debt.

The first step we need to take to get debt free is to end the cycle of debt that we've developed. We need to draw a line in the sand today and commit to not taking on any new debt without first consulting wise counsel. We can't immediately reverse the consequences that came from years of bad decisions, so we may encounter situations where the only option is debt, but that's why godly counsel is so important. We need to explore all of our options and the wisdom of others may lead to some possibilities we haven't thought of on our own. If our wise counsel agrees that debt is the only solution, then we need to try to pay it off as soon as we can.

For most people, taking on debt has been an easy decision. We need to recognize the seriousness of debt and treat it accordingly. We can all calculate today the maximum time it would take to be debt free as long as we don't add new debt. Even minimum payments will eventually pay off our debts. The beauty is that a good plan and discipline can speed up that timeline to make it shorter. However, as soon as we take on a new debt, the timeline is reset and we have a new future debt-free date that is further out than the original one. There is no firm debt-free date that we can put on the calendar as long as new debt is an option.

Our emergency fund serves as the tool that will protect us from taking on new debt when the unexpected happens. This debt avoidance plan is absolutely crucial if we're going to succeed. We know that unexpected expenses are going to come, so we need to be prepared to pay them when they do. If we don't plan ahead, we're only one unexpected expense away from new debt, which often discourages individuals and blows up the whole plan like a donut destroys a diet. As humans, we need firm boundaries because when we can easily cross lines, we often do and then fail to come back to the original plan.

How Much Do You Need?

There are a lot of rules of thumb when it comes to emergency funds. Some experts will tell you to start by saving $1,000 and then go back to paying off debts. Others will tell you the ultimate

goal should be an amount equal to 3 to 6 months of expenses. While these are okay for general advice, let me give you a few things to consider as you think through the right amount for you. Most of these considerations boil down to your personal financial risks and how much it would take to cover the ones that are more likely to occur.

Risk of an income change? – The more your income varies, the greater your emergency fund should be. There's a big difference between the risks of a person earning commissions and the person with a steady salary. You don't want a bad month to blow up your entire financial plan, so build an emergency fund that smooths out the ups and downs of your income. If your pay is steady, but your job is not very secure, you'll also want to have a larger emergency fund to help cover the likelihood of a job loss.

Do you have free cash flow? – If you are barely able to pay the bills each month, you are obviously at more risk than the person that has extra income after the bills are paid. Free cash flow is able to be used to cover unexpected costs that come up during the month. That's not an option for the person that has every dollar already allocated. For that person, the emergency fund is important when trying to survive unexpected expenses.

Reliability of your equipment? – Are your appliances or your car on their last leg? If so, you have a much greater chance of needing money to cover repairs or replacement costs. These likely expenses need reserves set aside for when that day comes. It's not a matter of if that day will come, but when. If your landlord is responsible for appliances or the ones you have are new, the need for reserves to cover these expenses will be much less.

What is your uninsured risk? – You need to be able to cover expenses that won't be covered by your insurance. Know your insurance deductibles and out-of-pocket exposure in order to prepare for a possible medical expense or damage to your property. The higher your deductibles, the more you'll need to have available to cover those costs.

Once you've evaluated these risks, you'll have a better idea of what amount you feel comfortable with as a minimum in your emergency fund. The goal is to build your reserves over time, but we all need to start by establishing a minimum amount as a starting point.

Key Steps

Protect it – If you want your emergency fund to be there when you need it, you'll want to protect it from yourself. If it's easy to access for spontaneous decisions, there's a good chance it won't survive. I prefer to build an emergency fund at a separate institution from my regular bill-paying account. That makes it more difficult to go online and simply transfer some of it to my checking account to cover the monthly bills. The more out-of-sight it is, the more likely it will survive my short-term desires. It's like the old story of the lady that used to keep her

emergency cash frozen in a block of ice. The idea was that by the time she could thaw it out, the moment of weakness would be gone and the money would be safe.

Define its use – Let's not forget that it's called an emergency fund, so we need to know what constitutes an emergency. Anything short of that definition is not a good enough reason to use these funds.

Be consistent – Just like any other savings we want to grow, we need to contribute a little at a time and do it consistently. The best way for most people is to have a small amount direct deposited to the account from every paycheck. It probably won't be missed in the end, but it will certainly accumulate over time.

Capture extra income – You never want unbudgeted money to get away. So, if you receive a bonus, a raise, or a tax refund, grab that extra amount and use it to speed up your financial plan. Part of it could be used to pay down debt or increase your giving, but it could also be used to speed up the growth of your emergency fund to get it where it needs to be.

Conclusion

Remember that our financial plan is about much more than just getting out of debt. If not, we would sell everything we own and speed it up as much as possible. Our ultimate goal is to be good stewards and to use all that God has entrusted to us for His glory. That can't be accomplished with a one-dimensional plan. It requires a process and a lifestyle.

So, if you find yourself in debt today, don't simply look at how you can get it paid off the fastest. Instead, build a plan that will change your lifestyle and develop good financial habits that will continue on well after your last debt is paid off. Those habits include saving up for anticipated expenses as well as ones you don't expect. While it's not fun to use our savings to pay for the things that weren't in our plan, it's a blessing to have that money available when the bill comes due. At those times, we can thank God for His provision and continue moving forward with our plan instead of feeling like we're not making any progress.