Indians Save, Americans Invest: Why Financial Literacy Should Accompany Inclusion

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It is a fact of life that education contributes to financial literacy. But such literacy can take different forms. Research by Sumit Agarwal, senior financial economist in the research department at the Federal Reserve Bank of Chicago, and a visiting professor at the Hyderabad-based Indian School of Business (ISB), shows that while Indians know more about saving, Americans know more about investing. Overall, Agarwal finds that Internet-savvy Indians are 20% more financially literate than Americans. This puts them at the same level as Europeans.

The research paper -- Financial Counseling, Financial Literacy, and Household Decision Making -- was presented during an economics conference at Wharton last year. The survey of 2,500 individuals or families was conducted by financial website InvestmentYogi.com. Financial literacy was assessed by asking respondents to answer simple questions related to interest rates, savings and the growth of money.

The report cannot be extrapolated to the whole of India, particularly the rural areas that are the principal target of the government's goal of financial inclusion. Today, only 38% of bank branches are in rural areas and only 40% of the country's population has bank accounts. The banking system has been asked to first target all habitations having a population in excess of 2,000. According to finance minister Pranab Mukherjee, there are around 73,000 such areas. Banks will cover 20,000 villages this year (by March 31). The remaining 53,000 will be covered in 2011-2012. This will be through both bricks-and-mortar branches and banking correspondents (BCs). The latter are agents for the banks -- normally individuals, but the Reserve Bank of India (RBI) has recently allowed companies to be appointed as BCs also.

Possible Minefield

Inclusion comes with potential dangers. Recent experiences in India in the microfinance arena show that poor people take loans that they have no capacity to service. Farmers have also taken loans that they have not been able to repay. Many have been driven to suicide because of debt problems. Unless financial literacy goes hand in hand with financial inclusion, there could be a minefield ahead. "The mortgage crisis [in the U.S.] proved that we did not have a handle on how poorly educated consumers taking the loans, and agents offering the loans, really were," Agarwal told India Knowledge@Wharton.

That's in the U.S., where financial inclusion is not a major issue. For India and other emerging economies, where more than half the population doesn't have a bank account, Agarwal's study has a message: You can't pull the nation forward with the single horse of financial inclusion; you must ride in tandem with financial literacy also.

Agarwal's research is about the Net-savvy; the survey was conducted online. And its findings go beyond the headlines' numbers and conclusions. The saving versus investing aspect could have been logically deduced: According to Businessweek, the household savings rate in China is 38% and in India 34.7%. At the other end of the spectrum, it is 3.9% in the U.S. and 2.9% in Japan. Agarwal's numbers shore this up. According to the survey, Indians use about 38% of monthly income to cover monthly expenses -- they save or invest 62% of their salary.
Risk Averse

The real takeaways from the survey are in the realm of financial behavior. Indians tend to be underinsured: Only two-thirds of the participants report any insurance, including medical and life. Most report having clear financial goals, with education as the most popular goal (true for all risk categories -- those comfortable with some financial risk, much risk or no risk at all). Most Indians are not comfortable with taking risks, however.

As could be expected, higher education is a good indicator of financial skills. Highly educated Indians take on more financial risk; find better returns on investments and better rates for insurance policies; have more financial goals in general and specifically more long-term goals; and hold more financial instruments. Participants report an average of 1.67 loans per household, for either personal use, home loans or car loans. Home loans are the most prevalent liability (and the soundest), and this applies for all categories of risk tolerance and education. "Looking at how each education group distributes loans shows that home loans are the most popular, with all categories having above 50% of loans in home loans," says the survey report. "Post-grads have the highest concentration of car loans with 26% and the graduates have the most personal loans as a share of all liabilities with 22%.

Need for Financial Counseling

Some curious anomalies arose, which could merit further investigation. While males are more financially literate, married people are not. Says Agarwal: "I suspect that married people can use the spouse as 'insurance' [a safety net], and so they can afford to be less financially literate. Unmarried people do not have the insurance of a spouse and so they need to be more financially literate."

Further, it is true that the financially literate have more goals, investments, insurance policies and liabilities. But at a certain point, there is a non-linear pattern. "When they have too many goals, investments, insurance policies and liabilities, they tend to get the answers [on financial literacy] wrong." The assumption is that there has been an unplanned acquisition of assets.

On insurance, too, the findings are counter intuitive. "We find that aggressive growth individuals tend to have more insurance policies," says the study. "This increase appears to be correlated with the increase in the number of investments, suggesting that the insurance policies may not be as conservative as they initially appear." (In India, there is a continuing debate over whether insurance should be considered an investment. Because of certain personal income tax concessions, policies are sold as "tax-saving investment instruments.")

Agarwal says that the wealth of information is why the study is more than just a warning for the financially under-educated. "The study not only tells you about the impact of financial literacy but also how consumers use savings, investment and debt management techniques in their personal finances," he notes. "Any executive involved in an industry where consumer financial behavior is important will find this useful. From a consumer point of view, they can learn how to make better financial decisions. A firm can learn which kinds of consumers make better decisions and which cannot. They can better select the types of customers that have a good chance of success within their business model."

"We find that most consumers are ill prepared to meet their goals based on their asset, liabilities and risk profiles," the study concludes. "Financial counseling is an important tool in educating consumers in their decision making." And it's not just India alone. Says Agarwal: "An aging global population is on the increase all over the world, and this group in particular doesn't tend to make good decisions."