IFMR FINANCE FOUNDATION

Research Plan for Household Finance

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I. Introduction:

According to Campbell[1], household finance "*asks how households use financial instruments to attain their objectives.*" He also identifies features that are distinct to the field of household finance: "*Households must plan over long but finite horizons; they have important non-traded assets, notably their human capital; they hold illiquid assets, notably housing; they face constraints on their ability to borrow; and they are subject to complex taxation.*"

While traditional research in understanding financial decision making has focused on the individual as the unit of inquiry (as in consumer finance research), there is a paucity of research when it comes to understanding household financial behaviour. As Campbell has posited, households present certain unique characteristics and when presented with low-access environments, as is the case in India, their financial decisions and strategies continue to be poorly understood and demand rigorous inquiry.

II. Objective:

"To empirically study the financial decisions of low income households and their underlying rationale in meeting household objectives."

The Household Finance research agenda is meant to generate a deeper understanding of financial strategies that households adopt in order to move resources across time, space and states of the world. Financial strategies encompass not only the use of financial instruments such as bank accounts, crop loans, life insurance and mutual funds, but also the use of non-financial instruments and strategies such as buying livestock to hedge against rainfall risk, and having children as a substitute for old-age pensions. Currently the outcomes of these financial strategies for low income households are not systematically understood, and part of the reason for this is the lack of substantial research that treats the household as the unit for financial decision making. The purpose of this research agenda is to fill this void and enable the generation of a body of work that contributes to a deeper, rigorous, and more systematic understanding of the nature of household financial outcomes and the reasons underlying these outcomes. We expect that this research will have significant implications for financial sector policy and practice.

III. Themes:

Theme 1:

Understanding various financial decisions that households make and strategies that they adopt to achieve their objectives

Relevance to Policy:

This research is expected to provide insights into missing or inefficient markets that inhibit effective achievement of public policy objectives. This could include, for instance, the development of deeper insights into the link between financial exclusion and effective transmission

[1] http://dash.harvard.edu/bitstream/handle/1/3157877/campbellnber_householdfinance.pdf

of monetary policy or between lack of access to financial savings and investment options and household ownership of physical assets.

Sample question sets:

1. How do households plan for and deal with an important life cycle event such as old age and planning for retirement? Why do they adopt the strategies they do and is this linked to the availability of financial solutions like pensions? What inefficiencies, if any, are they forced into on account of being in a low-access environment?

   What about other important life-cycle events, such as: (i) education of children; (ii) marriage of daughter; (iii) purchase of a house; (iv) taking care of parents; and others?

2. How and why do households undertake financing decisions such as lending to families and friends? How, if at all, are such decisions linked to the absence of or lack of access to formal credit providers?

   What about other financial decisions such as: (i) gifting; (ii) refinancing existing debt; (iii) real sector diversification; and others?

3. What is the composition of rural asset portfolios? Are these portfolios weighted heavily towards fixed assets such as gold, land, and housing? What, if any, are the inefficiencies in the construction of these portfolios? In low access environments, how would the addition of financial products to extant household portfolios change the risk-return profiles?

4. What is the occupation profile of rural households? Are multiple occupations for each earning member the norm? If so, is this related to the low-access environment and the inability to diversify their asset portfolios?

5. How do agricultural households perceive the risk related to weather and rainfall on their livelihoods? What mitigating strategies do they adopt to counter this risk? Is the mitigating strategy efficient for the household? If not, can financial products enable more efficient solutions and how?

   What about other risks such as: (i) longevity; (ii) disability; (iii) health; (iv) loss of or damage to productive assets; (v) price risk of agricultural produce; and others?

6. One of the assumptions with regards to low-income or rural households is that they are risk-averse and therefore financial planning for these households needs to address this characteristic. Is this a reasonable assumption? How do we understand risk preference of these households?

Theme 2:

Understanding the interaction of financial products with the portfolios of households

Relevance to Policy:

This research will be critical to providing insights into the nature of product appropriateness for different types of households which can be of value in informing policy about globally unsuitable products as well as unsuitable products for households with specific characteristics. Revealing the complex nature of interactions between products and portfolios can also be of value in injecting a more nuanced understanding into the debate on the issue of ‘simple’ and ‘complex’ products.

Sample question sets:

1. The impact of any product on a household is a function of the interaction of the new product with the existing portfolio of the household. Depending upon the nature of these interactions, a given product can be suitable or unsuitable for the household. Therefore, understanding these interaction effects is critical to determining the suitability or unsuitability of a product for a household. Based on an understanding of interaction effects, what are the drivers of "unsuitability" for different products? Are there certain characteristics or traits of households that make certain products fundamentally unsuited to them, i.e. the addition of the product to the household's portfolio leads to welfare losses for the household? This question assumes salience especially in low-access environments where most providers of financial services offer only one product. What are the drivers of unsuitability for the following products: (i) Joint Liability Group (JLG) loan; (ii) Life Insurance; (iii) NPS-Lite pensions product; and others?

2. How can a knowledge of the financial situation, needs, risk preferences and goals of households be translated into the development of a household portfolio of 'suitable' financial products, ensuring that the overall interactions between all the products enhance (or, at worst, do not compromise) the welfare of the household? Is it possible to develop household typologies with 'suitable' portfolios of financial instruments?

3. What are the real impacts of finance on low-income households in terms of their ability to: (i) enhance risk taking ability; (ii) enable increased occupational specialisation; (iii) smooth consumption; (iv) aspire towards bigger goals; (v) enhance psychological well-being in terms of reduced stress and/or enhanced mental bandwidth; and others?

IV. Outcomes:

The on-going performance of the Household Finance Research Agenda will be assessed based on the following parameters:

1. Number of research publications in leading Economics and Finance journals

2. Number of PhD students undertaking household finance research for their thesis