Emergency Funds: How to Get Started

There's no one-size-fits-all formula for how much you'll need.

Emergency funds typically fall into one of two broad categories. One is set up to handle unexpected expenses—say, when your car breaks down or your water heater springs a leak. The other provides income if you lose your job. You should have both types, but when it comes to keeping a roof over your head, the second is the most important.

Your personal circumstances will dictate how much money you'll need if you lose your job. If you're the sole wage earner, you should have six to 12 months' worth of monthly living expenses set aside, whereas dual-income households can normally get away with three to six months of emergency reserves, says Jamie Lima, a certified financial planner in San Diego.

However, if one or both members of a dual-income household work in a sector sensitive to changes in the economy, you may need to save more. For example, if you're employed in the travel-and-leisure sector, which experiences a lot of ups and downs, you may need to cover more than six to nine months of expenses. Conversely, if you work in an industry that's less sensitive to economic swings, such as a public sector job, two to four months of expenses may be enough. But spouses who both work in the same industry may need to save at least six months of expenses in an emergency fund because both could be laid off at the same time.

When calculating your monthly expenses, focus on the basics, including housing, transportation, food and health insurance, along with any other insurance you may need, such as homeowners and car insurance, says Eliot Pepper, a CFP and cofounder of Northbrook Financial, in Baltimore.

Set your priorities. Paying off credit card debt and building an emergency fund are both important, but if you must choose between the two, building an emergency fund should come first, says Brandon Renfro, a CFP in Hallsville, Texas. If you are faced with a situation in which you need money, you can't tap the paid-off debt the way you can an emergency fund. (If you've lost your job and don't have an emergency fund—or the amount you've saved falls short of what you'll need—see below for other strategies to raise cash.)

Because you don't know when you'll need it, the money in your emergency fund should be immediately accessible. Pepper recommends a high-yield savings account that has no fees, requires low (or no) minimums and is federally insured. You can link it to your regular checking account so that you can transfer money easily.

Click here to learn more about the NYSUT Member Benefits Corporation-endorsed Synchrony Bank Savings Program which offers online savings accounts with competitive interest rates.

One drawback: Rates on high-yield savings accounts could drop. One way to lock in a rate for at least a few months is to invest in a "ladder" of short-term certificates of deposit. Stagger them so that each month one matures with enough to cover that month's living expenses. If you don't need the cash that month, reinvest it in another CD that matures at the end of your current series.

Plan B if you need cash fast

If you don't have an emergency fund and the bills are starting to pile up, you may be tempted to start charging more expenses to your credit cards. But before you run up a high-interest balance that could take years to pay off, explore these options.

Roth IRA. If you need the money, a Roth is a low-cost source of funds. You can always withdraw the amount of your contributions tax- and penalty-free. That money comes out of the account before earnings do; you won't pay taxes until you've depleted your contributions.

A 401(k) or 403(b) loan. Many 401(k) and 403(b) plans allow you to borrow money from your account. Typically, you may borrow up to 50% of the account value, but not more than $50,000. Though this gives you quick access to your money, you could be hit with fees and a tax penalty if you're younger than 59 ½ and fail to repay the loan on time.

Your health savings account. If you have an HSA, you can use money in the account for a variety of medical expenses, from dental work to co-payments. And if you lose your job, you can use money from your HSA to pay premiums under COBRA, the federal law that lets you continue group coverage. You can also use money from your HSA to pay health insurance premiums while you're receiving unemployment benefits.

Your life insurance policy. A permanent life insurance policy has two components: a death benefit, which is the amount that will be paid to your beneficiaries when you pass away, and a cash value, a tax-advantaged savings account that's funded by a portion of your premiums.

You can withdraw your basis—the amount in the cash-value account you've paid in premiums—tax-free. Just make sure you don't take out more than the basis in your cash value account, because the excess will be taxable. The death benefit will be reduced by the total amount you withdraw.

Alternatively, you can borrow against your policy. Interest charges range from about 6% to 8%, depending on market rates and whether the loan is fixed or variable. If you don't repay the loan, or pay back only part of it, the balance will be deducted from your death benefit.

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