Report of the

Household Finance Committee

Indian Household Finance

July 2017

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RBI publishes report of the Household Finance Committee

The Reserve Bank of India today placed on its website the report of the Household Finance Committee.

Background

In pursuance of the discussions in the Sub Committee of the Financial Stability and Development Council (FSDC-SC) held on April 26, 2016 a committee was set up to look at various facets of household finance in India.

The Committee chaired by Dr. Tarun Ramadorai, Professor of Financial Economics, Imperial college London, had representation from all the financial sector regulators, namely, Reserve Bank of India (RBI), Securities and Exchange Board of India (SEBI), the Insurance Regulatory and Development Authority of India (IRDAI) and Pension Fund Regulatory and Development Authority (PFRDA). Highlighting the unique aspects of Indian households' financial decision-making, the Committee has set out several recommendations on enabling better participation by Indian households in formal financial markets, including a Regulatory Sandbox for assessing the role of new financial technologies and products.

Comments and Suggestions, if any, on the report may be sent by email or by post to the CGM-in-Charge, Department of Banking Regulation, Reserve Bank of India, Central Office, Shaheed Bhagat Singh Marg, Mumbai-400 001 on or before September 15, 2017.

Jose J. Kattoor
Chief General Manager

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Executive Summary

In the first part of this report, we provide our responses to points i) and ii) on the ToR. We describe the results of an international benchmarking exercise, in which we document how Indian households allocate assets and take on liabilities both along the lifecycle and across the wealth distribution, and compare these patterns to those evident in micro-data on households in a range of advanced and emerging economies.

We find several attributes of Indian households that are exceptional in the international context. Importantly, these distinctive features of Indian household balance sheets cannot be explained by differences in the demographic characteristics, wealth, or income of Indian households relative to their counterparts in other countries. We also find that these properties of Indian balance sheets are difficult to explain using a standard lifecycle portfolio choice model, which we calibrate using estimated data on the income dynamics of Indian households. Taken together, it appears that these patterns are likely driven by unique aspects of Indian households' financial decision-making. The distinctive features of Indian household balance sheets are:

1. A large fraction of the wealth of Indian households is in the form of physical assets (in particular, gold and real estate). This is unusual in the international context, and especially unusual for younger households, and for households in the bottom 40% of the wealth distribution, i.e., those with the lowest amounts of gross assets.

2. Despite the high holdings of real estate, mortgage penetration is low early in life, and subsequently rises as households age. This is also at variance with Indian households' counterparts in other countries, where debt has a characteristically hump-shaped pattern over the lifecycle. Indian households tend to borrow later in life and are more likely to reach retirement age with positive debt balances, which is a source of risk given that they are no longer earning income during these years.

   a) We note that 1. and 2. above are clearly connected. Social arrangements in which households bequest housing wealth to future generations and in turn receive support during retirement are an underlying determinant of these patterns. Such traditional approaches to household financial management have likely evolved over time as a rational response to prevailing economic conditions. We note, however, that these traditional structures are increasingly under pressure from shifting demographic patterns, social norms, and changing economic conditions, introducing risks to economic well-being especially as households age.

3. The Indian household finance landscape is distinctive through the near total absence of pension wealth. Pension accounts and investment-linked life insurance products exist, but they are only used frequently by households located in a small

group of states, while in most other states, the contribution of pensions wealth to household wealth is negligible.

4. We document high levels of unsecured debt, and perhaps more importantly, debt taken from non-institutional sources such as moneylenders. Such debt generates high costs for Indian households, and as we document later in the report, is likely to lead to households becoming trapped in a long cycle of interest repayments. We note that this phenomenon has been well-documented over the decades, but nevertheless remains stubbornly persistent.

5. There are low levels of insurance penetration (life and non-life) despite numerous sources of risk such as rainfall (leading to income shocks in largely agrarian segments of the population), health shocks, and catastrophes such as floods or cyclones.

6. There is a strong negative correlation between participation in insurance and the incidence of non-institutional source debt, suggesting that households are dealing with risks through high-cost borrowing ex-post as opposed to insuring against such risks ex-ante. We find that this is a costly approach for households, as high interest payments on informal debt impose substantially greater costs on Indian households relative to the (counterfactual) policy of purchasing actuarially fair insurance.

   a) This is an important observation, since it suggests that efforts to reduce informal lending will likely fail in an environment in which households are not sufficiently well-insured against risks.

   b) We note that some of these risks could be mitigated through strengthening the public provision of health and social welfare services. We also observe that this finding could arise from tight constraints on household budgets which do not permit them to take on insurance ex-ante; or as a consequence of adverse selection, moral hazard, or other issues causing premiums in the insurance market to become unaffordable for households.

Next, we attempt to evaluate the implications of these features of Indian household balance sheets in response to point ii) on the ToR. We also attempt to evaluate the size of any gains from counterfactual policies that households might pursue, and conclude (in this partial equilibrium exercise) that Indian households can potentially realise significant benefits from several changes to their balance sheets. In particular, we find that:

1. If the current patterns of allocation are maintained, demographic projections indicate that there will be significant additional pressure on the demand for assets such as gold and real estate in the coming decades.

2. Over the coming decade and a half, the elderly cohort is expected to grow by 75 percent. Only a small fraction of this cohort has saved in private pension plans. Moreover, a large segment of the population of households in all age cohorts has

not actively taken steps to insure adequate financial coverage during retirement. The need to finance adequate consumption during retirement is therefore a looming issue, and when combined with the low penetration of insurance, households appear particularly vulnerable to adverse shocks later in life.

3. Indian households can benefit greatly by re-allocating assets towards financial markets and away from gold. If households in the middle third of the gold holdings distribution re-allocated a quarter of their existing gold holdings to financial assets, on average, they could earn an amount equivalent to 0.8% of their annual income per year (on an ongoing flow basis). Expressed differently, the wealth gain in real present value terms accruing from this shift would be sufficient to move these households roughly 1 percentage point (pp) up the current Indian wealth distribution. For households that hold more substantial amounts of gold, i.e., those in the top third of the cross-sectional distribution, the ongoing annual income gain from re-allocating a quarter of their gold holdings to financial assets is 3.4%, which when capitalised, translates into a upwards movement of roughly 5 pp along the Indian wealth distribution. These projected gains are almost always above zero, even when we account for volatility which may lead to different realisations of returns on gold and financial assets.

4. For the median Indian household, shifting from non-institutional debt to institutional debt can lead to gains equivalent to between 1.9%–4.2% of annual income on an ongoing basis, or equivalently when capitalised, to upward moves along the current Indian wealth distribution of 2.5 pp–5.5 pp. These gains are almost always above zero in the cross-section of all households, regardless of the reason that the debt was incurred (medical costs, or financing business operations), and regardless of whether the debt is secured by collateral or unsecured. We also note that these numbers are quite conservative, as we accept self-reported "friends and family" interest rates as zero, despite the fact that there is likely significant non-monetary compensation demanded for the provision of such informal credit.

5. By avoiding the interest burden of emergency credit associated with medical costs, the median Indian household can gain 0.4%–1.2% of annual income on an ongoing basis, or equivalently, move up the Indian wealth distribution between 0.4 pp–1.6 pp. Households could avoid such costs if they were able to access strengthened public health services or if they were able to purchase actuarially fair insurance ex-ante that exactly covered the ex-post debt principal incurred in order to finance future emergency (such as health) expenditure.

Having documented that the expected gains from these changes to Indian households' balance sheets are high, we turn to point iii) on the ToR. Here, we uncover significant evidence for the underlying causes of the deviations between Indian household financial allocations and what might be considered to be more desirable financial allocation and behaviour. In particular, we find that the following causes are important:

1. High transactions costs and bureaucratic impediments to efficient participation create a high "nuisance factor" for households hoping to engage in formal financial markets. For example, we find from the empirical analysis of several household surveys that Indian households strongly associate formal banking institutions with large administrative burdens and complicated paperwork.

2. Trust issues that households face in their participation in formal financial markets. We find that these arise from households' often negative perceptions of formal providers, which are exacerbated by occasional poor experiences with unscrupulous providers. These trust issues appear to correlate highly with the income level of the household, and low income households often report their belief that access to financial products is the prerogative of elite groups in society. This lack of trust in financial institutions helps to explain the tendency of households to eschew financial products and to invest in instruments such as gold instead. It also helps to explain the continuing reliance of Indian households on traditional systems of provision of financial services.

3. The use of non-institutional debt is related to the type of expenditure for which the liability is incurred, and the urgency of the financial need. This points once again to non-institutional debt serving as a high-cost, imperfect form of insurance.

4. Behavioural factors such as a lack of self-confidence in engaging with formal financial systems. For example, we find that the lack of participation in the market for life insurance products appears to be related to the self-perceived financial management skills of the household head. As in many other parts of the world, we also find that cognitive issues such as present bias are widely prevalent, and can lead to issues such as low pensions take-up.

5. The high complexity of Indian households' financial needs:

    a) We note that there are significant differences across households located in different states even after controlling for households' demographic characteristics (for example, there is a particularly high demand for gold in southern Indian states). This is further evidence that traditional and cultural factors are strong determinants of observed allocations. Effective policies in Indian household finance should attempt to complement, or at least recognise, such longstanding traditional approaches to financial management in order to be effective.

    b) Self-reported financial goals of households are often driven by "life events," such as marriage, which disproportionately affect the household budgets of the poor because of the high fixed costs of such events. This highlights the importance of traditional social insurance in driving household financial decisions. Notably, such life events appear to be more important to households than goals such as financing education.

c) There are the usual lifecycle and wealth considerations leading to different demands by households. As added complications in the Indian context, informal labour market arrangements are widely prevalent, and income derived from agrarian sources generates significant variation in the timing and frequency of income that households receive. Such complications can make the often rigid contractual terms in standard financial products undesirable for such households.

d) Decisions concerning homeownership, savings product choice, insurance, pensions, mortgages, and emergency credit are inter-dependent and interrelated, increasing the total complexity burden on household decisions.

6. There is no unified framework or guidelines for the provision of high quality and low cost financial advice to Indian households.

The diagnosis of these problems naturally leads to a set of policy responses, which we are directed to provide in points iv) and v) of the ToR. To set the context for our recommendations, we make several observations about promising solutions in Indian household finance:

1. Indian households require customised financial products that account for their unique economic conditions, longstanding traditions, idiosyncratic life goals, and the complexity of their financial circumstances.

2. Such customised financial products are required at low marginal costs of servicing additional households. That is, they need to be scalable.

3. These products need to be relevant to households, in the sense that they should be delivered in a manner that is free from incentive problems, at a price that is fair, and dispensed alongside financial advice that is in the best interests of households.

4. Complicated paperwork and bureaucratic impediments can exacerbate feelings of embarrassment and shame for low income and poorly educated households in their initial engagement with financial markets. Financial product terms and conditions should therefore be explained to households in a manner that is both intuitive and salient.

5. Technological solutions hold significant promise for providing customisation and scalability simultaneously, and technological interfaces can help in depersonalising potentially embarrassing face-to-face interactions when households are making financial decisions.

6. Given the cognitive/behavioural issues that we uncover, "nudge" solutions, where sensible default options are provided to households also appear appealing to improve Indian household finance outcomes.

These observations lead us in turn to our recommendations, which we view as complementary to those in previous important committee reports in this space. These recommendations are listed in order of how quickly we believe they can be implemented:

1. We propose a set of sector-specific recommendations to improve the functioning of mortgage, collateralised lending, insurance, pensions, and gold markets. We believe that these "old fashioned" recommendations are potentially helpful in fixing obvious gaps in Indian household financial markets, and are an important complement to the technology-based solutions which we also propose. We also propose improvements to official survey data on Indian household finance, in an effort to spur more detailed analysis and research of these issues in the future, and to assist in the implementation of evidence-based policy.

2. At present, financial advice regulations are product-specific and vary across regulators. We make proposals about the current structure of financial advice in India. We suggest a set of standardised norms across regulators for financial advice to be implemented in a phased and unified manner, supported with a fiduciary standard for financial advisors. We propose that the provision of financial advice be clearly separated from the distribution of financial products, and provided in a manner that avoids conflicts of interest. We also discuss the promise of robo-advice, which appears to offer both scale and customisation, which, as discussed earlier, are twin imperatives for Indian household finance.

3. We propose a number of measures to streamline the delivery of and access to financial products that are relevant for Indian households, to eliminate or reduce informal transactions costs, such as filling in forms, bureaucratic impediments such as certification and verification costs, and costs arising from any uncertainty in knowing when approvals will happen. In particular, we propose that the total time and effort taken to engage in the financial market be substantially reduced through a combination of digital end-to-end distribution networks and the movement of know-your-customer (KYC) requirements into purely paperless form (i.e., eKYC). We also propose that regulators and service providers strive to enable quick, cost-effective, and seamless switching between financial service providers.

4. We suggest improvements to the electronic collateralised lending registry (CERSAI) to aid the development of this important market, as well as improvements to the RBI's recent policies on account aggregation to help households form a comprehensive and integrated view of their financial situation.

5. We describe a minimum set of financial products which Indian households should have in order to effectively harness the benefits of formal financial markets. Many of these products already exist, and indeed, are being delivered to households via government programmes such as PMJDY. Nevertheless, we believe that it is useful to provide this list for several reasons.

a) To serve as a checklist that can be used to evaluate progress on participation and use of household financial markets in India.

b) Where this is not already the case, products on the list could be made readily available to households, either seeded automatically at the point of PMJDY account opening (or added later to PMJDY accounts as a default but "opt-out" option), or by automatically pre-qualifying households to access all of these products at the point of e-KYC for any single product.

c) While households will have access to the essential minimum kit of assets by default, we propose requiring (either or both of) explicit opt-ins and mandatory education before households access more complex products. This is not to inhibit households from portfolio optimization, but rather, to permit an opportunity for households to reflect on whether the added complexity will appropriately serve their needs.

d) We recommend additional design features which could simplify access to, or improve the use of, several of the simple products which are currently out in the market.

6. We recognise that technological solutions to household finance problems often rely on households sharing personal data with financial product providers. This raises obvious issues of privacy. While this is not the principal focus of our recommendations, we do provide thinking about a sensible framework for data privacy in Indian household finance, and suggest the adoption of a rights-based privacy framework in contrast with the more common consent-based privacy framework.

7. Finally, we stress the need for flexible regulatory processes to further encourage financial innovation that will benefit households. Towards this aim, we propose the creation of a regulatory sandbox to allow regulators to facilitate small-scale tests by financial technology firms. In such a carefully controlled environment, certain regulations may be temporarily relaxed, and households can be allowed to participate in new products. The goal is to collect empirical evidence which can ultimately lead to better policy solutions, whilst simultaneously evaluating the risk of any new product or technology. Such an institution can provide a structured avenue for regulators to engage with the financial supply-side, develop innovation-enabling regulations, and holds promise to facilitate the delivery of relevant, customised, and low-cost financial products to Indian households.