# Understanding Financial Literacy in the Context of Indian Financial Markets

**Christopher Butel**
*Chairman*
*Invest India Market Solutions*

There is much continuing debate in India on the role of financial literacy as a determining factor in the disposition of household investment behaviour. A popular thesis is that everyday Indians are newcomers to the world of sophisticated finance, and new found affluence in Indian households occasion-ed by a lifting economy (and lifting incomes), is for the moment largely misdirected.

Despite booming stock markets and a rapidly expanding financial product range, it seems that small investors continue to be more attracted to lower yielding traditional investments in standard bank savings deposit schemes and a fixation with in gold and real estate. Moreover, the average Indian's investment horizon remains short-term with an apparent reluctance to participate in longer-term savings instruments that do not have as a feature unsustainable interest rate subsidies paid from Government coffers.

Theories abound on what to do to remedy this situation. However, in the course of this debate it appears not to be always understood that promoting financially literate behaviour bedevils financial markets worldwide. In other words, the issue is not a peculiarly Indian one, nor is it one that is peculiar to so called developing economies.

In this article I explore some international experience with promoting financial literacy in an attempt to better define what should arguably be the terms of this debate in India's case. In the process, I will dwell on what some of the as yet incomplete data in India suggests is the situation currently and discuss some options for moving forward.

**Defining Financial Literacy**

To my mind the financial literacy debate in India often stumbles at the first hurdle which is to seek consensus on what should be the terms of the debate.  Part of the reason for this is the differing agendas of self-interest among financial market segments. Market linked investment product providers, such as mutual funds, correctly in my view, perceive that a more literate small investor will be good for business. Accordingly, market-linked investment product providers often conceptualise financial literacy in terms of engendering greater understanding of the risks and returns equation and the time value of money and continue to search for the silver bullet to achieve this outcome. The incipient financial planning industry in India is peddling fast to convince the finance industry that the normative financial planning model is that silver bullet. While I would be the last person to discourage the development of a vibrant financial planning industry in India, I do not believe that this is the central issue although better application of financial planning principles in product marketing does represent one possibility for achieving improvements.

Life insurance firms in India, that traditionally have enjoyed tax preferred investment status, and who for the moment have the comfort of rising demand for insurance plans buttressed by the prospect of a growing pensions sector, appear to be less exercised on the issue of financial literacy. The life insurance industry also, perhaps understandably, is less aggressive on this issue by virtue of the fact that traditional life insurance customer segments in India have yet to realise that traditional life insurance products provide relatively unattractive returns, Similarly, it is not necessarily in the interests of banks to promote financial literacy given the existing strong attachment of small investors to low yielding savings bank products.

As with difficult problems everywhere, many of those involved in the debate in India look to Government to provide leadership, not least because of a perception that a significant and long-term investment is required to turn the current situation around. In particular, many in India argue, as do counterpart interests elsewhere, that a cohesive public education program is required for this purpose, and investment in financial literacy outcomes in school curriculums in particular is required. Seductive as this thought is, it too smacks of the silver bullet mentality particularly as the jury is still out in locations where this has been attempted on the long-term benefits of such an approach.

A now widely accepted definition of financial literacy internationally is one formulated originally by the U.K. National Foundation for Education Research which describes financial literacy as "the ability to make informed judgments and to take effective decisions regarding the use and management of money". The utility of this definition is that it successfully conceptualises the issue without overlaying value judgments concerned with particular financial market segments or particular financial product classes, socio-economic or cultural factors. By firmly placing the horse before the cart it also provides a solid foundation for considering the full logistics required for a successful journey forward.

With this definition as a starting point, the degree to which financial literacy exists in a particular locality has as its yardstick the extent of the mismatch between the actual financial behaviour of individuals and their actual capabilities, needs and savings goals. For example, for a day labourer in India with modest financial resources financial literacy could be said to exist if individuals have the ability to make informed judgments and take effective decisions regarding issues such as household budgeting, small savings schemes and access to basic credit facilities and insurance products. Knowledge of equity markets, or a willingness to invest in mutual funds would not be a criterion of financial literacy for such people. For middle and higher income earners with the opportunity to build wealth and financial security for themselves and their families greater sophistication obviously is required. In other words, financial literacy is multifaceted and varies according to the myriad circumstances and financial capabilities of investors.

Adaptation of the definition in a particular country's case of course is necessary to bring context, and in India's case the task of doing so has yet to be undertaken in any structured way. To illustrate, the Australian Securities and Investments Commission has identified four generic markers of financial literacy in the Australian context. These are:

- The ability of individuals to budget appropriately;
- The ability of individuals to identify financial products and services that meet their needs;
- The ability to locate reliable and independent financial advice; and
- The ability to avoid falling victim to abusive practices and scams.

What is immediately striking in the Australian adaptation is the degree of congruence with India's own situation, and there is I believe value for those in India seeking solutions in considering how to ride these understandings rather than attempting to reinvent the wheel. This observation is all the more powerful when it is understood that surveys of financial literacy in Australia[1] demonstrate that mismatches are most likely to occur for individuals with educational attainment below higher secondary, unskilled workers, persons with low incomes and savings levels and younger (aged 18 to 24 years) and older people (aged 70 years and over). Similar surveys[2] in other mature market economies such as the USA and the UK have yielded similar results.

Low levels of financial literacy therefore are not a problem that is unique to India. From the experience in other countries, nor can it be assumed that achieving developed economy status in the future will remove the problem. A pro active approach is required.

**Where Are We Now?**

The financial literacy debate in India presupposes of course that there is a problem of significant magnitude that needs to be addressed. Those of this view however have yet to roll up their sleeves and invest in the necessary objective evidence to substantiate this view. What then is the evidence available?

In 2004/2005 I had the privilege to lead an Asian Dev3elopment Bank Technical Assistance to the Government of India focused on the Government's plans to establish a broad based contributory pension scheme for paid members of India's 360 million strong informal sector workforce. A central activity in the project was a large nationally representative sample survey of the financial capabilities and savings habits and perceptions of the Indian workforce. On the basis of the Survey data, that is available on the Ministry of Finance and Pension Fund Regulatory and Development Authority's websites for those interested to mine deeper on this issue, there are some interesting observations that can be made.

The keystone of financial literacy is a perception that disciplined saving is important. Unwillingness on the part of individuals to save is the most adverse of financial literacy markers. There is of course much data in India on household savings rates, and Indians have the reputation of being good savers. Of interest in the ADB Survey data is that it is possible to directly measures savings as a proportion of income. What we see when that is done is that over half of the paid workforce (52%) do put aside at least some of their incomes in savings. Not surprisingly, dissevers, who comprise the majority of the remaining 48%, are concentrated in India's multitudinous and poorly paid agricultural and daily wage sectors. The correlation between the propensity to save and income therefore is strong with the propensity to save rising from 31% of earners with annual incomes below Rs. 25,000 to savings 86% for those with annual incomes in excess of Rs. 150,000.

For those with savings, at the upper end of the savings range, some 10% save in excess of 50% of their incomes, while around half of all workers with savings save at least 10% of income. What is more remarkable is that savers with very modest incomes (< Rs. 25,000) manage to put aside at least 10% of their incomes just like their higher paid counterparts. Surprisingly, however, savings rates do not increase dramatically with income over the middle and upper middle income ranges (annual incomes up to Rs. 1 lakh). Above that figure the increase is more dramatic with over six in ten managing to achieve at least the 10% threshold. While these observations do not vary significantly across States, there are distinct differences in savings rates between occupational classes, with the salaried classes, and government salaried workers in particular, outperforming other occupational groups.

The flip side of high savings rates is also a positive picture in India's case. That flip side is that the Indians generally are cautious borrowers and most have negligible debt portfolios. However, the signs are present that this is position may be shifting quickly with the explosion in retail credit through the banking sector and heightened interest in booming residential property markets. The ability of the growing middle income classes in particular to effectively source appropriate credit to meet borrowing needs for these and other purposes therefore should be seen as an urgent and important financial literacy issue that will grow in significance into the future. This observation is underscored by the fact that at the present time paid members of the workforce continue to access credit from moneylenders in significant numbers irrespective of their level of income. In 2004 for example, some 6% of urban workers and some 11% of rural workers with annual incomes in excess of Rs.150,000 had debts with moneylenders.

At ground zero therefore, the fundamental prerequisites of financial literacy of high savings rates and low debt levels is present in India's case to a degree that most other countries would envy. This places India in a relatively advantageous position to consider investments in financial literacy programs as the returns for succeeding at the task should be commensurately higher.

At this point, it is important to reflect on who stands to gain from efforts directed at this result. There is I believe a misconception among some financial market providers in India that higher levels of financial literacy would necessarily equate with an exodus of household investment into market linked and insurance products. I would argue that while some drift of investment over time in this direction might be expected, there will be no exodus unless the market providers concerned actively participate in the process and are prepared to invest in the necessary research to inform literacy program development designed to achieve that result.

The issue for India therefore is not strategies and incentives to promote household savings, but strategies and incentives aimed at how those savings are directed. The ability of individuals at the present time to identify financial products and services that meet their needs provides a salutary picture. Despite is long standing availability in Indian financial markets, three quarters of Indian paid workers have never taken up life insurance products, and negligible numbers have shown interest in general and health insurances (<2%). With the absence of broad based pension schemes in India, the reluctance to buy life insurance is particularly puzzling. Moreover, for those who do buy, only a minority do so as part of a retirement savings plan until their annual incomes rise into the higher income ranges above Rs. 75,000. In other words, most purchasers of life insurance at the present time are misconceiving the primary nature and central utility of the product.

The survey data provide other disturbing signs in relation to appropriate product utility ecognition. For example, the e*xtent of knowledge and understanding on the part of mandated pension scheme contributors of their pension scheme entitlements is surprisingly low, with nearly* half of the covered employees not knowing the full extent of their coverage under Government Provident, Government Pension and Gratuity Schemes or the underlying entitlements that the various schemes involve. Another example is that fewer than 10 percent of savers have long term savings objectives, even when the savings vehicle is designed for this purpose. For instance, only some 10 % of those investing in the Public Provident Fund at the time of the Survey indicated that their savings objective was related to retirement income needs. Disturbingly, over 80 % incorrectly believe that the Government guarantees bank deposits, and less than 20% were registering price inflation as an important factor in investment decision making.

Much of this situation arguably can be attributed to a lack of money management savvy among small investors. Formal financial advisory services in India remain in an incipient state and are in any event inaccessible to the majority of Indians. This is reflected in the fact that *less than one percent of Survey respondents indicated that they take advice about heir savings and investment decisions* from formal financial advisory sources such as accountants, tax and investment advisers, and over one in six indicated that they had been the victims of some form of financial scam in the past.

**The Way Ahead**

These vulnerability levels are both high and alarming and a primary objective of promoting financial literacy in the country should be to find affordable and accessible mechanisms for remedying this situation. How that might be achieved is worthy of greater attention by financial product providers themselves and should not be seen as a problem that Government alone should tackle. In fact, in the immediate term, the finance industry will need to take the lead if quick progress is to be achieved. Potential roles for Government, as elsewhere in the world, are likely to be more systemic and concerned with a longer-term effort in public education and public instruction streams.

Strategies for the finance sector in approaching the task desirably would involve action both at the institutional, or individual firm, level as well as syndication of the costs involved. At the individual firm level, investment in management information systems that profile a firm's customer base in terms of financial product differentiation within the vertical financial sector concerned would represent a good start. By assessing its own customer's investment perceptions, knowledge and savings goals individual firms would be well placed to better advise customers on more optimum investment decisions and in the process pass on the necessary information to raise literacy levels.

At the syndicated level, industry segments need to pool resources to create a war chest to achieve a working appreciation of the cross market investment behaviours of customers to determine whether investment portfolio composition is in fact consistent with investor motivations and goals. Armed with that knowledge, strategies for promoting more rational investment behaviour based on informed understandings could be developed. Syndicated effort could be organised on the basis of a pooled effort within market segments, for example, pooling by insurance firms or pooling by mutual funds, or syndicated efforts on a cross market basis, or both. In either case, investment is required in purpose-built, large scale survey data to establish the necessary knowledge chest as a first step.

In considering possible strategies I am reminded also of the old political adage that all publicity is good publicity. Given the prominence of agent workforces in retail finance sales, both individual firms and the finance industry at large, including financial regulators, would be well advised to revisit agent training and certification processes to promote greater financial literacy among the agents themselves. This would involve instilling in agents an appreciation of basic financial planning principles and tailoring agent training programs to position agents to understand the relative benefits of the products they sell compared to those offered by competing market segments. Properly designed, such training would add to the armory of sales strategies from the agent's perspective and as a consequence it could be expected that agents would embrace that knowledge as commercially useful. The fact that many agents would be likely to employ that knowledge in a sell-interested way to the detriment of competing product lines should not been seen as a disadvantage, as agents approaching the sales task in this manner would in the process necessarily bring to the customer's attention a range of relevant issues consistent with raising investor literacy levels.

In truth, all journeys begin with the first step. Soul searching, head scratching and the vain hope that by adopting a patient approach a silver bullet will turn up will not get the job done. Clear thinking founded on a reliable knowledge base that needs to be created for the purpose is required. For that to be achieved investment is required by those who will benefit most from success - the Indian finance sector.

[1] National Survey of Adult Financial Literacy in Australia, 2002.

[2] Comparable surveys with comparable results have been conducted in the U.K. (see *Financial Literacy in Adult Life: Research Summary*, National Foundation for education Research, 1996 and *Summing Up: Bridging the Financial Literacy Divide*, National Association of Citizens Advice Bureaux, November 2001)