Using Financial Innovation to Support Savers:

From Coercion to Excitement

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American families today are finding it hard to save, and it is no surprise that household saving is low.[1] Between 2005 and 2008, the personal savings rate hovered below 1 percent, a 50-year nadir.[2] Although the rate rose in the first quarters of 2008—and experts debate the proper way to measure that rate—it is clear that many Americans have saved little. In 2004, for example, 10 percent of households had less than $100 in financial assets.[3]

The Power of Innovations

Some observers are pessimistic about the potential to address this problem. To them it seems as though limited profit opportunities will restrain private entities from helping people save and high costs will restrain government action. But such concerns do not close the book on policy options. The recent economic crisis has prompted households to revisit savings behavior, at least temporarily, and we cast a wide net to identify savings innovations that work, laying out a range of options currently offered by stakeholders in the United States and abroad. These solutions can be distinguished as either *process* or *product* innovations.

Process Innovations

Process innovations change the ability or motivation to save. At one extreme are measures that take away the savings decision, either through outright transfers or through government-mandated savings. One could say, for example, that by mandating payroll tax deductions and contributions, Social Security coerces individual savings.

The United Kingdom's Child Trust Fund (CTF) is an involuntary program with a different approach in that it gives rather than mandates savings. Since 2005, every British child has received a grant of at least £250 at birth and will receive subsequent grants at age 7.[4] U.S. advocates hope Congress will create a similar system under ASPIRE (America Saving for Personal Investment Retirement and Education) Act.

Other process innovations leave the savings decision in consumers' hands but change the process with respect to the time and place of savings. One such set of strategies attempts to make it hard *not* to save. For example, employers may encourage retirement savings by having participation be the default setting for new employees' 401(k) enrollment. Those who do not wish to save must opt out.

A related strategy bundles saving with something consumers already do, such as shopping, using a credit or debit card, or borrowing. The North Carolina State Employees Credit Union (NCSECU), for example, offers an affordable payday-loan alternative called the Salary Advance Loan (SALO). In exchange for a low interest rate, borrowers are required to deposit 5 percent of each loan into a savings account. The bundling of lending and saving meets customers' short-term needs while helping them to accumulate sufficient savings to break the payday loan cycle.[5] Products like UPromise and Bank of America's Keep the Change are also examples of bundling.[6]

Other innovations require a conscious, unbundled savings decision but reduce impediments and make it easier to save—for example, by making savings products available when and where people can save, and by opening up convenient distribution channels like workplaces and retail stores. Tax preparation providers are also good distribution channels and help people save some of the more than $129 billion in tax refunds distributed by the Internal Revenue Service annually to families with adjusted gross incomes (AGI) of less than $40,000.[7]

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Spurred by small pilot programs at Volunteer Income Tax Assistance (VITA) sites and H&R Block offices, the IRS in 2007 introduced Form 8888 allowing filers to make a direct deposit of refunds into more than one account. The seemingly minor change allows filers to both mentally and financially split their refunds between spending and saving purposes.

However, because some low-income refund recipients lack a bank account, a simple savings option with a low minimum initial deposit is also needed. U.S. Savings Bonds fit that bill: they have no fees, are low-risk, earn competitive inflation-indexed rates, have no credit- or debit-check requirement, and cost as little as $25. As recently as the 1960s they were easily available at tax time, and making them available once again on the tax form would help people save.[8] Experiments conducted by the nonprofit D2D Fund Inc., H&R Block, and VITA sites show substantial promise for offering U.S. Savings Bonds again.[9]

Product Innovations

Product innovations reengineer the cost-benefit calculation of saving by adding financial, social, or psychological incentives. Many of the ways in which U.S. policy provides financial incentives for investing are familiar, including the mortgage-interest tax deduction, "529" plans that support education, and 401(k) and IRA accounts.

Additionally, individual development accounts (IDAs) encourage savings among the poor by providing grants that match what the savers deposit in bank accounts (so long as the funds are used for home ownership, education, or business development). IDAs, however, have had mixed success. Most participants accumulate only modest savings, and the programs remain small, leading to high per-account administration costs. More efficient ways to administer IDAs, such as the OnLine IDA developed by D2D Fund and Sungard, show potential. Other efficient models would likely emerge if large-scale funding were available.

Financial mutuals are products that leverage the social power of groups to support saving. They take different forms but share a fundamental behavioral logic featuring peer pressure and peer support. Although the most prominent form is the microfinance lending circle popularized by Muhammad Yunus, the rotating savings and credit associations (ROSCAs) operate on similar principles around the world. Members meet regularly, and each member contributes funds that are then aggregated and presented to one member. The meetings continue until everyone has been awarded the pooled sums. Social bonds encourage participation and keep defaults down. In developed countries, mutuals are seen among immigrant entrepreneurs.

Finally, prize-linked investment products manipulate psychological incentives to increase saving. First introduced in the United Kingdom in 1694, prize-linked savings products have now settled on a fairly simple construction. Investors purchase a savings product with no risk of losing the principal; they either forfeit interest payments or accept reduced ones in exchange for the chance to win large prizes allocated randomly among account holders. Prize-linked savings products have been offered in


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many countries. In Britain, the "Premium Bond" is available in denominations of £1 with a minimum purchase of £100. Each bond represents a chance to win a prize, with drawings held monthly and roughly 1.2 million prizes distributed at each drawing (including two grand prizes of £1 million). Ownership of the bonds is widespread, with £31.1 billion outstanding held by one-quarter of British households.[10]

From Ideas to Action

All too often, we focus on one type of savings (usually long-horizon goals like retirement or education) or one type of program (such as tax credits or a default scheme) without acknowledging the breadth of families' savings goals or the range of available mechanisms. A consideration of the alternatives quickly leads to the observation that some solutions are best suited to government action (savings bonds at tax time), others to the private sector (bundled or point-of-sale savings), and others to social groups or nongovernmental organizations (social network savings). Additionally, some solutions might appeal to "analytic types" (inflation-indexed savings bonds) and others to savers with different preferences (prize-linked savings.) Some might require government subsidies, while others create profitable private-sector activities.

Virtually all the examples cited here are being used today. Although many are not fully scaled up, they could be. Companies that have not previously served low- and moderate-income families may lack basic information about that demographic, and many financial services firms may be better positioned for delivery than for innovation. However, companies can effectively tackle such problems through partnerships. The Center for Financial Services Innovation (an affiliate of Chicago-based ShoreBank) and D2D Fund are among the groups that work on new-product development and also partner with for-profit entities.

Government initiatives need not cost billions. Important innovations like refund splitting, default 401(k) enrollment, or offering savings bonds at tax time require only minor changes to existing regulations and laws. The only surprise is that many of the newest savings innovations are already tried and true.

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Endnotes

[1] A longer version of this article was commissioned and funded by The National Poverty Center, with funding from the Office of the Assistant Secretary for Planning and Evaluation (ASPE) and the Ford Foundation. See *Insufficient Funds: Savings, Assets, Credit, and Banking Among Low-Income Households*, Rebecca Blank and Michael Barr, eds. (New York: Russell Sage Foundation, 2009).

[2] "Personal Saving Rate," Bureau of Economic Analysis, 2008.

[3] Authors' calculations from the 2004 Survey of Consumer Finances.

[4] Lisa Mensah, Rachel Schneider, and Magda Aboulfadi, *The Child Trust Fund: A Universal Long-Term Saving Policy* (New York: The Aspen Institute Initiative on Financial Security, 2004).

[5] *North Carolina State Employees Credit Union Annual Report*, 2006.

[6] See http://www.upromise.com and http://www.bankofamerica.com/promos/jump/ktc/index.cfm?&statecheck=MA.

[7] Internal Revenue Service, "Table 3.3 All Returns: Tax Liability, Tax Credits, and Tax Payments, by Size of Adjusted Gross Income, Tax Year 2006," 2008.

[8] Peter Tufano and Daniel Schneider, "Reinventing Savings Bonds," *Tax Notes* (October 31, 2005): 1-20.

[9] See Peter Tufano, "Just Keep My Money! Supporting Tax Time Savings with US Savings Bonds" (working paper, Harvard Business School, Boston, 2008); and Jeff Zinsmeyer, "The Nest Egg: Tax-Time Savings for Lower-Income Households," *Communities & Banking* 20, number 1 (winter 2009): 3-4. D2D Fund Inc., formerly Doorways to Dreams, was founded by Peter Tufano to test and promote savings innovations for lower-income consumers.

[10] Peter Tufano, "Saving Whilst Gambling: An Empirical Analysis of U.K. Premium Bonds," *The American Economic Review* 98, no. 2 (2008): 321-326.