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Module 1

Introduction to Household Financial Management

1.1 Financial literacy

1.2 Financial Discipline

1.3 Family Financial socialisation

1.4 Financial distress of families and its causes

1.5 Trends in Domestic Savings in India

Abstract

This study explores the significance of household financial management, emphasising the role of financial literacy, capability, and family financial socialisation in achieving financial well-being. It highlights how informed financial behaviours—such as budgeting, saving, and responsible borrowing—contribute to stability and long-term goal fulfilment. The paper also examines the causes and consequences of financial distress and the impact of consumerism and changing attitudes on domestic savings in India. Enhancing financial education and discipline is essential to promoting financial resilience and intergenerational financial competence.

Financial Management:

Procurement of funds and their effective utilisation to attain financial goals.

House Hold:

A group of people living together and eating food from a common kitchen.

House Hold Financial Management:

Management of income, expenses, assets and liabilities of households to attain financial goals.

Financial Goals of HH:

1. **Long Term**: House, Land, marriage of children
2. **Medium Term:** Car, Deposits/investments, Big/International Tours
3. **Short Term:** Cloths, Consumer Durables, Career Growth
4. **Immediate:** HH expenses, payment of EMI

HH FM- Components

Effective household financial management involves organising and controlling income, expenses, savings, and investments to achieve financial stability and meet long-term goals. Below are the key components:

1. HH Financial Objectives

Prioritise goals based on importance and timeline. Define SMART (Specific, Measurable, Achievable, Relevant, Time-bound) objectives.

2. HH Budget

A budget is a roadmap for achieving financial objectives. It allocates income toward expenses, savings, and investments.

3. HH Income

Identify all income sources (salaries, investments, business, etc.). Explore opportunities to increase income through additional work, upskilling, or investments.

4. HH Borrowings

Borrowing may be necessary for significant expenditures, but it needs to be managed wisely to avoid financial stress. For this, assess the necessity of loans or credit. Keep debt-to-income ratio within safe limits. Focus on repaying high-interest debts first.

5. HH Expenses

Managing expenses ensures that resources are used efficiently, leaving room for savings and investments. For a wise sending, differentiate between needs and wants. Reduce discretionary spending if necessary. Track expenses regularly for accountability.

6. HH Savings

Savings act as a financial safety net for emergencies and future goals. So, build an emergency fund (3-6 months of expenses). Automate savings to ensure consistency. Align savings with specific goals (e.g., education, vacations, homeownership).

7. Investment of Savings

Investments allow savings to grow over time and help achieve long-term objectives. For this, diversify investments across asset classes (stocks, bonds, mutual funds, real estate) to balance risk and return based on the household's financial goals and risk tolerance.

8. Protection of savings

Protecting savings from unforeseen risks ensures financial security. For this, secure adequate insurance (health, life, property), keep a portion of savings in low-risk, easily accessible forms (e.g., fixed deposits, liquid funds), and protect against inflation by investing in growth-oriented assets.

Financial literacy

Financial literacy means having the knowledge and skills to manage money wisely and achieve a balanced and responsible financial lifestyle. It includes understanding personal finance, budgeting, and investing. With financial literacy, people can make smart decisions about their money. The absence of these skills is called financial illiteracy.

“Financial literacy is the possession of the set of skills and knowledge that allows an individual to make informed and effective decisions with all of their financial resources.”

USFLEC[1]

"Financial education involves education of financial products, concepts, risks and financial skills to develop confidence to make 'informed financial decisions’ ”.

OECD[2]

Key Components of FL

US Financial Literacy and Education Commission emphasises earning, spending, saving/investing, borrowing, and protecting. The OECD focuses more on knowledge, skills, attitude, and behaviour in financial decision-making. Clubbing both, the key components of financial literacy are:

1. **Earn (Financial Knowledge & Skills)**

Understanding income sources, knowing how to earn money, and managing the inflow of funds. Skills for negotiating salaries, managing employment income, and creating additional income streams.

2. **Spend (Financial Skills & Behavior)**

Knowledge of budgeting and tracking expenses, understanding needs vs. wants, and managing daily spending. Responsible spending behaviour, avoiding impulse buying and ensuring expenses align with financial goals.

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[1] USFLEC- US Financial Literacy and Education Commission
[2] OECD- Organisation of economic cooperation and development

3. **Save and Invest (Financial Knowledge, Skills, and Behavior)**

Knowledge of saving methods, interest rates, and investment options. Skills in investing, saving for future goals, and calculating returns. Positive saving and investing behaviour include regularly setting aside money and taking calculated investment risks.

4. **Borrow (Financial Knowledge, Skills, and Behavior)**

Understanding borrowing options (loans, credit cards, etc.), interest rates, and the implications of debt. Skills to manage debt responsibly and understand borrowing terms. Healthy borrowing behaviour ensures debt is used wisely and repaid on time.

5. **Protect (Financial Knowledge & Behavior)**

Knowledge of insurance, risk management, and financial protection strategies (e.g., health insurance, life insurance, emergency funds). Responsible for protecting assets and preparing for unexpected financial events.

6. **Financial Attitude (Motivation and Commitment)**

The mindset to manage finances responsibly, set goals, and work towards financial independence. A positive attitude towards long-term financial planning, discipline, and smart money management.

Main benefits of Financial Literacy

1. Helps us make smart financial decisions.
2. It teaches how to manage money effectively by budgeting, saving, borrowing, and investing.
3. Guides navigating the financial system.
4. Builds confidence in managing money, setting goals, and reducing debt.

5. Supports a balanced, sustainable, ethical, and responsible financial lifestyle.
6. Helps entrepreneurs use funds effectively to grow their businesses.
7. Focuses on improving financial literacy.
8. Encourages creating a personal monthly budget.
9. Promotes building an emergency fund.
10. Emphasises planning for retirement.
11. Aims to eliminate debt.
12. Teach students how to check and improve credit scores.

Methodology of Assessing Financial Literacy

Assessing financial literacy is a dynamic process. It involves evaluating individuals' knowledge, skills, attitudes, and behaviours in managing personal finances. The methodology typically includes the following steps:

1. **Define Objectives**

Clearly outline what aspects of financial literacy are to be assessed (e.g., knowledge, skills, attitude, or behaviour).

Align objectives with frameworks like the OECD or national financial literacy standards.

2. **Design the Assessment Tool**

Questionnaire/Survey: Include multiple-choice, Likert-scale, or open-ended questions covering key financial concepts (e.g., budgeting, saving, borrowing, investing, and risk management).

Include situational questions to assess practical decision-making skills.

Tests/Quizzes: Focus on evaluating financial knowledge (e.g., understanding of interest rates or investment options).

3. **Select Financial Literacy Indicators**

Knowledge Indicators: Understanding income sources, expenses, savings, investments, and insurance.

Skills Indicators: Ability to create budgets, calculate interest, and plan for financial goals.

Attitude Indicators: Readiness to save, avoid impulsive spending, and commit to financial goals.

Behavior Indicators: Actual practices include maintaining budgets, investing, or paying bills on time.

4. **Data Collection Methods**

Self-Assessment Surveys: Respondents rate their financial literacy or behaviours.

Interviews: Gather qualitative insights about financial decision-making.

Focus Groups: Understand common challenges and knowledge gaps in specific demographics.

Observation: Monitor real-life financial behaviours (e.g., tracking savings habits or debt repayment).

5. Pilot Testing

Test the assessment tools on a small group from the target population to check for any clarity, difficulty, or bias issues. Collect feedback to improve and refine the assessment, ensuring it is reliable and accurate.

6. **Sampling**

Random sampling ensures diverse representation across age, income, education levels, and geographical areas.

Focus on target groups (e.g., students, employees, entrepreneurs) if assessing financial literacy for specific purposes.

7. **Data Analysis**

Quantitative Analysis: Use statistical tools to measure financial literacy scores and identify trends or gaps.

Qualitative Analysis: Analyse responses from interviews or open-ended questions for deeper insights.

Compare results with benchmarks or standards for financial literacy.

8. **Benchmarking and Reporting**

Compare results with national or international financial literacy standards (e.g., OECD guidelines). Interpret the assessment results in the context of the defined objectives.

Prepare reports highlighting strengths, weaknesses, and recommendations for improving financial literacy.

Major Indicators of Financial Literacy:

Major indicators of financial literacy include:

1. Budgeting skills
2. Savings knowledge
3. Debt management
4. Investment literacy
5. Financial goal setting
6. Understanding about credit score
7. Insurance Awareness

8. Tax literacy
9. Consumer rights
10. Retirement planning

The following are some financial literacy indexes used to assess financial literacy.

1. Financial behaviour index (FBI) involves assessing various financial habits and decisions. A higher score is positive.
2. Financial Attitude Index (FAI) assesses attitudes towards financial matters.
3. Financial knowledge index (FKI): Evaluating knowledge in budgeting, savings, and debt management.
4. Financial familiarity index (FFI): Measuring the familiarity of financial products and services
5. Financial planning index (FPI): Focusing on the respondents' ability to make financial plans that maximise return and wealth.

Financial Literacy Principles

Financial literacy principles serve as fundamental guidelines and concepts that individuals can use to make informed and effective financial decisions. These principles are crucial for navigating the complexities of personal finance and achieving financial well-being.

1. Fix Financial Goals – Short-term, medium-term and long-term.
2. Encourage saving habits
3. Importance to the protection of money earned
4. Improve Credit Scores (CIBIL Score)
5. Give importance to Income tax savings

6. Smart shopping – avoid unwanted expenditure
7. Preparation of budget
8. Financial Independence through money management

Core Financial Competencies

Core financial competencies include financial awareness, skills, attitude, and behaviour essential for effective money management.

1. **Financial Awareness**

   a. About financial goals

   b. About sources of income

   c. About sources of borrowings

   d. About avenues of investments of savings

   e. Protection of savings and investment

2. **Financial Skills**

   Preparation of budgets, tapping low-interest borrowings, investing short-term savings, and finding more sources of income.

3. **Financial Attitude**

   Use of financial knowledge and skills in financial decisions.

4. **Financial Behaviour**

   Timely payment of bills and EMI, controlled spending, controlled borrowing, habit of savings and investments, etc.

Financial Discipline

Financial discipline refers to the practice of managing financial resources efficiently and responsibly to achieve long-term financial stability, goals, and success. It involves adhering to financial principles, maintaining accountability, and making deliberate, informed decisions about spending, saving, investing, and borrowing. Financial discipline applies to individuals, organisations, and governments. It involves:

1. Setting HH Financial Objectives
2. Preparation of budget to meet financial objectives
3. Keep a balance between expenses and income.
4. Avoiding impulse spending
5. Control borrowings to avoid debt trap
6. Keep expenses in tap with budget
7. Timely payment of bills, EMIs and taxes
8. Creation of an emergency fund
9. To make investment of savings in formal channels
10. To abstain from illegal monetary activities.
11. To keep away from gambling and related unhealthy practices.

Components of Financial Discipline

By following these components, individuals can ensure financial stability, achieve goals, and maintain a disciplined approach to money management.

1. **Setting Financial Objectives**:

   Define clear and achievable financial goals, such as saving for emergencies, investments, or future needs.

2. **Budget Preparation**:

   Create a budget to plan income and expenses, ensuring resources are allocated to meet financial objectives.

3. **Balancing Income and Expenses**:

   Maintain a healthy balance between earnings and spending to avoid financial strain.

4. **Avoiding Impulse Spending**:

   Practice self-control by focusing on needs over wants and resisting unnecessary purchases.

5. **Debt Management**:

   Borrow responsibly, control loans, and avoid falling into a debt trap.

6. **Adhering to the Budget**:

   Keep expenses aligned with the planned budget and regularly review it for adjustments.

7. **Timely Payments**:

   Pay bills, EMIs, and taxes on time to avoid penalties and maintain financial stability.

8. **Emergency Fund Creation**:

   Set aside savings to handle unexpected financial challenges like medical emergencies or job loss.

9. **Investing Savings**:

   Make informed investments in formal and secure channels to grow wealth over time.

10. **Avoiding Illegal Activities**:

    Abstain from unlawful financial practices, ensuring ethical and legal compliance.

11. **Steering Clear of Gambling and Unhealthy Practices**:

    Refrain from gambling and other activities that can lead to financial and personal losses.

Financial Capability

61 It is the knowledge, skills, attitudes, and behaviours that enable an individual to make wise and effective decisions regarding various financial resources. It encompasses the ability to manage money responsibly, plan for the future, and navigate financial systems confidently.

Key Components of Financial Capability:

Financial capability involves key components such as financial knowledge, money management skills, financial planning, and informed decision-making to effectively manage personal finances. It also includes access to financial services, resilience to financial shocks, positive financial behaviours, and an awareness of financial rights and responsibilities.

1. **Financial Knowledge**:

    64 Understanding basic financial concepts such as budgeting, saving, investing, debt management, and the risks and rewards of financial products.

2. **Money Management Skills**:

    The ability to create and stick to a budget, track expenses, save regularly, and manage debts effectively.

3. **Financial Planning**:

   Setting financial goals, planning for emergencies, and preparing for long-term needs like retirement or education.

4. **Informed Decision-Making**:

   The capacity to evaluate financial options, compare products, and make choices that align with personal financial goals.

5. **Access to Financial Services**:

   Knowing how to use financial tools and services like bank accounts, credit facilities, insurance, and digital payment systems.

6. **Resilience to Financial Shocks**:

   Building an emergency fund and having strategies to cope with unexpected expenses or income loss.

7. **Positive Financial Behaviors**:

   Regular saving, responsible spending, avoiding unnecessary debt, and maintaining a disciplined approach to finances.

8. **Awareness of Financial Rights and Responsibilities**:

   Understanding consumer rights, financial obligations, and the importance of ethical practices in financial dealings.

Financial Competency

It refers to the capability of an individual to have successful control over his money. Components of financial competency include financial knowledge, financial skills, financial attitude, and financial behaviour.

Family Financial socialisation

Socialisation is the process through which a person acquires knowledge, values, attitudes and behaviour from the interaction with his society. Financial socialisation is the process through which a person acquires financial knowledge, financial values, financial attitude and financial behaviour from the interaction with his society. Different social channels include family, school, colleges, religious institutions, etc. Among these social channels, family influences the most. Its outcomes are financial knowledge, attitude, behaviour, and well-being.

Family Financial Socialisation Theory – FFST

Family Financial Socialization refers to the process by which individuals learn and internalise financial behaviours, attitudes, and practices, typically influenced by their family environment. This socialisation is crucial for shaping financial habits, values, and decision-making skills that impact an individual's financial capability and competency throughout life.

The theory was proposed by Gudmunson and Danes in 2011. The theory has two dimensions- (a) Financial socialisation process and (b) Financial socialisation outcomes.

A. Financial socialisation process:

There are two types of family financial socialisation processes-

(1) Implicit/Non-purposive FFS: Children learn the basics of financial knowledge, attitude, and behaviour by observing their parents.

(2) Explicit/Purposive FFS: Parents take deliberate steps to inculcate financial knowledge, financial attitude and financial behaviour in their children

B. Financial socialisation outcomes:

Financial knowledge, attitude and behaviour leading to financial well-being are the broad outcomes of FFSP. It creates responsible financial behaviour among children. The outcomes include:

1. Setting HH Financial Objectives
2. Preparation of budget to meet financial objectives
3. Keep a balance between expenses and income.
4. Avoiding impulse spending
5. Control borrowings to avoid debt trap
6. Keep expenses in tap with budget
7. Timely payment of bills, EMIs and taxes
8. Creation of an emergency fund
9. To make investment of savings in formal channels
10. To abstain from illegal monetary activities.
11. To keep away from gambling and related unhealthy practices.

Role of Parents in Financial Socialisation (Role Modelling)

Parents play a central role in family financial socialisation. They are children's primary source of financial knowledge and behaviours, consciously or unconsciously shaping their understanding of money, saving, spending, and investing. Key ways parents influence financial socialisation include:

1. **Modelling Financial Behaviors**: Parents' financial practices, such as budgeting, saving, investing, mature behaviour of shopping, payments of bills and debts, etc., provide children with firsthand examples of how to manage finances.
2. **Direct Teaching**: Through discussions and lessons, parents explicitly teach financial concepts like earning, saving, and budgeting. This can occur through practical activities like involving children in household financial decisions.
3. **Setting Expectations and Rules**: Parents set financial expectations for children, such as how to save for goals, manage debts, or make purchasing decisions. These rules guide how children approach money management.
4. **Encouragement and Support**: Parents who encourage children to take on financial responsibilities, such as managing their own spending or saving for long-term goals, help build financial independence and competence.
5. **Emotional Support and Guidance**: Financial decisions often involve emotional elements, and parents' guidance can help children navigate money-related stress, such as saving for future goals or managing debt.
6. **As financial advisors** – Parents should inculcate the qualities of responsible financial behaviour. As teachers of financial literacy, parents should provide students with financial literacy.

Significance of Family Financial Socialisation

The role of parents is foundational to an individual's financial competence and capability. The attitudes learned from their parents significantly shape the children's financial decision-making throughout life. Family financial socialisation leads to financial literacy and financial competence. Researchers found that FFS has a mediating effect on FL and FB. Generally, children get guidelines from their families regarding monetary practices. The following points show the significance:

1. **Financial Capability**:

Family financial socialisation plays a crucial role in shaping an individual's financial capability by imparting knowledge, decision-making skills, and problem-solving abilities from an early age.

- **Understanding Financial Concepts**: Family financial socialisation provides the foundational knowledge of financial concepts such as budgeting, debt management, and investing, which enhances financial capability.
- **Decision-Making Skills**: Parents influence how children make financial decisions, helping them develop the skills to evaluate choices, prioritise needs, and manage resources effectively.
- **Problem-Solving Abilities**: Children learn to solve financial problems creatively and responsibly through exposure to financial challenges and decisions.

2. **Financial Competency**:

Financial competency is developed through family financial socialisation, enabling individuals to apply practical financial skills, self-regulate, and build resilience in managing real-life financial situations.

- **Practical Application**: Family financial socialisation equips individuals with the necessary skills to manage real-life financial tasks, such as paying bills, saving for emergencies, and navigating credit and loans.

- **Self-Regulation**: Parents who emphasise self-control and delayed gratification help children develop habits that lead to better financial outcomes, like saving for the future or avoiding impulse purchases.
- **Resilience in Financial Challenges**: Those raised in a financially socialised environment are often more prepared to handle financial setbacks and make informed decisions to recover from economic challenges.

Constraints of Family Financial Socialization

1. **Lack of Financial Knowledge**: Parents may lack financial knowledge to teach their children effectively.
   - **Solution**: Parents can learn about finances through workshops, courses, or books, and schools can provide financial education.
2. **Financial Stress**: Families in financial difficulty may focus more on surviving than teaching financial skills.
   - **Solution**: Financial counselling and support programs can help families manage stress and improve financial knowledge.
3. **Cultural Norms**: In some cultures, money talk is considered taboo, making it hard to discuss finances.
   - **Solution**: Encourage open discussions about money to normalise financial education.
4. **Mixed Messages**: Parents may send conflicting messages, like promoting saving but spending excessively.
   - **Solution**: Parents should model consistent financial behaviours and align their actions with what they teach.

5. **Generational Gaps**: Older generations may lack knowledge about modern financial tools (e.g., digital banking).

   ○ **Solution**: Encourage intergenerational learning, where younger generations help older ones understand modern tools.

6. **Psychological Barriers**: Negative emotions like fear or guilt about money can stop families from discussing finances.

   ○ **Solution**: Financial counselling can help address these emotional barriers, and children can be taught to approach money with a healthy mindset.

7. **Lack of Time**: Busy family schedules leave little time for financial education.

   ○ **Solution**: Short, accessible financial education programs or online resources can be used to fit into busy lives.

8. **Parental Influence**: Children may not trust or listen to parents' financial advice if they've had poor financial experiences.

   ○ **Solution**: Parents can involve children in financial decisions to build trust and responsibility.

9. **Limited Access to Resources**: Families without access to banking or credit may struggle to teach financial concepts.

   ○ **Solution**: Community programs can provide financial resources and education for needy families.

Measures to Overcome These Obstacles

1. **Improved Financial Education**: Offer accessible financial programs for parents and children through schools and community centres.

2. **Government and NGO Support**: Provide financial counselling and low-cost services to support struggling families.
3. **Community and Peer Support**: Create local programs to help families learn about finances in a comfortable setting.
4. **Addressing Psychological Barriers**: Integrate mental well-being into financial education to reduce money-related stress.
5. **Use of Technology**: Use apps and online resources to make financial learning accessible for everyone.

Financial Capability

FC refers to the performance of desirable financial behaviour for achieving financial well-being. It means the knowledge, attitude, skills and behaviour of people about:

(a) Their financial resources

(b) Usage of various financial services that fit their needs. The use of financial products and services leads to financial inclusion.

Assessment of Financial Competency

The financial capability will be different in different socio-economic environments. Financial literacy is not an indicator of financial competency. But FC requires F Literacy. The financial capability index is used to measure the level of financial capability. It is a tool developed through a questionnaire to measure the level of knowledge, skills, attitude, and behaviour. It covers the aspects of planning, earning, saving, spending, borrowing, investing, etc.

Financial Well-being (FWB)

FWB is one where the individual feels satisfaction with one's financial position. It is the ability to control one's daily and monthly financial transactions, handle financial uncertainties, meet financial goals, and have the financial freedom to make choices that allow one to enjoy life. FWB is the outcome of financial management. It is the capability to manage finances.

The financial distress of families

The dictionary meaning of 'distress' is extreme anxiety, sorrow, or pain. Its psychological meaning is a range of symptoms of a person's internal life that troubles and confuses. Financial distress is a condition where a family or individual is unable to generate sufficient income to meet their current and ongoing financial obligations. Financial obligations include payment of EMI, bills, other dues, and meetings of emergencies.

Causes of Financial Distress

Financial distress is a condition where an individual/family cannot meet their financial obligations. He/they is/are unable to generate sufficient income. It denotes economic hardship and financial distress. There are many reasons for this situation. The most important are:

I. Educational reasons

1. Lack of financial literacy – including financial knowledge, financial skills, financial attitude, and financial behaviour.
2. Absence of setting financial goals
3. Lack of financial plans.
4. Lack of accounting and budgeting

5. Absence or non-adherence to family budgets.

II. Income Related

6. Irregular disposable income.
7. Dependence on a single source of income.
8. Reduced number of earning members in a family
9. Loss of investments in informal systems.

III. Lack of access to the formal financial system

10. Lack of knowledge
11. Lack of skills to access
12. Over formalities of the formal system
13. Lack of flexibility in the formal system

IV. Behaviour Related

14. Uncontrolled and excess spending over income.
15. Impulse spending or lack of financial discipline.
16. Dependence on borrowings from informal systems.
17. Week debt management
18. Spoiled children – Especially due to over-support with finance
19. Divorce
20. Lack of proper financial communication between members.

V. Ethical Behaviour

21. Involvement in financial fraud

22. Involvement in gambling activities like online games, lottery, etc.
23. Alcohol or drug addiction of family members
24. Involvement in illegal and immoral activities.

VI. Unpredictable Reasons

25. Unexpected reduction of income due to price reduction or loss of job or business loss.
26. Unexpected medical expenses due to illness, accidents, etc.
27. Unexpected loss of income or investments due to calamities or market risks
28. Death of earning member.

VII. Economic Reasons

29. Inflation
30. Trade Cycle – recession and depression phases
31. Industry failure and related layoff, retrenchment, business failure, etc.

Common Responses to Financial Distress

Financial distress often leads to psychological and behavioural issues such as anxiety, depression, substance abuse, and sleep disturbances. It can also cause family problems, including strained relationships, neglectful parenting, and an inability to meet basic needs like food, shelter, and education.

1. Psychological and Behavioral Issues

Financial distress leads to behavioural issues. The common symptoms found are anxiety, depression, post-traumatic stress, severe grief, alcohol or drug abuse, nightmares, panic, overwhelming levels of stress, confusion, over- or under-eating, inability to sleep (or excess sleep), upset stomach and other physical and mental symptoms of stress and depression.

2. Family Problems

Financial distress may lead to problems in the family. Parents may transfer their distress to others. There can be indulgent /neglectful parenting and difficulties in providing for their children's needs. Family may fail to meet the physical needs of food, shelter, clothing, medicine, good education, effective nurturing, etc.

Remedies to Financial Distress of Families

1. Implement good record-keeping practices.
2. Create a budget -to eliminate debt and save money.
3. Establish priorities and stick to them.
4. Determine the family's budget needs- The family’s budget needs can be determined by considering the bank statements, monthly bills, monthly income information, etc.
5. Eliminate debt and save money- The family head may prepare a budget in such a way that it eliminates debt and saves money.
6. We can approach creditors to make manageable payment arrangements if credit issues are out of control.
7. Seek professional help through Consumer Credit Counseling.
8. Family therapy/ structured form of psychological counselling.

Family Therapy/ Structured Psychological Counselling

Family therapy is a structured form of psychological counselling that helps family members improve communication, resolve conflicts, and cope with stress—including that caused by financial problems.

Family therapy acts as a bridge between financial knowledge and emotional healing. It promotes a healthier financial environment by improving communication, resolving conflicts, and enabling collaborative financial behaviour.

"Family therapy is a type of psychological counselling (psychotherapy) that can help family members improve communication and resolve conflicts."

APA (American Psychological Association)

Significance of Savings on

Financial Destiny of Individuals and Families

People save to spend later. Savings has an objective of meeting financial objectives. The significance of savings on the financial destiny of individuals and family are:

1. Savings helps to achieve financial goals.
2. Savings help create an emergency fund.
3. Savings helps to get rid of financial stress.
4. It provides economic security to individuals and family
5. It helps to make sound investment
6. It helps to meet emergencies or unexpected situations.
7. It helps to meet education, marriage, etc.
8. It helps to achieve dreams like a house, car, etc., with no or least borrowings.
9. It reduces peace of mind.
10. It helps to improve the standard of living.

Trends in Domestic Savings in India

The Centre for Statistical Organisation (CSO) defines savings as "The excess of current income over current expenditure. It is the balancing item on the income and outlay accounts of producing enterprise, households, government administration, and other final consumers."

Gross Domestic Savings: GDS

GDS = Gross Domestic Product - Final consumption expenditure. It is expressed as a '% of GDP'.

GDS is the total savings of savings of the household sector, private corporate sector, and public sector.

Major Components of GDS

For GDS calculation, the entire economy can be classified into three major sectors: the household sector, the private corporate sector, and the Public Sector.

1. **Household Sector:**

   This includes individuals, non-profit institutions, and unincorporated private businesses. This includes:

   Financial Savings: Currency possession, net deposits, investments in securities, and small savings

   Physical Assets: Machinery, equipment, construction, and inventories.

2. **Private Corporate Sector:**

   This includes net savings revealed in the Profit and loss accounts of:

   - Non-government, non-financial companies.

- Private financial institutions.
- Cooperative institutions (data sourced from NABARD).

3. **Public Sector:**

   Includes net savings from excess current receipts over current expenditures of:

   - Governmental departments.
   - Non-departmental enterprises.
   - Administrative departments.

Trends in Domestic Savings in India

1. Domestic savings in India show an increasing trend from 1950 onwards.
2. Financial savings and savings in the form of physical assets show an increasing trend.
3. DS as a percentage of GDP also increased from 1960 to 2007.
4. The progress of DS to DGP is not a straight line.
5. DS percentage to GDP decreased in 2008 and 2009 and increased in 2010.
6. DS as a percentage of GDP shows a decreasing trend from 2011 onwards.
7. Savings as a percentage of GDP-10 year average showed a slowly increasing trend up to 1990.
8. From 1990 to 2010, accelerated growth was present in the GDP-10-year average.

9. The next 10 years, starting in 2010, show a slow decline.

Effect of Consumerism and Changing Attitude towards Life on Domestic Savings

Consumerism and changing attitudes have increased spending on luxury goods and experiences, reducing savings. Credit access and digital payments promote a "buy now, pay later" mindset. Younger generations focus on instant gratification over long-term planning. Urbanisation and global trends add to lifestyle inflation, further lowering savings.

Consumerism

Consumerism is the belief that increased consumption of goods is economically desirable. It emphasises happiness and well-being through acquiring consumer goods and material possessions. Advertising plays a key role in driving consumerism.

Features of Indian Consumerism

1. **Unique Development Pattern:** Does not follow typical development models.
2. **Non-linear Development Path**: India's growth path does not adhere to standard chronological sequences or traditional models of social change.
3. **Technological Advances:** Rapid economic changes due to new technologies.
4. **Growing Middle Class:** Rising demand for goods and changing values.
5. **Changing Family Roles:** Increased labour participation of women and evolving family structures.

6. **Higher Aspirations:** Increased spending across population segments.
7. **Luxury Spending:** Growth in spending on luxury goods, supported by savings and credit.
8. **Modern Shopping Trends:** New shopping environments and outlets.
9. **Media Influence:** Proliferation of TV, films, and English-language media.
10. **Consumer Awareness:** High awareness among different population groups.
11. **Global Exposure:** Indian consumers travelling abroad and experiencing global goods.
12. **Global Brands in India**: Entry of Multinational Corporations Reshaping Consumer Preferences.
13. **Strong Manufacturing:** Thriving domestic manufacturing of consumer goods.
14. **Entry of Multinational Corporations:** More global brands are entering the market.
15. **Emerging Rural Consumers:** Increased consumption in rural areas.

Effect of Consumerism on Domestic Savings

1. **Reduced Savings:** Consumerism decreases household and individual savings.
2. **Increased Spending:** This leads to higher household expenses.
3. **Lower Gross Savings:** Reduces overall domestic savings.

4. **Rising Credit Demand:** Boosts demand for credit and credit cards.
5. **Impulse Spending:** Credit cards and offers like cashback, sales, and no-cost EMIs encourage unplanned purchases.
6. **Financial Stress:** Overuse of credit increases financial pressure.
7. **Materialism over Spirituality:** Shifts cultural focus to materialism.
8. **Higher Demand for Goods:** Increases demand for durable goods and fast food.

Changing Saving Habits of Indian People

There is a noticeable decline in domestic savings alongside a growing preference for financial assets over physical ones. Additionally, tradable assets like stocks are becoming more popular, and corporate sector savings have significantly improved.

1. **Decline in Savings Rate:** Domestic savings are decreasing.
2. **Shift to Financial Assets:** Preference for financial assets over physical ones.
3. **Growth in Tradable Assets:** Financial investments like stocks are gaining popularity.
4. **Improved Corporate Savings:** Significant growth in corporate sector savings.

Discourse of Consumerism in India

Consumerism in India is driven by advertising, media, and technology, which shape branding, lifestyles, and shopping habits. Cultural shifts and modernisation, influenced by Westernisation and urbanisation, have transformed mobility, fashion, and daily consumer choices.

1. **Advertising as a Pillar of Consumerism**

   Advertising, supported by media columns and exclusive magazines, drives consumerism by influencing branding, fashion, and lifestyle choices.

2. **Influence of Media and Entertainment**

   Movies, TV, and entertainment media heavily shape consumer preferences, with various domestic and global brands advertised widely.

3. **Impact of Technology on Consumer Life**

   Technologies like TVs, smartphones, and digital payments have transformed everyday life, while online markets redefine shopping habits.

4. **Changing Lifestyles and Mobility**

   Young families and professionals use motor scooters for convenience, reflecting modernisation through urbanisation and media exposure.

5. **Cultural Shifts in Consumerism**

   Westernization has influenced clothing, food, and language, blending traditional Indian values with global trends.

Summary

Household Financial Management involves the effective handling of income, expenses, savings, investments, and borrowings to meet both short-term needs and long-term goals like home ownership or children’s education. Key practices include budgeting, debt control, emergency savings, goal-based investing, and financial protection. Financial literacy is essential for informed decision-making and responsible money management, enhancing saving, budgeting, investing, and borrowing skills. It also fosters confidence, discipline, and independence. Assessment tools like the Financial Knowledge and Behavior Index evaluate one's literacy, which is influenced heavily by *family financial socialisation*. In this process, financial habits and attitudes are learned from parents through role modelling and guidance. Financial capability, combining literacy with behaviour and planning, is crucial for achieving financial well-being—a state of satisfaction, stability, and control over finances. Lack of financial capability can lead to financial distress, marked by the inability to meet financial obligations, which causes emotional strain and family issues. Remedies include financial education, counselling, and structured budgeting. However, rising consumerism, credit reliance, and lifestyle inflation, influenced by media, technology, and globalisation, have reduced household savings in India, shifting preferences from traditional saving to increased spending and investment in financial assets.

REVIEW QUESTIONS

Part A **(Short Answer Questions)**

1. State the benefits of financial literacy programs.
2. What are the main causes of financial distress?
3. What is the role of family therapy and parenting to overcome financial distress?
4. State the relevance of financial well-being in the present world.
5. Why youngsters should be trained with financial principles?
6. How do bank deposits form a major share in household savings?
7. What is subjective financial well-being?
8. Differentiate between BFMI and BFMA
9. What is intermediate outcome?

Part B (Short Essay/Problems)

10. Describe the practical recommendations with respect to financial literacy assessment.
11. Explain various indicators of financial discipline in detail.
12. State the relevance of financial competency in daily life with suitable examples.
13. Explain Consumerism? Give examples
14. Mention how family socialising will lead to an inclusive way of teaching financial literacy?

15. What is the role of family therapy and parenting to overcome financial distress?
16. Describe the common responses of individual in financial stress.
17. Explain the ways to improve financial well-being.
18. "Biases should not be viewed in isolation". Discuss.

Part C (Essay Type Questions)

19. Narrate the influence of consumerism on household savings.
20. Critically evaluate the statement 'Parental financial teaching is more appropriate and effective than general financial education'
21. What is the role of family therapy and parenting to overcome financial distress?
22. Financial literacy is the backbone of financial socialization – Critically evaluate the statement.
23. Give a detailed picture of the saving behaviour of Indian population.

TACKLING ANALYTICAL QUESTIONS

PART B – Short Essay

1. Describe the practical recommendations with respect to financial literacy assessment.

   Answered under "Methodology of Assessing Financial Literacy" and "Indicators"

2. Explain various indicators of financial discipline in detail.

   Covered under "Financial Discipline" and its components.

21. What is the role of family therapy and parenting to overcome financial distress?

Covered Under:

- Family Financial Socialisation.
- Financial Distress of Families.
- Remedies to Financial Distress.
- Role of Parents in Financial Socialisation (Role Modelling)
- Family Therapy/ Structured Psychological Counselling.

✅ **Short Answer**

Financial distress is the inability of a family to meet its financial obligations, often leading to stress and dysfunction. **Parenting** plays a vital role through financial role modelling and direct teaching of budgeting and saving. **Family therapy** a structured form of psychological counselling that helps family members improve communication, resolve conflicts, and cope with stress—including financial stress.

✅ **Short Essay**

Financial distress – Causes -remedies **Parenting -** significance - setting clear financial expectations- emotional support. **Family therapy -** psychological counselling - improve communication - resolve conflicts.

✅ **Long Essay**

Points to Develop the Essay:

I. Introduction

- Financial distress, Financial literacy, emotional support, parenting and family therapy as a tool.

II. Causes of Financial Distress (Brief Overview)

- Lack of financial literacy, absence of budgeting and saving. Behavioural causes: impulse spending, spoiled children, divorce, lack of communication. Irregular income and high debt burden.

III. Role of Parenting

- Financial Role Modelling, Explicit Teaching, Setting Rules and Expectations, Emotional Support, Building Competency

IV. Role of Family Therapy

- Facilitates open communication about financial issues. Addresses emotional responses—anxiety, guilt, blame—stemming from financial strain.
- Resolves behaviour-related issues such as neglectful parenting or conflict avoidance. Encourages shared responsibility in budgeting and spending decisions. Reinforces positive financial attitudes and teamwork.

V. Combined Impact

- Strengthens family unity, trust, and cooperation. Builds financial capability and emotional resilience. Encourages better financial decisions and long-term planning. Prevents long-term damage caused by unresolved financial stress.

VI. Conclusion

- Financial distress affects both financial stability and emotional health. A combination of strong parenting and family therapy offers a holistic approach to recovery. Together, they enhance financial literacy, foster resilience, and contribute to overall financial well-being and healthy family dynamics.

Qn 20: Critically evaluate the statement: "Parental financial teaching is more appropriate and effective than general financial education."

Covered Under:

- Family Financial Socialisation (FFS).
- Role of Parents in Financial Behaviour.
- Financial Literacy & Education.
- Constraints and Remedies in FFS.

Points to Develop the Essay:

I. Introduction

Financial education, Parental financial teaching

II. Arguments in Favour of Parental Financial Teaching

- Early and Continuous Exposure. Based on real-life family situations (budgeting, bill payment, saving, investing).
- Emotional and Behavioural Influence**:** Parents instill discipline, attitudes, and habits (e.g., delaying gratification, avoiding impulse buying). Better Retention**:** Children tend to trust and remember what parents practice and preach. Role Modelling**:** Implicit socialisation builds deep-rooted financial values.

III. Limitations of Parental Financial Teaching

- Knowledge Gaps: Parents may lack financial literacy themselves.

- Mixed Messages: Inconsistent behaviours (preaching savings but spending recklessly).
- Cultural Barriers: In some families, money is a taboo topic.
- Psychological Barriers: Fear, guilt, or stress may limit open conversations.

IV. Strengths of General Financial Education

- Structured and Standardised**:** Covers a wide range of topics (budgeting, saving, investing, credit).
- Fills Parental Gaps**:** Offers correct information that families can't. Schools, community programs, and digital platforms ensure wide coverage. Encourages Financial Inclusion**:** Especially for families with limited financial exposure or access.

V. Weaknesses of General Financial Education

- May Be Too Theoretical. Lacks the real-life context and emotional learning from home. One-size-fits-all**:** May not suit every individual's situation. Short-term Exposure: Limited interaction time compared to everyday parental influence.

VI. Synthesis and Critical Evaluation

- Best Outcomes Come from Both**:** When general education supports and complements parental teaching.
- FFS as a Mediator**:** Research shows Family Financial Socialisation has a strong mediating effect on financial literacy and behaviour.
- Policy Implication: Encourage both—empower parents with knowledge and provide strong financial education in schools.

VII. Conclusion

- Parental financial teaching - General financial education
- Therefore, neither is fully sufficient alone. A hybrid approach is most appropriate and effective.

Essay Question:

19. Narrate the influence of consumerism on household savings.

Covered Under:

- Effect of Consumerism and Changing Attitudes on Domestic Savings.
- Features of Indian Consumerism. Changing Saving Habits of Indian People. Discourse of Consumerism in India

Points to Develop the Essay:

I. Introduction

- Consumerism**,** Household savings**:**
- State the thesis: Consumerism significantly reduces household savings by promoting spending over saving.

II. Features of Consumerism in India

- Changing Family Structures**:** Dual-income households, smaller families. Rise of the Middle Class and higher disposable income.
- Technological Influence**:** Online shopping, digital payments. Easy credit. Media and Advertising**:** Promotes aspirational lifestyles. Globalisation**:** Exposure to international brands and luxury consumption.

III. Influence on Household Savings

- Reduced Savings Rate: Preference for spending on gadgets, fashion, luxury, and travel. Increase in Credit Use with easy loans and EMIs. Shift to Short-Term Goals: Focus on lifestyle upgrades over long-term security. Impulse Spending: Offers like no-cost EMIs, cashback, etc., tempt unplanned purchases. Erosion of Saving Culture: Traditional saving practices (gold, chit funds, land) replaced by spending trends.

IV. Changing Saving Habits

- Decline in Domestic Savings: GDS as a percentage of GDP has decreased post-2011. Shift from Physical to Financial Assets: Popular investments are often speculative (e.g., stocks, crypto) rather than long-term. Preference for Liquidity: Households want quickly accessible money, rather than locked in.

V. Psychological and Social Impact

- Status Symbol Consumption, Peer Pressure, Social Media Influence, Lifestyle Inflation: As incomes rise, expenses rise even faster, neutralising savings potential.

VI. Summary and Critical View

- Consumerism boosts economic activity, offers individual comfort.
- Consumerism poses a threat to household financial stability. The sacrifice of long-term goals for short-term gratification can lead to financial distress.
- Balanced consumerism, supported by financial literacy and discipline, is necessary to preserve household savings.

VII. Conclusion

- Consumerism is reshaping the Indian household's relationship. Need conscious saving habits - financial planning. The culture of spending can undermine long-term well-being.
- A mindful approach combining moderate consumption with consistent savings is the need of the hour.

Module 2

Savings, Investment and Financial Well-being

Abstract

This module explores the relationship between financial and economic well-being, emphasising the importance of financial literacy, planning, and behaviour in achieving personal financial security. It categorises different types of investors, such as retail and institutional investors, and outlines various investment avenues, including physical and financial assets. Behavioural finance models, such as Barnewall's Two-Way Model and Bailard, Biehl, and Kaiser's Five-Way Model, are discussed to understand investor types based on their psychological traits. The paper also covers key aspects of household financial management, including budgeting, savings behaviour, credit behaviour, and financial well-being. It examines how factors like financial literacy, self-control, and social-financial culture influence financial decision-making and well-being. Moreover, the paper highlights the significance of economic well-being, suggesting that macroeconomic conditions like education, healthcare, and social protection directly impact individual financial health, thereby contributing to a virtuous cycle of personal and societal prosperity.

Types of Investors

Investors are categorised on the basis of investor category, risk tolerance, behavioural traits (behavioural finance perspective), and investment style.

I. Based on Investor Category

1. **Retail Investor:** Individual investors using personal funds to invest in stocks, mutual funds, etc. Often, they have limited market access and depend on financial advice or emotions. E.g. Individuals.

2. **Institutional Investor**: Large organisations such as banks, insurance companies, pension funds, and mutual funds that invest large amounts of capital. E.g. Pension Funds, Mutual Funds, etc.
3. **High-Net-Worth Individual (HNWI)**: Wealthy individuals with significant investable assets are often treated similarly to institutions in terms of access to exclusive investment options. They invest in large but less than institutions.

II. Based on Risk Tolerance

1. **Conservative Investor:** Low-risk appetite; prefers capital protection through bonds, FDs, etc.
2. **Moderate Investor:** Balances between safety and returns; combines equity and debt investments.
3. **Aggressive Investor:** High-risk appetite; seeks maximum return via equities, startups, crypto, etc.

III. Based on Behavioural Traits (PIBF Focus)

1. **Overconfident Investor**: Overestimates knowledge; trades excessively without sufficient research.
2. **Herding Investor:** Follows others' decisions without individual analysis (fear of missing out).
3. **Loss-averse Investor:** Avoids losses more than pursuing gains; may hold on to poor investments.
4. **Anchored Investor:** Fixates on initial values (e.g., buying price), resisting updated decisions.
5. **Mental Accountant:** Treats money differently depending on its source or purpose.

6. **Status Quo Investor:** Prefers doing nothing; avoids changes even when needed.

IV. Based on Investment Style

1. **Value Investor:** Seeks undervalued stocks with strong fundamentals.
2. **Growth Investor:** Invests in high-growth potential companies regardless of current valuation.
3. **Income Investor**: Focuses on regular income through dividends or interest.
4. **Speculative Investor:** Takes high risks on volatile or unproven assets like penny stocks or crypto.
5. **Passive Investor:** Invests in index funds or ETFs for long-term growth; minimal trading.
6. **Active Investor:** Frequently buys/sells based on market trends, news, or technical analysis.

V. Investor Role or Participation Type

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1. Angel Investors:

Angel investors are wealthy individuals who invest personal funds in early-stage startups or small businesses, often in exchange for equity (ownership). Since they exhibit all the characteristics, they can be classified under HNWI, Aggressive, Overconfident, Optimistic, or Speculative investors.

2. Regular Investor

An individual who invests personal savings in standard instruments like mutual funds, stocks, or fixed deposits, usually for long-term goals. Based on their characteristics, they can be classified under Retail Investor, Conservative, Moderate, or

Aggressive, Herding, Loss Aversion, Anchoring, Passive, or Value/Income-focused.

Features of Retail Investor

SEBI considers an investor as a retail investor when his application for securities doesn't exceed ₹2 lakh. Their major features are:

1. Individual investor.
2. Non-Professional investor.
3. Smaller purchasing power.
4. Smaller amounts of investments.
5. Invests for a long period.
6. Trade with less frequency.
7. Motivated to increase their wealth.
8. They have less knowledge of the market.
9. They are less disciplined.
10. More prone to behavioural and emotional errors.
11. More sensitive to market sentiments.

Retail Investment Avenues

Investments are broadly categorised into physical assets, such as real estate and precious metals, and financial assets, which include non-tradable assets like fixed deposits and tradable assets like stocks and bonds. They are broadly classified into two:

I. Investment in Physical Assets

II. Investment in Financial Assets

1. Non-Tradable Financial Assets

2. Tradable Financial Assets

I. Investment in Physical Assets

Investment in physical assets includes real estate, precious metals like gold and silver, precious stones, and antiques such as paintings, sculptures, and coins.

1. Real Estate: Investments in real estate involves purchasing property to generate income through rental or capital appreciation over time.
2. Precious Metals- Diamond, Gold, Silver: Precious metals, like gold and silver, are considered safe-haven investments due to their ability to retain value, especially during economic uncertainty.
3. Precious Stones: Precious stones such as diamonds and rubies can serve as both aesthetic investments and stores of value, often appreciating over time based on rarity and demand.
4. Antiques – Paintings, sculptures, coins, etc.: Antiques, including art and rare collectables, can offer significant returns due to their historical value and increasing demand among collectors.

II. Investment in Financial Assets

Financial assets are further divided into non-tradable (such as savings accounts, pension plans, and life insurance) and tradable assets (including stocks, bonds, and cryptocurrencies), offering a wide range of investment opportunities for various risk appetites and financial goals.

1. Non-Tradable Financial Assets

Non-tradable financial assets include stable, long-term investment options like savings accounts, pension plans, fixed deposits, and life insurance policies, which provide low-risk and predictable returns.

1. Commercial Banks (SB, FD, RD): These savings and fixed deposit accounts offer stable returns with low risk, often used by conservative investors seeking liquidity and safety.
2. Treasury Savings (SB a/c, FD): These savings accounts and fixed deposits are backed by government securities, offering a secure and low-risk investment option.
3. Pension Plans: These long-term investment products are designed to provide income after retirement, offering tax benefits and financial security.
4. Micro Finance – JLG scheme: Microfinance investments, particularly Joint Liability Group (JLG) schemes, focus on providing financial services to low-income groups and promoting financial inclusion.
5. PO Savings: Post Office savings schemes are government-backed investment options offering safe and stable returns with tax-saving benefits.
6. National Savings Schemes: Government-backed schemes like National Savings Certificates (NSC) provide guaranteed returns, making them popular among risk-averse investors.

7. Fixed deposits in Companies: Corporate fixed deposits offer higher interest rates than bank FDs but come with higher risk as they are not government-backed.
8. Provident Fund Schemes: Provident funds, including EPF, are retirement-focused savings accounts that offer tax benefits and secure, long-term savings growth.
9. Life Insurance Policies: Life insurance policies can serve as both protection and investment, offering financial security for families and returns on premiums over time.
10. Mutual Funds: Mutual funds are the method of pooling money from multiple investors to invest in stocks, bonds, or other securities, providing diversification and professional management.

2. Tradable Financial Assets

Tradable financial assets are investment instruments like stocks, bonds, and cryptocurrencies that can be bought and sold on financial markets, offering the potential for higher returns but with increased risk and market volatility.

1. Corporate Equity shares: Equities represent ownership in a company, and shareholders may benefit from dividends and capital appreciation, but they also carry market risks.
2. Corporate Preference Shares: These are the preference shares that offer fixed dividends and priority over common shares in the event of liquidation, making them a hybrid between stocks and bonds.

3. Corporate Debentures: Corporate debentures are long-term debt securities issued by companies to raise capital, offering fixed interest payments to investors.
4. Liquid Bees: Liquid Bees are exchange-traded funds that invest in short-term debt instruments and offer high liquidity with low risk.
5. Money Market Instruments (CPs, CDs): These short-term debt securities offer high liquidity and low risk, typically issued by companies or banks.
6. Crypto Currencies: Cryptocurrencies like Bitcoin offer high-risk, high-reward opportunities for investors, often used for speculative purposes.
7. Crowd Funding: This investment method involves pooling money from multiple investors for a specific project or venture.
8. Govt. Securities (G-Sec): Government securities offer a safe investment option with returns backed by the government, suitable for risk-averse investors.
   a. Money Market Instruments (T Bills, TMBs): These are short-term debt securities issued by the government, used to raise funds for a short duration, usually less than a year.
   b. Bonds: Bonds are long-term debt securities issued by corporations or governments.

(Explained detail in page no: 72-90)

Classification of Retail Investors

Retail investors are classified based on their behaviour, tendencies, etc. Traditional finance assumes that all investors are Rational

Economic Men. However, modern behavioural finance assumes that individuals do not behave rationally. Interests, spending habits, hobbies, activities, opinions, values and attitudes are the psychographic characteristics of individuals.

Psychographic models of behavioural finance explain persons' attitudes, tendencies, characteristics, and behaviours exhibited while investing. These models help to:

a. Better understand the client. b. Portfolio construction.

There are two most commonly used psychographic models based on behavioural characteristics. They are: Barnewall's Two Way Model and Bailard, Biehl, And Kaiser's Five-Way Model

Barnewall's Two-Way Model

This model was developed in 1987. It was published in their paper titled "Psychological characteristics of the individual investor". This model classifies retail investors into two: Active Investors and Passive Investors.

1. **Active-Investors:** They have generated wealth by risking their capital. They have a higher risk tolerance than passive investors. E.g. Entrepreneurs.
2. **Passive Investors:** They have generated wealth by inheritance or salary. They have a less risk tolerance than active investors. They have fewer economic resources. People with fewer resources tend to become passive investors.

Limitations of the Two-way model:

1. Many individuals show the characteristics of both active and passive groups.
2. Individual investment characteristics change with the situation.

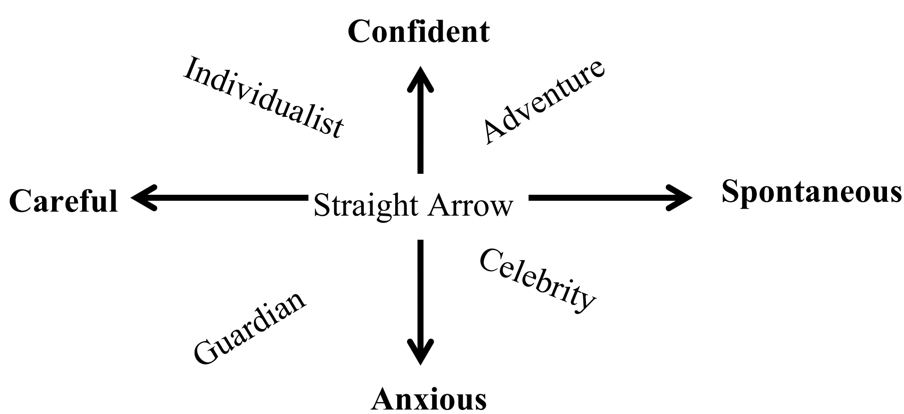
3. Individuals act irrationally and unpredictably.

BB & K FIVE-WAY MODEL

Bailard, Biehl, and Kaiser Five-Way Model

It is a behavioural finance model that was developed in 1986. The model was published in the Book “Personal Money Management”. This model classifies investors into five behavioural types based on how they approach their lives.

Retail investors approach their lives in two dimensions: Confidence/Anxious and Method of Action. He may be confident or anxious. He may be careful or spontaneous in action. Accordingly, there are five behavioural types: individualist, adventure, celebrity, guardian, and straight arrow.



1. **Individualist:** They show confident but careful action. Makes own decisions after analysis. They listen and process information rationally. E.g. typical small businessman.
2. **Adventures:** They show confident, spontaneous action. They are adventurous, confident and spontaneous. They

concentrate on portfolios. They are willing to take risks. They prefer to make their own decisions.

3. **Celebrity**: They show spontaneous but anxious action. They recognise limitations. They do not make their own decisions. They prefer to get investment advice.
4. **Guardian:** They show careful and anxious action. They are anxious and careful about their money. They recognise their limited earnings and time. They are concerned with future and asset protection. They seek advice and perceive knowledge.
5. **Straight Arrow:** They are average investors. They are neither confident nor anxious. They are neither overly careful nor spontaneous. They are willing to take risks for expected increased returns.

Investor type	Personality Axis	Methodology Axis	Adviser relationship notes
Adventurer	Confident	Spontaneous	Reluctant to take advice
Celebrity	Anxious	Spontaneous	May be willing to take advice
Individualist	Confident	Careful	Will listen to advice
Guardian	Anxious	Careful	May seek advice
Straight Arrow	Mid-point	Mid-point	Rational

Personal Financial Planning

Personal financial planning means a systematic and continuous process of planning one's money to achieve personal goals. It is one of the components of financial discipline. It includes:

a. Determining the current financial position, including net worth and cash flow analysis.

b. Setting financial goals like the creation of an emergency fund, saving for a wedding, savings for retirement, savings for the construction of a house, etc.

c. Developing financial plans to maintain liquidity, flexibility, taxation, and insurance.

d. Implementing financial plan

e. Reviewing financial plan

Household Budgeting

A budget is an estimation of income and expenses for a period of time. Budgeting is the process of preparation of a budget. The household budget is a budget showing the anticipated income and expenses of a family. It can be a surplus, deficit or balanced budget.

Household Budgeting Process

Household budgeting involves a systematic approach to planning, managing, and monitoring a family's income and expenses to achieve financial stability and effectively meet future goals.

1. **Setting household financial objectives**

   Preparation of immediate, short-term, medium-term and long-term financial goals of the household is the first step in the process of budget preparation. It should be specific, measurable, relevant, time-bound and attainable.

2. **Preparation of estimated income**

   All the family's sources of income should be listed and evaluated. The estimated inflow of income from all these sources should be calculated. Expected cash inflow and the month in which the income is expected should also be analysed. For this past, records of at least one year are required.

3. **Preparation of estimated expenses**

   All the family's sources of expenditure should be listed and evaluated. The estimated outflow of expenses through all these sources should be calculated. Expected cash outflow and the month in which the expenditure is expected should also be analysed. Fixed, variable and periodic expenses should be calculated separately. For these past records, at least six months are required.

4. **Calculation of estimated savings/deficit**

   A comparison of expected expenses and income will show either a deficit or a surplus. It can also be a balanced budget (where income = expenses). The nature of expenses and income will lead to either a surplus or deficit in a few months.

5. **Estimation of investment/borrowings**

   If there are expected savings in any month, we should evaluate the nature of savings – short-term, medium-term or long-term. Accordingly, one should evaluate the investment plan. If there is an expected deficit in any month, we should evaluate the nature of the deficit – short-term, medium-term or long-term.

Accordingly, one should evaluate the sources of borrowings and the repayment plan.

6. **Preparation of Budget**

   Once the estimation of income, expenses, deficit/surplus, and sources of investment /borrowings are prepared, the next step is the compiling of all these in a sheet. This is the final budget.

7. **Recording of actuals**

   A budget will be effective only if it is compared with actuals. Hence, the recording of actual income and expenses is important. This recording can be made in a separate notebook. The daily recording of expenses and income should be a family practice. One family member should take the initiative to do that. Free mobile accounting applications can be used to support this.

8. **Periodical review of budgets**

   Periodic comparison of actuals with budget is important for the effective utilisation of the budget. The budget can be reviewed in the light of this comparison.

Analysis of Household Budget

The preparation of a budget is one of the key components of household financial management, as well as financial literacy and competency. Preparation and analysis of the budget help in the family's financial socialisation. Household budgets can be evaluated with the help of ratios and SWOT (Strengths, weaknesses, opportunities and challenges) analysis.

SWOT Analysis of Household Budget

A SWOT analysis of a household budget helps in identifying its internal strengths and weaknesses, along with external opportunities and challenges, to ensure better financial planning and decision-making.

Strengths of Budget

1. Stable income
2. Multiple sources of income
3. No outstanding liabilities
4. Provision for a contingency fund
5. Provision for investment of surpluses
6. Sufficient income to meet essential expenses
7. At least 20% savings ratio- $\frac{Monthly\ savings}{Monthly\ Income} X100$
8. Surplus budget
9. Provision for life and health insurance
10. Provision for retirement plans
11. Debt income ratio less than 40% $\frac{Debt\ repayment}{Total\ Income} X100$
12. House affordability ratio less than 60% $\frac{EMI\ of\ Housing\ Loan}{Monthly\ Income} X100$

Weakness of Budgets

1. Irregular income
2. Single source of income
3. Outstanding Liabilities, including credit card outstanding
4. Absence of contingency fund
5. Keeping excessive cash in hand

6. Borrowings to meet essential expenses
7. Savings ratio less than 20% $\frac{Monthly\ savings}{Monthly\ Income} X100$
8. Deficit Budget
9. Absence of life and health insurance
10. Absence of retirement plans.
11. Debt income ratio more than 40% $\frac{Debt\ repayment}{Total\ Income} X100$
12. House affordability ratio of more than 60%
$$\frac{EMI\ of\ Housing\ Loan}{Monthly\ Income} X100$$

Opportunities

1. Opportunity to generate multiple sources of income
2. Opportunity to generate additional income
3. Opportunity for family financial consultancy
4. Opportunity to convert high-interest loans to low-interest loans.
5. Opportunity to repay loans in advance

Challenges

1. Financial emergencies – Accidents, job loss, pandemics like Covid 19, etc.
2. Inflation
3. Reduction in the market value of investments
4. Reduction in the interest rate of savings
5. Increase in the interest rate of loans

Debt-to-Asset Ratio of a Family

The ratio reflects the proportion of assets financed through debt. A high debt-to-asset ratio is linked to increased perceived stress, higher depressive symptoms, and poorer self-reported general health. Psychological perception of debt can have real health impacts, sometimes more than objective financial measures. [3]

$$\text{Debt-to Asset Ratio} = \frac{Total\ Household\ Debt}{Total\ Household\ Assets}$$

Household Debt includes:

- Home loans/mortgages, Personal loans, Car loans, Credit card debt, Student loans.

Household Assets include:

- Home/property value, Vehicles, Bank balances, Investments (stocks, bonds, mutual funds), Retirement funds (PF, pension, etc.), Gold or other valuable items.

Contingency Planning

Planning for contingencies by analysing unforeseen events. This means the creation of a contingency fund.

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[3] Based on an article on the official website of the United States government, the National Library of Medicine.
Sweet, E., Nandi, A., Adam, E. K., & McDade, T. W. (2013). The high price of debt: household financial debt and its impact on mental and physical health. *Social science & medicine (1982)*, *91*, 94–100. https://doi.org/10.1016/j.socscimed.2013.05.009
Retrieved from https://pmc.ncbi.nlm.nih.gov/articles/PMC3718010/

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Personal Net Worth Analysis

In Personal net worth analysis, an individual's financial health is assessed by calculating net worth, which is the difference between total assets and total liabilities. This analysis helps individuals understand their current financial standing, plan for the future, and take steps to improve or maintain financial stability.

Assets include everything a person owns that has monetary value (e.g., cash, bank balances, real estate, investments, vehicles).

Liabilities include all debts and financial obligations (e.g., loans, credit card balances, EMIs).

Formula:

Net worth = Total Assets – Total Liabilities

Personal Loans

Personal loans are unsecured loans provided by banks and other financial institutions to individuals for their personal use—such as medical emergencies, education, weddings, or travel. These loans do not require collateral and are usually repaid in fixed monthly instalments (EMIs) over a defined period (usually 1 to 5 years). While convenient, personal loans should be used carefully to avoid falling into a debt trap.

Key features

a. Interest rates vary based on credit score and income.
b. Quick processing and disbursement.
c. Penalty charges apply for late repayment.

Insurance

Insurance is a risk management tool that provides financial protection against unexpected events such as illness, accidents, death, or property damage. In return for paying a regular premium, the insured receives a sum assured or coverage. Insurance gives financial security peace of mind and helps in long-term financial planning.

Types of Insurance:

Life Insurance – Provides financial support to the insured when it matures or in the event of death of the insured it provides financial support to family members.

Health Insurance – It covers medical expenses of the insured.

Vehicle Insurance – Protects against damages or theft of a vehicle.

Property Insurance – Covers homes or other properties from risks like fire, theft, etc.

Financial Advisory Services – Need and Scope

Financial advisory services help individuals and families plan, manage, and grow their finances effectively. A financial advisor provides expert guidance on budgeting, investing, tax planning, retirement planning, estate planning, and more. The demand for trustworthy financial advisory services is growing rapidly with increasing financial awareness.

Need for Financial Advisory:

a. Rising financial complexity.
b. Need for personalised investment strategies.
c. Planning for life goals (like education, house buying, retirement).
d. Managing risks and uncertainties.

Scope financial advisory services include:

a. Investment planning (stocks, mutual funds, etc.)
b. Retirement solutions (PF, pension plans)
c. Tax saving strategies
d. Debt management and loan restructuring
e. Insurance and risk management

Savings Behaviour of Individuals

Savings are the excess of income over expenditure. The behaviour of an individual in financial decision-making situations is termed savings behaviour. It is related to spending behaviour. Spending less than income, avoiding impulse and imitating spending, fixing financial objectives, using a savings bank account, creating an emergency fund, regular savings, etc., are some remarkable examples of positive savings behaviour. The absence of such qualities is denoted as negative savings behaviour.

Factors Affecting Savings Behaviour

Savings behaviour is influenced by a variety of personal, social, economic, and psychological factors that determine an individual's ability and willingness to save money regularly. They include:

(1) Financial Literacy
(2) Financial socialisation
(3) Attitude towards savings
(4) Social financial culture
(5) Peer group influence
(6) Religious beliefs
(7) Self-Control
(8) Optimism and confidence
(9) Inflation
(10) Trade cycles
(11) Interest rate
(12) Tax saving options

Credit Behaviour of Individuals

Credit behaviour refers to how individuals transact in the debt market during the pre-credit and post-credit periods. It covers the purpose of borrowings, how they borrow, from where they borrow, whether they enquire about alternative sources of borrowing, whether they are keen about the interest rate, pre-mature closure penalty or hidden charges, do they pay timely, whether they bothered about over dues, etc.

Factors Affecting Credit Behaviour

The following are key factors affecting the credit behaviour of individuals:

1. Financial Literacy – Awareness of credit terms, interest rates, repayment obligations, and credit scores influences responsible borrowing and repayment habits.

2. Income Level and Stability – Individuals with stable and sufficient income are more likely to borrow wisely and repay on time.

3. Attitude towards Debt – A person's mindset (e.g., cautious vs. impulsive) strongly affects their borrowing decisions and repayment discipline.

4. Credit History and Score – A good or poor credit record influences both access to credit and the borrower's attitude towards maintaining good repayment behaviour.

5. Interest Rates – Higher interest rates may discourage borrowing or lead to more cautious credit behaviour.

6. Access to Credit Facilities – The availability of formal credit sources (banks, NBFCs) vs. informal sources (friends, moneylenders) affects how people borrow.

7. Social Influence and Peer Pressure – Friends, family, or societal expectations can impact borrowing decisions, especially for lifestyle or status-related expenses.

8. Spending Habits – Habitual overspenders are more likely to misuse credit or fall into debt traps.

9. Emergency Needs – Unexpected medical, educational, or family needs may force individuals to borrow hastily, often without evaluating terms properly.

10. Regulatory Environment – Consumer protection laws, credit rating norms, and banking regulations influence how individuals are treated and expected to behave responsibly in credit markets.

11. Cultural and Religious Beliefs – In some cultures or belief systems, debt may be discouraged, influencing conservative credit behaviour.

12. Psychological Traits – Traits like self-control, risk tolerance, and future orientation play a key role in how credit is managed.

1) Financial Literacy
2) Financial socialisation
3) Attitude towards borrowings
4) Credit discipline
5) Self-Control
6) Household income
7) Socio financial culture
8) Peer group influence
9) Religious beliefs
10) Five C's of Credit – Character, Capacity, Capital, collateral and economic conditions.

Financial Well-being

21 Financial well-being is a sense of security and feeling as though one has enough money to meet one's needs. It is a state of being where an individual can meet his current and ongoing financial obligations. It makes one feel secure in one's financial future. He can make choices that allow him to enjoy his life. In this state, he/she has the financial capacity to achieve financial security and freedom.

"A state wherein a person can fully meet current and ongoing financial obligations can feel secure in their financial future, and can make choices that allow enjoyment of life." Consumer Financial Protection Bureau, 2015 [4]

Components of Financial Well-being

1) Present Security-Meet his daily household expenditures.
2) Future Security- Absorb a financial shock.
3) Future freedom- Attain his short, medium and long-term financial objectives.
4) Present Freedom- Make choices to enjoy life.

Factors Affecting Financial Well-being

1) Financial Literacy
2) Financial socialisation
3) Financial Skills
4) Household income
5) Level of Debt
6) Socio financial culture
7) Credit discipline
8) Self-Control
9) Meaningful and rational goals
10) Social status and social comparison
11) Beliefs about locus of control - Locus of Control refers to an individual's perception of the underlying causes of events in his/her life. For example, do you believe that your destiny is controlled by you or by external forces (such as fate, God, etc.)?

[4] http://files.consumerfinance.gov/f/201501_cfpb_report_financial-wellbeing.pdf

Models of Financial Well-being

Researchers have developed several financial well-being models. Some of the notable models are:

1. Consumer Financial Protection Bureau (CFPB) in the US
2. Commonwealth Bank of Australia Model
3. University of New South Wales in Australia
4. Financial Literacy Australia Model.

1. CFPB Model of Financial Well-being

Financial well-being is "a state of being where a person can fully meet his current and ongoing financial obligations and make choices that allow him to enjoy his life." Thus, CFPB has four elements of financial well-being:

	Present	Future
Security	Control over day-to-day expenses	Capacity to absorb a financial shock
Freedom of Choice	Freedom to make choices that allow one to enjoy life	Capacity to attain future goals

According to this model, financial well-being is influenced by:

1. Financial behaviours
   a. Behaviours related to effective, routine money management.
   b. Behaviours related to seeking knowledge.
   c. Behaviours related to financial goal-setting and planning.

2. Financial knowledge and financial ability
3. Personal traits
4. Social and economic environment
5. Life stages - working-age and older consumer

Based on the above criteria, the model put forth 10 questions to assess the financial well-being of individuals.

2. **CBA Model**

This model emphasises three situations relevant to financial well-being- Every day, Rainy day and One day. To assess the model, 10 questions were put forth to assess the financial well-being of individuals in that financial situation.

A. 'Every day' financial situations: how well people meet their immediate needs, such as mortgage, rent, and utilities payments. Six questions are framed. They are:

1) I have money left over at the end of the month
2) My finances control my life
3) Difficulty meeting necessary living expenses
4) I feel on top of my day-to-day finances
5) I can enjoy life because of the way I am managing my money
6) I am comfortable with my current levels of spending relative to the funds I have coming in.

B. 'Rainy day' financial situations: How well-prepared people deal with unexpected, adverse events such as illness or job loss. Two questions are framed. They are:

1 1) I could handle a major unexpected expense.

2) Giving a gift would put a strain on my finances for the month.

8 **C. 'One day'** financial situations: how well people can achieve long-term goals such as buying a house or a comfortable retirement. Two questions are framed. They are:

1 1) I am securing my financial future.

2) I am on track to have enough money to provide for my financial needs in the future

Economic Well-being

The Organisation for Economic Co-operation and Development (OECD)[5] defines economic well-being as "the capacity to create a virtuous circle in which citizens' well-being drives economic prosperity, stability and flexibility, and vice-versa those good macroeconomic outcomes allow to sustain well-being investments over time."

Thus, economic well-being refers to the welfare derived by an
39 individual from the economic activities of the government. The inflation rate, unemployment rate, and growth rate of the gross domestic product are the key indicators of economic well-being. According to the OECD, an economy of well-being has four main pillars:

1. Education and skills
2. Health of People
3. Social protection and lower inequality

[5] https://www.oecd.org/about/secretary-general/the-economy-of-well-being-iceland-september-2019.htm

4. Gender equality

Financial and Economic Well-being- Relationship

Economic well-being is a broader concept than financial well-being. Economic well-being is associated with the ability of the government to strengthen the pillars of economic well-being- Education, skills, health, social protection and gender equality.

Economic well-being provides for individuals' education and skill development, which enhances their financial literacy and ability to generate income.

In short, economic well-being leads to financial well-being.

Subjective Financial Well-Being

This is how a person feels about their financial situation. It is based on personal perception and emotional responses. This includes financial satisfaction, stress levels, and confidence about the future. It's about perception and emotions, not actual money. It can vary even among people with similar incomes. For example, two people earn ₹50,000/month—one feels secure, the other feels anxious.

Objective Financial Well-Being

This refers to a person’s actual financial situation based on measurable facts. This includes income, savings, debt levels, expenses, credit score, assets, etc. This can be observed and compared with standards or others. It is about real numbers, not feelings. For example, someone has ₹ five lakhs in savings and no debt—objectively reasonable.

Retail Investment Avenues: Details

A. LIQUID BEES

They are also called DSP Black Rock liquid ETFs. It is a basket of call money, short-term securities, and short maturities. They are exchange-traded funds (ETFs) that trade just like a share. They invest in money market instruments. The objective is to enhance returns and reduce price risk.

B. CROWDFUNDING

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It is the practice of funding a project/venture by raising small amounts of money from many people, typically via the Internet. They are of various types.

Forms of Crowdfunding

1. Donation/Social Lending Crowdfunding
2. Pre-order Crowdfunding
3. Reward Crowdfunding
4. Debt Crowdfunding
5. Equity-based Crowdfunding

1. Donation/Social Lending Crowdfunding

Contributions are made as donations without any motive for any return. This is very popular in India. E.g. Crowdfunding for the treatment of cancer/heart patients.

2. Pre-order Crowdfunding

Investors contribute to crowdfunding to receive a product later. This is a pre-purchase product. E.g. Funding for the publication of a book.

3. Reward Crowdfunding

Funds are remitted to receive future or existing tangible rewards. E.g. Offering a unique service (rewards) or a new product (pre-selling) in return for their investment/donation. For example, funding is needed for the construction of resorts.

4. Debt Crowdfunding

It is an online platform that matches investors with borrowers in order to provide unsecured loans, and it is the platform that sets the interest rate. In India, NBFC licensed to operate as a P2P (Peer to Peer[6]). The platform may only undertake such transactions.

5. Equity-based Crowdfunding

Fundraising by a business to invest in ownership shares. Equity Crowdfunding is illegal in India. SEBI considers digital equity crowdfunding in India to be 'unauthorised, unregulated and illegal'.

Crowd Funding -Steps

1. Register with a crowdfunding website through email and Phone OTP.
2. Set a goal for the Fund
3. Decide an amount for the project
4. Tell a story about the purpose of the Fund
5. Share the link through online platforms like social media, email, etc.
6. Raise the money through the website
7. Withdraw the amount to the registered party's account.

[6] Peer to Peer means parties of equal status.

8. An online crowdfunding platform will take some of the funds raised as their commission.

C. Crypto Currencies

A cryptocurrency is Digital/virtual currency. It is an internet-based medium of exchange. It uses cryptography. National governments do not regulate it. They are under decentralised control. They are termed Alternative currencies. Miners and Blockchains are the two backbones of Cryptocurrency.

42 **Miners:** They are the record-keepers for cryptocurrency communities and indirect arbiters of the currencies' value. They create a new blockchain in the economy. Mining periodically produces new cryptocurrency units.

Blockchains: They are the master public ledger that records and stores all transactions. Here, transactions are chained together. Chaining blocks together makes it impossible to modify transactions. Modification in any block requires modifying all subsequent blocks. It validates the ownership of all units.

Cryptography is a method of protecting information and communications through codes. 'Crypt' means 'hidden' or 'vault'. 59 "Graphy" means "writing." Only those for whom the information is intended can read and process it.

Features of CC

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1. A peer-to-peer (P2P) currency. P2P means that there is no central authority which issues new money or tracks transactions.
2. These tasks are managed collectively through the network.

3. It enables instant payments to anyone, anywhere in the world, just like a cash payment.
4. Once settled, it is irreversible, like a cash transaction.
5. Nobody can block or freeze a transaction of any amount.
6. It can support strong financial privacy.

Process/Steps in CC Transaction.

1. Choose a valet for Crypto Currency

Mobile Valet (Mobile application), Desktop valet, Hardware valet

E.g.. Bitcoin Wallet for Android wallets for Bitcoin.

2. Purchase Cryptocurrency through Debit/credit cards or internet banking.

3. Find outlets for spending Cryptocurrency

D. Pension Plans in India

Pension plans in India are designed to provide financial security during retirement through various government-backed schemes and life insurance-based plans offered by public and private institutions.

1. **National Pension Schemes –NPS**
   a. National Pension System (NPS)
   b. Employee Pension Scheme (EPS)
   c. Atal Pension Yojana (APY)
   d. Pradhan Mantri Shram Yogi Maan-dhan (PM-SYM)
   e. Indira Gandhi National Old Age Pension Scheme (IGNOAPS)

2. **Pension Schemes of Life Insurance**

Schemes by LIC

a. Pradhan Mantri Vaya Vandana Yojana (PMVVY)

b. Varishtha Pension Bima Yojana (VPBY)

c. LIC Jeevan Akshay 6 Plan:

d. LIC Jeevan Nidhi Plan

Schemes of others

a. SBI Life Saral Pension plan

b. HDFC Life - Click2Retire

c. HDFC Life - Assured Pension Plan

d. ICICI Pru - Easy Retirement

E. Microfinance

10 Microfinance provides loans, credit, insurance, access to savings accounts, and money transfers to poor individuals and entrepreneurs in underdeveloped parts of India. Interest rates on microloans are 10 generally higher than those on traditional personal loans. The beneficiaries of microfinance are those who do not have access to traditional financial resources.

Features of Micro Finance

1. The borrowers are from low-income backgrounds
2. Loans availed are usually of small amounts.
3. The loan tenure is short.
4. Microfinance loans do not require any collateral.
5. Loans are usually repaid at higher frequencies.

6. The purpose of MF loans is income generation
7. The borrower decides the repayment schedule

Channels of Micro Finance

1. SHG-Bank Linkage Programme (SBLP)
2. Joint Liability Groups – JLGs
3. NGOs/Federation of SHGs
4. Micro Credit / Microfinance Institutions (MCIs & MFIs)

F. National Savings Schemes

13 National Savings Schemes are organised to regulate and channelise the savings from the general public into Government Savings Schemes. Its primary objective is to promote the habit of thrift and savings among citizens. The scheme is governed by the Government Savings Bank Amendment Act, 1959 and Chapter VIII of the Finance Bill, 2018.

- **Operating agencies** are (a) Post Offices and (b) Banks
- **Canvas and collection** are (a) Standardised Agency System, (b) Mahila Pradhan Kshetriya Bachat Yojana, and (c) Pay Roll Savings Scheme

Existing National Savings Schemes

1. Post Office Savings Account (SB)
2. National Savings Monthly Income Account (MIS)
3. National Savings Recurring Deposit (RD)

4. National Savings Time Deposit (TD) -1, 2, 3 and 5 years
5. Senior Citizens' Savings Scheme (SCSS)
6. Sukanya Samridhhi Account (SSA)
7. Savings Certificates:—
   a. Kisan Vikas Patra (KVP)
   b. (discontinued in 2011 and restarted in 2014)
   c. National Savings Certificates (NSC) -VIII Issue
8. Public Provident Fund Scheme (PPF)

National Savings Institute[7]

It functions as a customer relations unit of 'Department of Economic Affairs', Ministry of Finance. NSI assist the Ministry in mobilising and managing Small Savings Schemes of Govt. of India. It functions as a liaison of the Ministry with operating agencies, i.e., the Department of Post, Banks and other institutions for smooth and investor-oriented operations of small savings schemes. It also undertakes national-level publicity for National Savings Schemes.

Operating Agencies of NSS

Post offices and banks are the operating agencies from which the public can invest under the national savings scheme. The scheme also provides canvass and doorstep assistance to the public through the following:

1. **Standardised Agency System:** The government (district collector) appoints **authorised agents** (qualified local citizens) to canvass specified National Savings Schemes for sale.

[7] http://www.nsiindia.gov.in/InternalPage.aspx?Id_Pk=152

2. **Mahila Pradhan Khestriya Bachat Yojna** (MPKBY) agency system: Govt. (district collector) appoints an individual woman as Mahila Agent. She should be a resident of a locality and sufficiently educated.
3. **Pay Roll Savings Scheme:** Under this scheme, the employer deducts the savings from his salary. Here, the employee voluntarily authorises the employer to deduct a fixed amount from the monthly salary for deposit in various post office savings schemes.

Post Office Savings Account Scheme

- Minimum deposit ₹ 500/-.
- No maximum deposit limit
- Adults can open individual or joint accounts.
- A guardian can open the account on behalf of a minor or someone of unsound mind.
- A minor of 10 years can open the account independently.
- Interest in the a/c up to ₹ 10,000 qualifies for tax saving under sec 80 TTA.
- The facility of the cheque is available.
- The rate of interest up to 6/2021 is 4%

National Savings Monthly Income Account (MIS)

- The account matures in 5 years.
- Minimum ₹ 1000/- & in the multiples thereof.
- Maximum ₹ 4.5 Lakhs in a single account and ₹ 9 lakhs in Joint Account.

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- A depositor may operate more than one account at a time subject to the ceiling of the maximum amount.
- A guardian can open an account on behalf of a minor or someone of an unsound mind.
- Premature closing:
  - After 1 year, a deduction of 2% of the deposit.
  - After 3 years, on deduction of 1% of the deposit.
- The rate of interest up to 6/2021 is 6.6 %

National Savings Recurring Deposit Account Scheme

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- Minimum ₹100/- per month and any amount multiples of ₹10/-.
- No Maximum Limit.
- The account can be opened jointly by an adult in his name or up to three adults.
- Guardian can open an account on behalf of a minor or someone of unsound mind.
- The account matures in 5 years.
- Withdrawal to the extent of 50% is permissible after one year.
- An a/c can be continued with or without deposits after maturity for another five years.
- The account can be closed prematurely after 3 years.
- The rate of interest up to 6/2021 is 5.8%

National Savings Time Deposit Account Scheme

- Four categories of Time Deposit– 1, 2, 3 & 5 year

- Minimum deposit ₹1000/- and thereafter in the multiples of ₹100.
- No maximum deposit limit.
- A guardian may open an account on behalf of a minor or someone of unsound mind.
- An account can be closed after six months.
- 5 year Time Deposit qualify for Tax benefit u/s 80-C
- Minimum deposit ₹1000/- & in the multiples thereof with a maximum deposit of ₹15 lacs.
- Rate of interest up to 6/2021 is 5.5% for 1,2,3 years & 6.7% for 5 year

Senior Citizens' Savings Scheme (SCSS)

- Senior Citizens for account opening:
  a. An individual - 60 years.
  b. Retired person -55 years
  c. Retired personnel of Defence Services – 50 years
- A depositor may open an account individually or jointly with the spouse.
- Interest shall be payable on the first working day of April/July/October/January.
- The account can be closed after the expiry of 5 years.
- Premature closure is permissible after one year's expiry.
- Deposits in SCSS qualify for deduction u/s 80-C.
- The rate of interest up to 6/2021 is 7.4%

Sukanya Samriddhi Account Scheme

- Minimum deposit ₹ 250/-
- Maximum deposit ₹ 1.5 Lakh in a financial year.
- A/c can be opened in the name of a girl child till she attains the age of 10 years.
- Only one a/c can be opened in the name of a girl child.
- A/c can be opened in post offices and authorised banks.
- Withdrawal is allowed for higher education of the Account holder.
- The a/c can be prematurely closed in case of marriage of a girl child.
- The a/c can be transferred anywhere in India from one Post office/Bank to another.
- The a/c shall mature 21 years from the opening date upon completion.
- An income tax rebate under sec.80C of the IT Act is available.
- The rate of interest up to 6/2021 is 7.6%

Savings Certificates: National Savings Certificates (NSC)

- Account matures in 5 years
- Minimum deposit ₹1000/- and in multiple of ₹100.
- No maximum deposit limit.
- A certificate can be purchased for himself or a minor.
- Joint 'A' Type certificate -issued to up to 3 adults payable to holders jointly or to the survivor.

- Joint 'B' Type certificate - issued to up to 3 adults payable to either of the survivors.
- Loan facility available by pledging with the banks.
- The rate of interest up to 6/2021 is 6.8%

Savings Certificates:—Kisan Vikas Patra (KVP)

- Minimum ₹ 1000/- and in multiples of ₹100.
- No maximum deposit limit.
- A certificate can be purchased for himself or a minor.
- Joint 'A' Type certificate -issued to up to 3 adults payable to holders jointly or to the survivor.
- Joint 'B' Type certificate - issued to up to 3 adults payable to either of the survivors.
- KVP can be transferred from one person to another.
- KVP can be transferred from one post office to another.
- KVP can be encashed after two and a half years.
- Money Doubles on Maturity.
- The rate of interest up to 6/2021 is 6.9%

G. Public Provident Fund Scheme (PPF)

- Minimum deposit ₹ 500/-
- Maximum deposit ₹ 1,50,000/- in a Financial year.
- A loan facility is available from 3rd year up to the sixth financial year.
- Withdrawal is permissible every year from the seventh financial year.

- Account matures in 15 complete financial years.
- The account can be retained indefinitely without further deposit after maturity.
- The deposit qualifies for deduction under Sec.80-C of the IT Act.
- Interest earned is free from Income Tax under Sec -10 of the IT Act.
- The rate of interest up to 6/2021 is 7.1%

H. Micro Finance Options

Microfinance provides several facilities to poor individuals and small entrepreneurs in underdeveloped parts of India, such as loans, credit, insurance, access to savings accounts, money transfers, etc. The beneficiaries of microfinance are those who do not have access to traditional financial resources. Interest rates on microloans are generally higher than those on traditional personal loans.

Features of Micro Finance

1. The borrowers are from low-income backgrounds
2. Loans availed are usually of small amounts.
3. The loan tenure is short.
4. Microfinance loans do not require any collateral.
5. Loans are usually repaid at higher frequencies.
6. The purpose of MF loans is income generation
7. The borrower decides the repayment schedule

Micro Finance – Channels

1. SHGs-Bank Linkage Programme (SBLP)
2. Joint Liability Groups - JLGs
3. NGOs/Federation of SHGs
4. Micro Credit Institutions
5. Microfinance Institutions (MFIs)

1. SHGs-Bank Linkage Programme (SBLP)

The origin of self-help groups (SHGs) can be traced back to the Grameen Bank of Bangladesh, which was founded by Mohamed Yunus in 1975. SHG is a group of rural poor. It's a voluntary association of themselves into a group to wipe out poverty. The major objective of SHGs is to eradicate poverty. They regularly save to build up a common fund known as group corpus. The members of SHGs use this common Fund when they need it. The following are the common features of SHG-Bank linkage programmes in India:

a) Initiated by NABARD

b) Encourages financially backward women in groups of 10-15 members.

c) Contribute their individual savings to the group at regular intervals.

d) Primarily a savings-oriented group

e) Borrowing power is determined based on savings.

f) Loans are provided to members of the group.

g) SHGs are not permitted to lend outside the group[8]

h) SHGs can decide the cap on borrowings per Member.

2. Joint Liability Groups – JLGs

JLG is a credit-oriented group. They are primarily formed to provide loans from banks/formal credit institutions. It is a lending model. Here, group members guarantee each other's loans. It is an informal group comprising of 4-10 individuals. JLG can submit a simple loan application to the bank. The individual members of JLG become eligible for bank loans after verification of the individual members' credentials. Each individual in the group is liable for repayment.

3. NGOs/Federation of SHGs

A federation is an apex-level institution that draws support from the membership of SHGs. The main objective of promoting SHG federations is to overcome the inherent limitations of small and informal groups—the SHGs. In India, RBI insists that the SHGs transform themselves into section 25 companies or cooperative societies within 2-3 years of formation.[9]. The loan size to individual members of SHGs should not exceed ₹ 50000.

4. Micro Credit/Finance Institutions (MFIs & MCIs)

Microcredit is an extremely small loan given to impoverished people. In India, Rural cooperative banks, Regional Rural banks, Commercial Banks (under their priority sector lending schemes), Small Finance Banks, NBFCs and Credit Unions provide

[8] https://www.rbi.org.in/scripts/PublicationReportDetails.aspx?ID=340
[9] https://www.rbi.org.in/scripts/PublicationReportDetails.aspx?ID=340

microfinance to the poor. RBI insists on maintaining a separate book of accounts for MFIs' microfinance activities.

The Regional Rural Banks (RRBs):

It was established in 1975 under the provisions of the Regional Rural Banks Act 1976. Its objective is to develop the rural economy by providing sufficient credit and other facilities, particularly to small and marginal farmers, agricultural labourers, artisans and small entrepreneurs[10].

Non-Banking Finance Companies (NBFCs)[11]

NBFC are companies registered under the Companies Act, 1956/2013. They are engaged in the business of:

a) loans and advances

b) acquisition of marketable securities

c) leasing, hire-purchase, insurance business, chit business

However, NBFC cannot accept demand deposits, does not form part of the payment and settlement system, and cannot issue cheques drawn on itself. The deposit insurance facility of Deposit Insurance and Credit Guarantee Corporation is not available to depositors of NBFCs, unlike in the case of banks. An NBFC should register with RBI if:

a) Financial activity is its principal business

b) When a company's financial assets constitute more than 50 % of the total assets

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10 https://sbi.co.in/web/agri-rural/rural/regional-rural-banks

11 https://www.rbi.org.in/Scripts/FAQView.aspx?Id=92

c) Income from financial assets constitutes more than 50 per % of the gross income

E.g., Muthoot Finance Ltd. and Manappuram Finance Ltd.

I. Mutual Funds

34 Mutul Fund is a professionally managed investment fund that pool money from many investors to purchase securities. Mutual Funds are an investment product. The funds are collected from the public. A Professional money manager runs a Mutual Fund. Their earnings include:

(a) Interest and dividends from invested securities

(b) Increase in the value of investments

Fund House: MF Company that manages the Fund.

MF Portfolio: The combined holdings of the MF.

MF UNIT: An equal division/share in the 'Value of Portfolio minus Liabilities'

NAV (NET ASSET VALUE): The per unit market value. MF NAV denotes the price at which MF units are traded.

Mutual Funds – Types/ Classification

A. Basis of Ownership

Public Sector MFs: SBI MF, LIC MF, Canbank MF, etc.

Private Sector MFs: ICICI MF, HDFC MF, DSP Merrill Lynch MF, Reliance MF

Foreign MFs: KOTAK US Equity Fund, JP Morgan Europe Dynamic Equity, FRANKLIN Asian Equity, etc.

B. Basis of Function

Open-End Funds – No restrictions on the number of units

Closed-End Funds – Issue fixed number of units through IPO

C. Basis of Portfolio (Categories of MFs)

Mutual Funds India (a subsidiary of ICRA) categorises MF as follows:

1. Equity Fund
2. Debt Fund
3. Balanced Fund – Equity, debt and money market
4. Liquid Fund - debt funds in short-term fixed-interest generating money market instruments.
5. Gilt Fund- debt funds in government securities.
6. Dynamic Fund- Long-duration debt fund to invest in long-term securities
7. Specialty Fund -invests exclusively in a single industry/sector
8. ETF - Exchange Traded Fund- They are traded on stock exchanges
9. FOF – Fund of Funds - invests in other existing mutual fund schemes

Mutual Funds- Methods

SIP (Systematic Investment Plan) and SWP (Systematic Withdrawal Plan) are two different strategies used in mutual fund investing. SIP systematically invests money into mutual funds to build wealth over time. SWP systematically withdraws money from mutual fund investments to generate regular income. Both SIP and SWP are popular strategies mutual fund companies offer to help investors achieve their financial goals.

Mutual Funds- Methods of investing

1. Invest a lump sum amount
2. **SIP –Systematic Investment Plan-** Invests a fixed amount at fixed intervals

Mutual Funds- Methods of withdrawals

1. Withdraw in a lump sum
2. **SWP – Systematic Withdrawal Plan**: Facility for investors to withdraw a fixed amount from an MF scheme regularly.
3. **DRIP – Dividend Reinvestment Plan**: Cash dividends are reinvested to purchase more stock

REVIEW QUESTIONS

Part A –Very Short Essay

1. Explain significance of financial well-being.
2. What is subjective financial well-being?
3. What is objective financial well-being?
4. What is debt-to-asset ratio?
5. Who is an Angel investor?
6. Explain briefly Contingency planning.
7. Who is a Regular Investor?
8. Who is a passive investor?
9. Explain the concept of "Expected value".
10. What is crypto currency mining?

Part B – Short Essay

11. Distinguish between individual investors and institutional investors.
12. What are the features of personal loan?
13. Differentiate between SIP and SWP.
14. Write notes on Barnewall's Two Way Model.
15. Explain the personal financial planning process.
16. Give criticism of EUT.
17. Groupthink bias can cause a group to make irrational decisions. Explain the impact of groupthink bias on financial decision making.

18. What is Framing? How does it affect the investor?

Part C –Long Essay

19. Explain in detail financial advisory services in the Indian scenario.
20. Write a note on savings behaviour of individuals and also state the factors affecting savings.
21. Explain Prospect Theory along with its practical applications and limitations.
22. What is cognitive bias? Make a note on various cognitive biases.

TACKLING ANALYTICAL QUESTIONS

17. Groupthink bias can cause a group to make irrational decisions. Explain the impact of groupthink bias on financial decision making.

Develop answers from
Groupthink Bias- related discussions on herd mentality, thought contagion, and peer pressure from the same document.
The Story of the Dot-com Herd" — ways to overcome biases.

Module 3

Behavioural Issues in Financial Decision-making

3.1 Behaviour and decision making

3.2 Evolution of Behavioural Finance (BF)

3.3 Discounting

3.4 Prospect Theory

Behavioural Issues in Financial Decision-making

Behavioural Issues in Personal Finance refer to the psychological and emotional factors that influence how individuals make financial decisions, often leading to irrational or suboptimal financial behaviour despite having sufficient knowledge or resources.

Financial decision-making is influenced by cognitive biases, emotional factors, and psychological tendencies, often leading to irrational choices and suboptimal outcomes. Key biases include overconfidence, anchoring, herd mentality, loss aversion, and confirmation bias**,** which distort judgment. Emotional influences like fear, greed, and regret aversion further impact decisions.

Behavioural Influences in Financial Decision-Making

Financial decision-making is not always rational; it is influenced by cognitive biases, emotional factors, and psychological tendencies that shape how individuals and businesses evaluate risks, returns, and choices. Understanding these influences can help improve financial decisions by recognising and mitigating their effects.

1. Cognitive Biases in Financial Decisions

Investors make irrational decisions due to biases like **overconfidence, loss aversion, and anchoring**.

a) Overconfidence

Investors often overestimate their knowledge and abilities, leading to excessive trading, underestimating risks, and ignoring diversification. For example, traders believe they can predict market movements better than others and take on high-risk trades, leading to unexpected losses.

b) Anchoring

Individuals rely too much on the first information they receive (the "anchor") when making financial decisions. E.g. If an investor sees a stock's past high price of $100, they might hesitate to buy it at $80, even if fundamentals suggest it is still overvalued.

c) Herd Mentality

People tend to follow the crowd, even when the financial rationale is weak. For example, investors rush to buy cryptocurrencies or stocks because others are doing so, leading to bubbles and crashes.

d) Loss Aversion

People feel the pain of loss more than the pleasure of equivalent gain, which leads to risk-averse behaviour. For example, an investor refuses to sell a loss-making stock, hoping it will recover, even if reinvesting elsewhere would be more profitable.

e) Confirmation Bias

Individuals seek information that supports their existing beliefs while ignoring contrary evidence. For example, a person bullish on gold only reads reports predicting price increases while ignoring bearish analyses.

2. Emotional Factors in Financial Decision-Making

a) **Fear** (Panic Selling) can lead to panic selling in market downturns. For example, during a stock market crash, an investor sees their portfolio drop by 30% and sells all their stocks in a panic, fearing further losses. However, the market recovers shortly after, and they miss out on potential gains.

b) **Greed** (Excessive Risk-Taking) can cause excessive risk-taking, like investing in high-return schemes without proper research. E.g. A trader sees Bitcoin rapidly increasing in price and invests all their savings without research, hoping to make quick profits. The market crashes soon after, wiping out their investment.

c) **Regret Aversion** (Avoiding Decisions to Prevent Future Regret) makes people avoid decisions that might lead to future regret, even if they are financially sound. For example, a person avoids investing in the stock market because of fear, even though they know long-term investing is beneficial. Instead, they leave their money in a low-interest savings account, missing out on potential growth.

3. Psychological Tendencies Affecting Financial Choices

a) Mental Accounting

30 People treat money differently based on its source or intended use rather than considering it as part of a total financial portfolio. For example, a person eagerly spends a work bonus on a luxury trip instead of using it to pay off high-interest debt, treating the bonus as "extra" money rather than part of their overall financial situation.

b) Prospect Theory

This theory, explains how people make decisions under risk. It shows that people value gains and losses unequally—this is
67 called asymmetrical valuation. People are generally risk-averse when facing gains but become risk-seeking when facing losses.

e.g., losing ₹100 hurts more than gaining ₹100 feels good.

A gambler takes a risky bet to recover losses rather than accept a smaller guaranteed loss.

c) Endowment Effect

Individuals overvalue assets they own simply because they own them. For example, a homeowner refuses to sell their house at market price, believing it is worth more.

d) Status Quo Bias

Preference for keeping things as they are rather than making changes. For example, a person sticks with their bank's low-interest savings account for years, even though better options with higher interest rates are available, simply because they prefer not to change.

4. Decision-Making Errors from Cost and Time Misjudgment

a) Sunk Cost Fallacy

People continue investing in a losing proposition because they have already invested in it. E.g.. A business keeps funding a failing project instead of cutting losses and reallocating resources.

b) Time Inconsistency

People prefer smaller immediate rewards over larger future rewards, leading to poor long-term financial planning. E.g., Choosing to spend on luxury goods now instead of saving for retirement.

Financial Decision Making

Financial decision-making involves choosing the best financial options to achieve business or personal financial goals. It includes assessing risks, returns, and financial constraints to make informed decisions. The key aspects of financial decision-making include:

1. Investment Decisions

This includes:

(a) Choosing where to allocate funds (e.g. capital budgeting, asset purchases).

(b) Evaluating potential returns and risks of investments.

2. Financing Decisions

This includes:

a) Determining the best sources of funding (debt vs. equity).

b) Managing capital structure to balance risk and return.

3. Dividend Decisions

This includes:

a) Deciding how much profit to distribute to shareholders as dividends.

53 b) Retaining earnings for reinvestment in the business.

4. Working Capital Management

This includes:

a) Managing short-term assets and liabilities.

b) Ensuring liquidity to meet operational expenses.

Behaviour and Decision Making in Financial Decision Making:

This involves how individuals' emotions, cognitive biases, social influences, and personal values affect their financial choices, often leading to decisions that may not align with rational economic models or long-term financial well-being.

Expected Value

Financial decisions are influenced by **human behaviour, risk perception, and logical analysis**. One key tool for making decisions under uncertainty is **Expected Value (EV).**

EV is a statistical measure that calculates the **average expected outcome** of a decision by considering all possible scenarios and their probabilities. It helps businesses and individuals make **rational financial choices**, especially when dealing with risk.

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$EV=\sum(P_i \times V_i)$

P_i = Probability of outcome I

V_i = Value or payoff of outcome i

Application of EV in Financial Decision-Making

1. **Investment Decisions:** Investors use EVs to compare potential returns of stocks, bonds, or business ventures based on risk and reward probabilities.
2. **Insurance Policies:** Insurance companies calculate expected payouts to set profitable premium rates over time.
3. **Business Strategy:** Firms evaluate the expected financial impact of launching new products, entering new markets, or pricing strategies.
4. **Gambling and Betting:** In casinos and sports betting, EV helps determine whether a game or bet is favourable over time.

5. **Risk Management:** Decision-makers use EV to assess financial risks and decide whether to hedge investments or diversify portfolios.

Example of Expected Value Calculation

A company is choosing between two projects:

- Project A:
    - 60% chance to earn ₹1,00,000
    - 40% chance to lose ₹50,000
    - EV = (0.6 × ₹1,00,000) + (0.4 × -₹50,000) = ₹60,000 - ₹20,000 = ₹40,000
- Project B:
    - 50% chance to earn ₹80,000
    - 50% chance to lose ₹30,000
    - EV = (0.5 × ₹80,000) + (0.5 × -₹30,000) = ₹40,000 - ₹15,000 = ₹25,000

Since Project A has a higher EV (₹40,000) than Project B (₹25,000), the company may prefer Project A if the EV is the only factor considered.

Limitations of Expected Value in Decision-Making

1. **Risk Aversion:** Individuals may prefer a lower EV option if it has lower risk (e.g. choosing a safer investment over a high-risk, high-reward opportunity).
2. **Emotional and Psychological Biases:** People often make decisions based on emotions, heuristics, and past experiences rather than purely on mathematical calculations.

3. **Uncertain Probabilities:** In real-world scenarios, estimating accurate probabilities can be difficult, affecting the reliability of EV calculations.
4. **Short-Term vs. Long-Term Decisions:** Expected value works well in repeated scenarios but may not be ideal for one-time, high-stakes decisions.

Expected Utility (EU) Theory

EUT is a fundamental concept in decision theory and economics, explaining how individuals make choices under uncertainty. John von Neumann and Oskar Morgenstern developed the theory in their 1944 book, *Theory of Games and Economic Behaviour*. It provides a mathematical framework for rational decision-making when outcomes involve risks.

Key Principles of Expected Utility Theory:

1. **Rational Decision-Making:** Individuals make choices that maximise their expected utility rather than expected monetary value.
2. **Probability-Weighted Outcomes:** The utility of an uncertain outcome is weighted by its probability.
3. **Risk Aversion:** Many individuals prefer to have a certain outcome over a risky one with the same expected value (concave utility function).
4. **Independence Axiom:** If a person prefers A over B, they should still prefer a lottery involving A over a similar lottery involving B.

Applications of Expected Utility Theory:

- **Economics & Finance:** Used in investment decisions, insurance, and risk assessment.
- **Game Theory:** Helps model strategic interactions where players choose among uncertain payoffs.
- **Behavioural Economics:** Analyses deviations from expected utility due to biases (e.g. prospect theory).

Criticism of Expected Utility Theory

Expected Utility Theory remains a foundational concept in economics and decision theory. Real-world decision-making often deviates from its predictions. EU Theory has been widely criticised, particularly in behavioural economics and decision theory. Some key criticisms:

1. Violations of Rationality Assumptions

Allais Paradox (1953). People prefer certainty over risky choices, even when Expected Utility (EU) theory says otherwise. **For:** Most choose ₹1,00,000 for sure (Option A) over a riskier option with a chance of ₹5,00,000 but also a 1% chance of nothing (Option B) because they value certainty.

Ellsberg Paradox (1961). People prefer known risks over unknown ones (ambiguity aversion). **E.g.**. Most pick Option A due to fear of the unknown, given a 50% known chance to win ₹1,000 (Option A) and an unknown probability of winning ₹1,000 (Option B).

2. Risk Preferences Are Not Always Stable

EU theory assumes a consistent risk preference (e.g. risk-averse individuals always prefer safer choices). However, Prospect Theory (by Kahneman & Tversky, 1979) shows that people are risk-averse in gains but risk-seeking in losses. This contradicts the EU theory's predictions.

3. Overemphasis on Rationality

Emotions, cognitive biases, and heuristics influence real-world decision-making. EU theory does not account for this. People often make choices based on shortcuts (heuristics) rather than complex probability calculations.

4. Utility is hard to Measure

The theory assumes that individuals have a well-defined utility function, but in practice, measuring and comparing utility across different situations or individuals is difficult.

5. Bounded Rationality

Herbert Simon (1955) introduced the concept of bounded rationality, arguing that people do not always maximise expected utility due to limited cognitive resources and information. Instead of optimising, people often satisfice (choose a "good enough" option rather than the best possible one).

6. Context-Dependent Preferences

People's preferences change based on framing effects (how a problem is presented). The certainty effect (overweighting of certain outcomes) and probability distortion challenge the assumption that people evaluate probabilities rationally.

Efficient Market Hypothesis (EMH).

Behavioural Finance emerged as a response to the shortcomings of the EMH. While EMH assumes that markets are rational and fully efficient, real-world evidence shows that investors often behave irrationally due to psychological biases, leading to market anomalies. Behavioural Finance explains these irrational behaviours and challenges the idea that markets always reflect all available information correctly. The EMH is based on these main ideas:

1. **Investors are rational** – They make logical decisions based on information.
2. **Prices change randomly** – You can’t predict future stock prices using past trends.
3. **No free profits** – If there's a way to make easy money, investors quickly take advantage, and prices adjust.
4. **New information spreads fast** – Stock prices instantly reflect all available information.
5. **Many investors compete** – With so many people trading, prices stay fair.
6. **No big trading costs** – Buying and selling stocks is easy and doesn’t affect prices much.
7. **Same expectations** – Everyone similarly interprets information.

Criticisms of EMH:

1. **People make emotional decisions** – Fear and greed drive markets, not always logic.
2. **Bubbles and crashes happen** – Prices don’t always reflect real value (e.g. Dot-com bubble, 2008 crash).
3. **Insiders have an advantage** – Some people trade on private information, making markets unfair.
4. **Some investors** such as Warren Buffett beat the market, and others consistently outperformed.

5. **Past trends can matter** – Strategies like momentum and value investing have worked.
6. **Trading isn't always free** – Costs, taxes, and delays slow down efficiency.

Key Differences: EMH vs. Behavioural Finance

Aspect	EMH	Behavioural Finance
Investor Rationality	Investors are rational and process information efficiently.	Emotions and cognitive biases influence investors.
Market Efficiency	Prices always reflect all available information.	Prices can be distorted due to irrational investor behaviour.
Market Bubbles & Crashes	Unlikely in efficient markets.	Occur due to overreaction, herd mentality, and biases.
Investment Strategy	Passive investing is best (index funds).	Understanding psychological biases can create opportunities for outperformance.
Examples	Random Walk Theory, EMH by Eugene Fama.	Prospect Theory (Kahneman & Tversky), Herding Behaviour.

Normative Analysis

Normative analysis is a type of analysis that focuses on what should be done, not just what is happening. It gives recommendations or ideal solutions based on logic, values, or financial goals. In finance, it assumes people are rational and try to make the best possible decisions to get the most benefit.

Positive Analysis:

While positive analysis describes actual behaviour or real-world facts, normative analysis suggests how people should behave under ideal conditions.

Examples: Normative (Prescriptive)

Investors should diversify their portfolios to reduce risk.

Investors should diversify their portfolios to reduce risk.

People should save 20% of their income.

Examples: Positive (Descriptive):

Most investors hold concentrated portfolios despite higher risk.

Most investors hold concentrated portfolios despite higher risk.

Most people save less than 10% of their income.

Evolution of Behavioural Finance (BF)

Behavioural Finance emerged as a response to traditional finance theories like the Efficient Market Hypothesis (EMH), which assumes investors always act rationally. Research has shown that psychological biases influence financial decisions, leading to market inefficiencies. Behavioural Finance has transformed finance by explaining how emotions and biases impact financial decisions.

Key Stages in the Evolution of BF

1. **Early Ideas (1940s–1970s)**

   Herbert Simon (1955). Introduced bounded rationality—people make decisions with limited information.

   Paul Samuelson (1965). Developed Random Walk Theory—stock prices are unpredictable.

2. **Key Breakthroughs (1970s–1980s)**

   Kahneman & Tversky (1979). Developed Prospect Theory—people fear losses more than they value gains.

   Showed that investors make irrational choices based on emotions and biases.

3. **Behavioural Finance Takes Shape (1980s–1990s)**

   Richard Thaler (1985). Introduced mental accounting (people treat money differently based on its source).

   Robert Shiller (1981, 2000) showed that stock prices often move due to emotions, not just fundamentals.

   The 1987 stock market crash highlighted irrational investor behaviour.

4. **Modern Recognition (2000s–Present)**

   Kahneman (2002) and Thaler (2017) won Nobel Prizes for their work in Behavioural Economics.

   Governments use nudging strategies (e.g. automatic retirement savings plans).

   Investors apply behavioural insights in stock market strategies.

Micro & Macro Behavioural Finance

Behavioural Finance (BF) is divided into **Micro** and **Macro** perspectives based on individual and market-level behaviours.

1. Micro Behavioural Finance (Individual Investor Behaviour)

Focuses on how individuals make financial decisions and the psychological biases that influence them. The key determinants are cognitive Biases, Emotional Factors, Psychological Tendencies, and Decision-Making Errors.

2. Macro Behavioural Finance (Market & Economy Behaviour)

Analyses how investor psychology affects financial markets and economic trends. The key determinants are market anomalies, overreaction and underreaction to bad news, noise trading, financial crises, etcs.

Assumptions of Behavioural Finance

Behavioural Finance challenges traditional finance theories like the **EMH** by assuming investors are not always rational. BF assumes that human psychology and biases impact financial decisions, leading to market inefficiencies. By understanding these assumptions, investors can make better financial choices, and policymakers can design better regulations.

1. Investors Are Not Always Rational

People make financial decisions based on emotions, biases, and psychological factors rather than logic. For example, an investor holds onto a losing stock due to **loss aversion**, even when selling is the better option.

2. Markets Are Not Always Efficient

Stock prices do not always reflect all available information due to herd behaviour, overreactions, and underreactions. For example, stock prices rise irrationally during a financial bubble before a sudden crash.

3. Investors Have Cognitive Biases

Decision-making is influenced by mental shortcuts (**heuristics**) and biases like:

Overconfidence Bias: Believing in one's ability to predict the market better than others.

Anchoring Bias: Relying too much on the first information received in a decision-making context.

Confirmation Bias: Seeking out information that supports one's existing beliefs or theories.

4. Social and Emotional Factors influence Investors

Herd Mentality: People follow the crowd rather than making independent decisions.

Regret Aversion: Fear of making the wrong choice leads to inaction or poor decisions.

E.g. Investors panic sell during market downturns because others are selling.

5. Risk Perception Varies Among Individuals

Investors do not always evaluate risk objectively. Prospect Theory (by Kahneman & Tversky) states that People are risk-averse when gaining but risk-seeking when losing.

For example, a gambler takes bigger risks to recover losses but avoids risk when ahead.

Building Blocks of Behavioural Finance

Behavioural finance challenges the traditional assumption of rational decision-making. It integrates psychology and economics to explain why investors and financial decision-makers behave irrationally. Understanding these building blocks helps investors, policymakers, and financial analysts make more informed decisions, mitigate biases, and improve financial outcomes. The key building blocks of behavioural finance include:

1. Heuristics (Mental Shortcuts)

Heuristics are mental shortcuts that help people make decisions quickly and efficiently. E.g. :

Representativeness Heuristic: Judging probability based on similarities.

Availability Heuristic: Making decisions based on readily available information.

Anchoring Bias: Relying too much on initial information.

2. Cognitive Biases

These systematic errors in thinking influence financial behaviour. Common biases include:

Overconfidence Bias: Overestimating one's knowledge and predictive ability.

Loss Aversion: Fear of losses leading to risk-averse behaviour.

Confirmation Bias: Seeking out information that supports pre-existing beliefs.

3. Prospect Theory

This theory, explains how people make decisions under risk. It shows that people value gains and losses unequally—this is called asymmetrical valuation. People are generally risk-averse when facing gains but become risk-seeking when facing losses.

People tend to:

Prefer to avoid losses more than acquiring equivalent gains.

Exhibit risk aversion in gains and risk-seeking behaviour in losses.

4. Mental Accounting

57 Investors categorise money into separate "accounts" based on subjective criteria rather than treating all money as fungible. For example, spending windfall gains more freely than salary.

5. Market Anomalies

Behavioural finance explains anomalies that contradict efficient market theories, such as:

Momentum Effect: Stocks that have performed well continue to rise, while poorly performing stocks decline further.

Herding Behaviour: Investors follow the crowd, leading to bubbles and crashes.

6. Emotional Influence

Investor decisions are often driven by emotions like:

Fear and Panic: Leading to irrational selling.

Greed and Overconfidence: Driving speculative bubbles.

7. Social and Cultural Influences

Financial decisions are also shaped by social norms, peer influence, and cultural beliefs, leading to variations in financial behaviour across regions.

8. Self-Control and Time Inconsistency

Hyperbolic Discounting: People prefer smaller, immediate rewards over larger future benefits, leading to poor savings habits.

Self-Control Issues: Difficulty in sticking to long-term financial plans, such as retirement savings.

9. Framing Effect

The way financial information is presented affects decision-making. For example, investors may react differently to "90% chance of success" vs. "10% chance of failure," even though both mean the same.

10. Status Quo Bias

People tend to prefer keeping things the same rather than making financial changes, even when switching could lead to better returns.

11. Regret Aversion

Investors avoid making investment decisions due to fear of regret, leading to missed opportunities or holding onto poor investments for longer.

12. Behavioural Portfolio Theory (BPT)

Suggests that investors create portfolios based on layers of goals (e.g. wealth preservation, growth, security), not just risk-return optimisation.

13. Noise Trading

Investors often make decisions based on irrelevant information, rumours, or short-term trends rather than fundamental analysis.

14. Neurofinance

A newer field is studying how brain activity and emotions influence financial decisions, using neuroscience techniques like fMRI scans (neuroimaging technique).

Applications of Prospect Theory

Prospect Theory has wide applications in explaining real-world decision-making, especially when people face risk, uncertainty, and emotion-driven choices.

1. Investment Decisions

54 Explains why investors often hold on to losing stocks (risk-seeking in losses) and sell winning stocks too early (risk-averse in gains). This helps understand loss aversion in portfolio management.

2. Insurance Buying Behaviour

People over-insure against small losses (like mobile insurance) due to fear of loss. Prospect theory explains this as a response to the pain of potential loss, even if it is minor.

3. Marketing and Consumer Behaviour

Companies frame offers to highlight gains or avoid losses: e.g., “Save ₹500!” sounds better than “Don’t lose ₹500!” Consumers often respond more to loss-based messages.

4. Retirement Planning and Saving

Loss aversion can discourage people from investing in riskier but higher-return options. Understanding this helps design nudges and automatic savings plans.

5. Behavioural Finance Models

Forms the foundation for behavioural asset pricing and risk perception models. It helps explain market anomalies like the disposition effect, mental accounting, and irrational trading patterns.

6. Policy Making and Public Economics

Used in framing public policies to encourage better choices: e.g., "Avoid penalty" works better than "Get a reward."

Uses of Behavioural Finance

1. **Understanding Investor Behaviour**

   Helps explain why investors deviate from rational decision-making, such as overtrading, panic selling, or herd behaviour.

2. **Improving Investment Strategies**

   Assists fund managers and investors in designing portfolios that mitigate biases like loss aversion and overconfidence.

3. **Enhancing Financial Planning**

   Helps individuals overcome self-control issues and time inconsistency to improve savings and retirement planning.

4. **Reducing Market Anomalies**

   Identifies inefficiencies in financial markets caused by cognitive biases and emotional influences.

5. **Better Risk Management**

   Aids in recognising irrational risk perception and implementing strategies to manage financial risks effectively.

6. **Developing Behavioural-Based Financial Products**

   Banks and financial institutions use insights to design products that align with investor behaviour, such as automated savings plans.

7. **Optimising Corporate Financial Decisions**

   Helps businesses understand managerial biases in mergers, acquisitions, and capital budgeting decisions.

8. **Enhancing Public Policy and Regulations**

   Assists policymakers in designing financial regulations and nudges to promote responsible financial behaviour among individuals and institutions.

9. **Behavioural Trading Models**

   Supports the development of trading strategies that capitalise on predictable behavioural patterns in the market.

10. **Financial Education and Awareness**

    Helps in educating individuals and professionals on recognising biases and making informed financial choices.

REVIEW QUESTIONS

Part A –Very Short Essay

1. What is the reason for difference in behaviour of individuals?
3. Who is a Regular Investor?
4. Who is an Angel investor?
5. What is normative analysis?

Part B – Short Essay

6. Explain the causes of behaviour difference as per behaviour finance?
7. Enumerate the applications of Prospect Theory.
8. Explain eight step approach to be followed by an investor while making financial decisions?

Part C –Long Essay

9. Enumerate the uses and applications of Behavioural finance.
10. Examine the applications and use of behavioural finance.
11. Elaborate the stages of evolution of Behavioural Finance.

TACKLING ANALYTICAL QUESTIONS

1. What is the reason for difference in behaviour of individuals?

   Covered under sections on Cognitive Biases, Emotional Factors, Psychological Tendencies, and Behavioural Finance Assumptions.

(Points to develop answer)

1. Cognitive Biases 2. Emotional Factors
3. Personality & Psychological Traits
4. Mental Heuristics 5. Financial Socialisation
6. Financial Literacy 7. Cultural and Environmental Factors

8. Explain **eight-step approach** to be followed by an investor while making financial decisions?

There is no universal financial decision-making model, but globally recognized financial planning bodies such as the CFP Board (USA) and FPSB India have developed structured approaches. The CFP Board promotes a **7-step model** [12], which includes understanding the client's circumstances, identifying financial goals, analyzing the current situation, developing and presenting recommendations, implementing the plan, and monitoring progress.

In India, SEBI and the NCFE recommend a simplified **5-step model** [13] for retail investors: setting goals, assessing current financial position, determining risk appetite, selecting appropriate investment options, and reviewing the plan regularly. By combining the strengths of both models, an eight-step approach to financial decision-making can be formulated. These steps are: (1) setting financial goals, (2) gathering financial information, (3) assessing

[12] Certified Financial Planner Board of Standards. (n.d.). Guide to the financial planning process. https://www.cfp.net/-/media/files/cfp-board/standards-and-ethics/compliance-resources/guide-to-financial-planning-process.pdf

[13] National Centre for Financial Education. (2023). *Financial literacy booklet for college students*. https://ncfe.org.in/wp-content/uploads/2023/12/College-Students-Booklet.pdf

current financial status, (4) determining risk tolerance, (5) exploring investment options, (6) evaluating and selecting suitable investments, (7) implementing the plan, and (8) monitoring and reviewing the strategy regularly.

This adapted model ensures that investors make rational, informed, and goal-oriented financial decisions while accounting for individual risk profiles and market conditions.

Module 4

Influence of Bias on Financial Decision Making

4.1 Asymmetric Information

4.2 Biases

4.3 Cognitive Bias

4.4 Other Irrational Investment Behaviour

4.5 Thought Contagion, Overreaction, etc.

4.6 Framing Loss Aversion

Abstract

Biases play a critical role in financial decision-making, often leading individuals and institutions to make irrational or suboptimal choices. Behavioural finance highlights how cognitive and emotional biases—such as overconfidence, herd behaviour, and loss aversion—interfere with rational economic theories. A major concern is asymmetric information, where one party has more or better information than the other, influencing behaviours such as insider trading, moral hazard, and adverse selection. These imbalances distort markets and amplify biases, leading to issues like herding, overconfidence, and market anomalies. Concepts such as heuristics and egocentricity further explain how individuals simplify complex financial decisions, often inaccurately. The Deficient Market Hypothesis (DMH) challenges traditional views like the Efficient Market Hypothesis (EMH), emphasising that markets are inherently inefficient due to information gaps, psychological biases, and institutional limitations. As shaped by various psychological theories, human behaviour deeply influences investment patterns. Understanding these behavioural tendencies is essential for designing better financial strategies, regulations, and education to reduce irrationality and promote sound financial decision-making.

Bias

Bias is a preference or prejudice for or against something, someone, or a group, often in an unfair way. For example, a person might be biased against people from a particular region.

Egocentricity in Behavioural Finance

Egocentricity refers to an individual's tendency to view situations primarily from their own perspective, often overestimating their knowledge, control, or influence. In behavioural finance, egocentric biases can significantly impact investor decisions, leading to market inefficiencies and irrational behaviour.

Reasons of Bias

Bias plays a significant role in financial decision-making, often leading individuals and organisations to make suboptimal choices. Behavioural Finance acknowledges that psychological biases influence investors.

Sources of Bias

Bias can come from a variety of internal and external sources. These classifications are used in Psychology, sociology, and research methodology. [14]

1. Internal Bias

Bias that comes from within a person—their personal beliefs, emotions, past experiences, habits, or mental shortcuts.

Internal Source Example

a) **Personal experiences:** A bad experience shaping future opinions
b) **Emotions:** Fear, anger, or pride clouding decisions
c) **Cognitive biases (heuristics):** Confirmation bias, overconfidence
d) **Attitudes and beliefs:** Prejudices, stereotypes
e) **Lack of self-awareness:** Not realising one's own biases

2. External Bias

Bias comes from outside influences, such as the environment, media, peer pressure, social norms, or institutional practices.

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[14] In Behavioural Finance, biases are broadly categorised into emotional and cognitive biases.

External Source Example

a) **Culture and social norms:** Gender roles, caste assumptions
b) **Media and information exposure:** Biased news influencing beliefs
c) **Peer pressure and groupthink:** Conforming to group opinions
d) **Institutional systems:** Biased recruitment software or rules
e) **Education or training systems:** Curriculum that lacks diversity

Asymmetric information

Asymmetric information in behavioural finance highlights how differences in access to knowledge can distort markets. It refers to a situation where one party in a transaction has better information than the other one. These biases become more pronounced when asymmetric information exists, leading to irrational decision-making.

E.g.

Insider Trading: Corporate insiders have privileged information, leading to unfair advantages.

Retail vs. Institutional Investors: Large institutions can access better research, giving them an edge over retail investors.

Earnings Manipulation: Companies might withhold negative information, causing investors to make suboptimal decisions.

Implications of Asymmetric information

1. **Herding Behaviour**: Investors with less information tend to follow the actions of others rather than conducting independent analysis.
2. **Overconfidence Bias**: Investors who believe they have superior information may take excessive risks, mispricing assets.

3. **Market Anomalies**: Events like momentum trading and contrarian investing arise due to differences in information processing among investors.
4. **Moral Hazard & Adverse Selection**: In financial markets, asymmetric information may lead to risky investments, as seen in the 2008 financial crisis, where investors underestimated the risk of mortgage-backed securities.

Types of Asymmetric Information in Economics and Finance

24 An asymmetric information occurs when one party in a transaction has more or better information than the other one. This can lead to market failures, moral hazard, and adverse selection in various economic and financial settings.

1. Adverse Selection

Occurs before a transaction takes place, where one party has hidden information that affects the outcome.

E.g.

- **Insurance Markets:** High-risk individuals (e.g. sick people) are more likely to buy health insurance, leading to rising costs.
- **Used Car Market (Lemon Problem):** Sellers know the true condition of the car, while buyers lack this information, leading to the undervaluation of good cars.
- **Hiring Decisions:** A job applicant may misrepresent their skills, making it hard for employers to choose the right candidate.

2. Moral Hazard

Occurs after a transaction takes place, where one party takes excessive risks because they do not bear the full consequences.

E.g.

- **Bank Bailouts:** If banks believe the government will rescue them, they may take riskier investments.
- **Insurance Policyholders:** People with car insurance may drive more recklessly since they won't bear the full cost of an accident.
- **Employee Behaviour:** Workers might slack off after being hired because their employer cannot fully monitor them.

3. Information Asymmetry in Financial Markets

Occurs when insiders (such as company executives) have access to private information that outsiders (investors) do not.

E.g.

- **Insider Trading:** Executives buying or selling stocks based on non-public financial information.
- **Earnings Manipulation:** Companies may overstate profits to attract investors.
- **Venture Capital Funding:** Startups often know more about their true growth potential than investors.

4. Principal-Agent Problem

Happens when an agent (e.g. manager) makes decisions that are not in the principal's best interest (e.g., shareholders).

E.g.

- **Corporate Governance:** CEOs may focus on short-term stock prices rather than long-term growth to secure bonuses.
- **Government Bureaucracies:** Public officials may use funds inefficiently because taxpayers cannot monitor them directly.

- **Investment Funds:** Portfolio managers might take excessive risks to boost short-term returns, knowing investors will bear the losses.

5. Market Signaling and Screening

Ways to reduce asymmetric information problems.

- **Signalling:** The informed party sends credible signals (e.g. a college degree as proof of skills).
- **Screening:** The uninformed party sets mechanisms to filter good/bad participants (e.g. insurance companies requiring medical exams).

Human Behavioural Theories

Human behavioural theories aim to explain why people act the way they do, considering psychological, social, and environmental factors. Here are some major behavioural theories:

1. Behavioural Theories

Learning through rewards, punishments, and associations.

- **Classical Conditioning**: According to Pavlov, learning occurs through association (e.g. Pavlov's experiment on dogs).
- **Operant Conditioning**: According to Skinner, behaviour is shaped by rewards and punishments.

2. Cognitive Theories

How thinking and perception influence behaviour.

- **Piaget's Cognitive Development Theory**: Explains how children develop thinking abilities.

- **Social Learning Theory (Bandura)**: Learning occurs through observation and imitation (e.g. role models).

3. Psychoanalytic Theories

Unconscious mind and early childhood shape behaviour.

- **Freud's Psychodynamic Theory**: Unconscious desires and early childhood experiences shape behaviour.
- **Erikson's Psychosocial Development Theory**: Emphasises social relationships across eight life stages.

4. Humanistic Theories

Personal growth, self-actualisation, and fulfilment.

- **Maslow's Hierarchy of Needs**: Behaviour is motivated by a hierarchy of needs, from basic survival to self-actualisation.
- **Carl Rogers' Self-Concept Theory**: Emphasises personal growth and self-awareness.

5. Biological and Evolutionary Theories

Genes, brain structure, and survival instincts impact behaviour.

- **Genetic and Neuroscientific Approaches**: Behaviour is influenced by genes and brain activity.
- **Evolutionary Psychology (Darwin-inspired)**: Human behaviour is shaped by survival and reproduction instincts.

6. Social and Environmental Theories

Society, relationships, and surroundings influence behaviour.

- **Bronfenbrenner's Ecological Systems Theory**: Behaviour is influenced by different levels of the environment, from family to society.

- **Social Exchange Theory**: People act based on perceived costs and benefits in relationships.

Heuristics

Heuristics are mental shortcuts that help people make decisions quickly and efficiently. While useful, they can sometimes lead to biases and errors in judgment.

1. Representative Heuristic

People judge the probability of an event based on a prototype or stereotype they have in mind rather than using actual statistical probability.

E.g. 1. Judging probability based on similarities.

2. Assuming a quiet, book-loving person with glasses is a librarian, even though there are far more farmers.

3. Believing a startup with a young, energetic founder will succeed just because it resembles successful companies like Apple or Facebook.

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2. Availability Heuristic

People estimate the likelihood of an event based on how easily examples come to his mind. They make decisions based on readily available information. More memorable events seem more common than they are.

E.g. 1. After watching news reports of aeroplane crashes, people may overestimate the risk of flying, even though statistically, it is much safer than driving.

2. If someone hears multiple stories about lottery winners, they may believe their chances of winning are higher than they are.

Deficient Market Hypothesis (DMH)

The **DMH** suggests that financial markets are inefficient due to various imperfections, such as information asymmetry, behavioural biases, regulatory constraints, and institutional limitations. This contrasts with the **EMH (Efficient Market Hypothesis)**. DMH challenges the assumption of perfectly efficient markets, highlighting real-world frictions that lead to mispriced assets and investment opportunities.

Key Aspects of DMH:

1. **Information Asymmetry:** Some investors can access better or faster information than others, leading to unfair advantages.
2. **Behavioural Biases:** Market participants often make irrational decisions based on emotions, heuristics, or herd behaviour.
3. **Regulatory Constraints:** Government policies, insider trading rules, and legal barriers may prevent full market efficiency.
4. **Liquidity Issues:** Some assets may not be easily traded, leading to price distortions.
5. **Transaction Costs:** Fees, taxes, and other costs can prevent prices from adjusting efficiently to new information.

Implications of DMH:

- Markets may not always allocate resources optimally.
- Investors can earn above-average returns by exploiting inefficiencies (e.g. arbitrage opportunities, behavioural trading strategies).

- Active investment strategies like fundamental and technical analyses may provide an edge over passive investing.

Comparison: DMH) vs. EMH

Feature	DMH	EMH
Core Idea	Markets are inefficient due to various imperfections like information asymmetry, behavioural biases, and liquidity constraints.	Markets are efficient, and asset prices fully reflect all available information.
Information Availability	Some investors have better access to information than others.	All investors have equal access to information, and prices adjust immediately.
Investor Behaviour	Investors make irrational decisions due to emotions, biases, and cognitive errors.	Investors are rational and act logically.
Price Reflection	Prices do not always reflect fundamental values.	Prices always reflect the true fundamental values of assets.

Feature	DMH	EMH
Market Predictability	Market inefficiencies create opportunities for above-average returns.	It is impossible to consistently beat the market using historical data or public information.
Trading Strategies	Active trading can exploit inefficiencies for higher returns.	Active strategies do not provide consistent excess returns.
Empirical Evidence	Evidence of market anomalies suggests inefficiencies exist.	Some financial studies on well-regulated markets support EMH.
Example	Stock market bubbles, insider trading, and arbitrage opportunities indicate inefficiencies.	Stock prices react instantly to earnings reports or economic news, which supports efficiency.

Biases in Behavioural Finance

In **Behavioural finance,** biases can be broadly categorised into **emotional** and **cognitive biases**. Recognising and mitigating these biases can help investors make more rational, evidence-based financial decisions. Below are key biases affecting financial decision-making:

1. Emotional Biases

These biases stem from personal feelings and emotions, often leading to irrational decisions. Emotional biases significantly affect investor decision-making, often leading to suboptimal financial outcomes. Emotional biases can lead to irrational financial decisions and deviate investors from optimal portfolio strategies. Below are key emotional biases related to behavioural finance:

1. **Endowment Effect**

People assign more value to assets they own compared to similar assets they do not own. E.g. Refusing to sell inherited stocks despite better investment opportunities.

2. **Loss Aversion**

The pain of losing is psychologically more significant than the pleasure of gaining.

For example, holding onto a losing investment longer than rationally because selling would confirm the loss.

3. **Disposition Effect**

Investors sell winners too quickly and hold losers too long. E.g. Selling a stock after a small gain but holding a declining stock, hoping it will recover.

4. **Overconfidence Bias**

Investors overestimate their ability to predict market movements. For example, you may trade too often and think you have superior stock-picking skills but increase costs.

5. **Regret Aversion Bias**

Fear of making a wrong choice leads to inaction. For example, they should Avoid investment decisions to prevent regret if the market moves against them.

6. **Self-Control Bias**

Investors focus on short-term gratification instead of long-term financial goals. For example, overspending now instead of saving for retirement.

7. **House-Money Effect**

Taking greater risks with profits, feeling like it's "free money."

8. **Herd Behaviour**

Following the crowd due to fear of being left out.

9. **FOMO (Fear of Missing Out)**

Rushing into investments to avoid missing potential gains.

10. **Sensation Seeking**

Taking excessive investment risks for excitement.

11. **Superstition**

Basing investment choices on irrational beliefs (e.g. lucky stocks, specific dates).

12. **Statistical Bias**

Investors misinterpret or misapply statistical data when making financial decisions. This includes survivorship bias, recency bias, and overgeneralisation of small sample sizes. For example, An investor assumes that a mutual fund will perform well in the future because it has done so in the past five years, ignoring survivorship bias and market conditions.

13. **Thought Contagion**

This is a type of Emotional Bias. It refers to the spread of ideas or behaviours from others, often without thinking rationally. Investors follow the crowd based on fear, hype, or social pressure. For example, Abin buys a stock just because everyone around him is talking about it, not because he researched it.

14. **Procrastination**

This is a type of Emotional Bias. It means delaying decisions, even when one knows it is not suitable for him. It often happens due to fear, anxiety, or the desire to avoid regret. It is linked to regret aversion and poor self-control. For example, An investor delays retirement savings or avoids rebalancing a portfolio out of fear of making mistakes.

2. Cognitive Biases

These biases result from errors in processing information or mental shortcuts (heuristics).

1. **Confirmation Bias**

People seek out information that supports their existing beliefs while ignoring contradictory data. For example, an investor only follows analysts who favour their stock picks.

2. **Hindsight Bias**

Believing past events were predictable, leading to overconfidence. E.g. Believing you predicted the market crash after it happened, even though it was uncertain.

3. **Anchoring Bias**

Fixating on an initial reference point when making decisions. For example, refusing to sell a stock because you're fixated on its past peak price, not its current value.

4. **Availability Bias**

Giving more weight to easily recalled information. For example, investing in a company because it was recently in the news, regardless of fundamentals.

5. **Representativeness Bias**

Drawing conclusions based on small sample sizes or stereotypes. For example, assuming all tech stocks will perform like Apple or Google.

6. **Framing Bias**

Decisions are influenced by how information is presented. E.g. Preferring an investment with a "90% success rate" over one with a "10% failure rate," even though they mean the same.

7. **Survivorship Bias**

Focusing on successful investments while ignoring failed ones. E.g., Believing hedge funds always generate high returns by only looking at surviving funds and ignoring those that failed.

8. **Gambler's (Monte Carlo) Fallacy**

Believing that past random events influence future probabilities. For example, expect a stock to rebound just because it has declined for several days.

9. **Recency Bias**

Giving too much importance to recent events while ignoring historical trends.

For example, assuming a recent stock market rally will continue indefinitely.

10. **Mental Accounting**

It refers to treating money in a different manner based on its source or intended use. For example, spending a tax refund on luxury items while being frugal with salary earnings.

11. **Reference Price Effect**

Consumers and investors compare prices to a reference point (past, competitor, or expected prices) rather than the actual value. This bias can lead to missed opportunities or poor financial decisions due to outdated comparisons.

12. **Overreaction**

This is a type of Cognitive Bias. It happens when investors respond too strongly to new information, causing significant price changes. This comes from misjudging or giving too much weight to recent events. It is related to recency and availability bias. For example, A company misses earnings slightly, but its stock drops 20%, even though the business is still strong.

13. **Groupthink Bias**

Conforming to group opinions instead of making independent decisions.

14. **Chasing Hot Stocks without Research**

Investing in trending stocks without proper analysis.

15. **Hot-Hand Bias**

Assuming a winning streak will continue indefinitely. A streak refers to a continuous sequence of similar outcomes. In investing or gambling, a winning streak means a series of consecutive successful outcomes, while a losing streak means consecutive failures.

16. **Conservatism**

Sticking to outdated beliefs despite new evidence.

E.g. Stock Investment: Refusing to buy a stock at ₹1,200 because it was ₹1,000 last month, even if it has strong growth potential.

Consumer Behaviour: Seeing a product as expensive at ₹500 because it was ₹400 before, despite market inflation.

Real Estate: Rejecting a house at ₹50 lakhs because similar ones were ₹45 lakhs last year, ignoring location value.

Impact of Biases on Behavioural Finance

1. **Poor diversification** (due to overconfidence or availability bias).
2. **Excessive trading** (from overconfidence and hindsight bias).
3. **Suboptimal asset allocation** (due to loss aversion or framing bias).

The Story of the Dot-com Herd

Event: During the late 1990s, investors rushed to buy internet company stocks, believing they would all succeed.

Outcome: The **Dot-com Bubble** burst in 2000, causing massive losses as many overhyped companies collapsed.

A **stock market bubble** occurs when the asset price rises significantly above their intrinsic value due to excessive speculation, investor enthusiasm, and herd behaviour. Eventually, the bubble bursts, leading to a sharp market decline.

Lesson: Blindly following market trends can lead to financial disasters.

REVIEW QUESTIONS

Part A – Very Short Essay

1. What is meant by loss aversion?
2. Explain Anchoring.
3. What is House-Money Effect?
4. What is Monte Carlo Fallacy?
5. Explain Conservatism.
6. What is Egocentrism?
7. What is Cognitive Bias?
8. What are Representative Heuristics?
9. What are the classifications of Bias?

Part B – Short Essay

10. What is the effect of overconfidence bias on portfolio selection?
11. Write a note on Endowment Effect and Disposition Effect.
12. Briefly explain Hot-Hand Bias and its effect on investors.
13. What is the effect of confirmation bias on investors?
14. What is the effect of self-control on investors?
15. Distinguish between internal and external biases.

16. Briefly explain the concept of Loss Aversion.
17. Write Short Notes on:
    i) Groupthink bias (ii) House-Money Effect.

Part C – Long Essay

18. Explain the effect of heuristics on the investors
19. What is Bias? Distinguish between internal and external bias. Make a short note on various emotional biases.
20. How does asymmetric information contribute to market biases like herding and overconfidence? Illustrate with examples.
21. Write short note:
    a) Thought Contagion and overreaction
    b) Gambler's Fallacy c) Hot Hand Bias
    d) Procrastination e) Conservatism and superstitions

TACKLING ANALYTICAL QUESTIONS

20. How does asymmetric information contribute to market biases like herding and overconfidence? Illustrate with examples.

Develop answers from:

Asymmetric Information in Behavioural Finance

Implications of Asymmetric Information section

Herding Behaviour under Implications + The Story of the Dot-com Herd

Overconfidence Bias under Emotional Biases

Points to Develop the Essay:

1. Define Asymmetric Information

2. Link to Behavioural Biases

- Less-informed investors to evaluate decisions rationally.
- This gap intensifies cognitive and emotional biases.

3. Explain Herding Behaviour

Many retail investors followed institutional investors into tech stocks during the dot-com bubble.

4. Explain Overconfidence Bias

Example: Institutional investors making high-stakes bets assuming they have better forecasts than the market.

5. The outcome of the Interaction

- market anomalies, asset mispricing, and financial bubbles. - Amplifies irrational behaviour - can result in massive losses when bubbles burst.

6. Conclude on Importance

Recognizing the link between information gaps and behavioural biases is essential for designing better market regulations and improving investor awareness.

Module 5

Ways to Overcome Biases

5.1 Interaction between Biases

5.2 Dealing with Biases

CHAPTER 5

WAYS TO OVERCOME THE BIASES

Abstract

This module explores the complex role of behavioural biases in personal investment decisions and presents systematic strategies to mitigate their negative effects. It begins by examining how various biases—such as overconfidence, confirmation bias, loss aversion, and herd mentality—operate individually and interact and compound one another, leading to distorted perceptions, flawed judgments, and suboptimal financial outcomes. These interactions are analyzed through **intermediate outcomes** (e.g., biased information processing, irrational risk assessment) and **outcomes** (e.g., poor financial decisions, increased losses, emotional trading).

The module then focuses on practical methods for **overcoming biases**, emphasizing financial literacy, self-reflection, decision journaling, and feedback mechanisms. Cognitive, behavioural, and structural debiasing strategies include systematized decision-making, automation, diversification, use of stop-loss mechanisms, and "consider-the-opposite" thinking. Professional financial advice, structured decision tools, and commitment devices are also emphasized.

Additionally, the module highlights the importance of **identifying potential biases** through self-awareness tools and feedback loops and **evaluating debiasing techniques** by monitoring investment outcomes, behavioural shifts, and consistency with long-term goals. By integrating these insights, investors can develop more rational, resilient, and disciplined financial behaviour, ultimately aligning

decisions with personal financial objectives and reducing the impact of emotional and cognitive errors.

Behavioural biases

Behavioural biases significantly impact personal finance decisions, often leading individuals to make irrational choices that detract from their long-term financial goals. Financial biases rarely operate in isolation; they often interact and compound, leading to a cascade of irrational decisions that can significantly impact financial outcomes. Understanding these interactions is crucial for investors to mitigate their effects.

Interaction between Biases

A detailed explanation of how various financial biases interact and the intermediate and final outcomes of these biases are explained below. Many biases can strengthen each other, while some of them amplify their negative effects**.**

Strengthening biases

1. **Confirmation Bias + Overconfidence Bias:**

   a. **Interaction:** Loss aversion (The emotional impact of a loss outweighs the joy derived from an equivalent gain.) is a primary driver of the disposition effect (individuals selling their winning investments at the early stage but holding the losing investment for a longer period). Regret aversion (individuals avoid making a decision that will later be seen as wrong), which again leads to holding onto losing investments for a longer period. Investors hold onto losers to avoid realizing the "regret" of a bad decision, hoping they'll break even. They sell winners quickly to avoid the "regret" of seeing gains vanish.

b. **Outcome:** This interaction creates an echo chamber, preventing investors from objectively assessing risks or considering alternative viewpoints. They become more entrenched in their flawed decisions, leading to excessive trading, inadequate diversification, and higher potential losses.

2. **Anchoring Bias + Confirmation Bias:**

a. **Interaction:** An investor might **anchor** on an initial price point for a stock (e.g., its historical high or their purchase price). Then, **confirmation bias** kicks in, leading them to seek information supporting the idea that the stock will return to that "anchor" price, even if fundamentals have changed.

b. **Outcome:** This can lead to holding onto losing investments for too long, hoping they will recover to the anchor price, or being unwilling to buy a stock above a previous low, even if its value has genuinely increased.

3. **Loss Aversion + Disposition Effect + Regret Aversion:**

a. **Interaction: Loss aversion** (The emotional impact of a loss outweighs the joy derived from an equivalent gain.) is a primary driver of the **disposition effect** (holding onto losing investments too long and selling winners too soon). **Regret aversion** (the fear of making a decision that will later be seen as wrong) further fuels this. Investors hold onto losers to avoid realizing the "regret" of a bad decision, hoping they'll break even. They sell winners quickly to avoid the "regret" of seeing gains vanish.

b. **Outcome:** This combination leads to portfolios filled with underperforming assets and missed opportunities for further gains from successful investments. It actively prevents investors from cutting losses and letting profits run.

4. **Herd Mentality + Availability Bias + Recency Bias:**

   a. **Interaction:** Recency bias makes recent impressive returns seem more significant when a "hot" investment trend emerges (e.g., a particular sector or cryptocurrency). **Availability bias** makes this information accessible and top-of-mind (everyone is talking about it). This fuels **herd mentality**, as investors see others making money and fear missing out (FOMO).

   b. **Outcome:** This often leads to speculative bubbles, where asset prices detach from fundamentals. Investors buy into popular assets without proper research, leading to potentially significant losses.

   c. Some biases can obscure the presence of others or amplify their negative effects.

5. **Overconfidence Bias Masking Lack of Diversification**

   a. **Interaction:** An investor with **an overconfidence bias** might believe they can pick winning stocks within a limited scope. This can be exacerbated by **home bias** (favouring domestic investments) or **familiarity bias** (investing only in what they know).

   b. **Outcome:** The overconfidence prevents them from seeing the need for broader diversification, leading to highly concentrated portfolios vulnerable to idiosyncratic risks (risks specific to a single company or industry).

6. **Mental Accounting + Sunk Cost Fallacy:**

   a. **Interaction:** **Mental accounting** causes people to compartmentalize money (e.g., "this is bonus money," "this is retirement money"). If investment from a "mental account" (e.g., a speculative "play money" account) starts losing value, the **sunk cost fallacy** kicks in. Investors feel compelled to continue investing more into that losing position because they've already committed funds to that specific "account."

b. **Outcome:** This can lead to throwing good money after bad, ignoring the overall portfolio health and rational financial principles.

7. **Optimism Bias + Underestimation of Risk:**

a. **Interaction: Optimism bias** leads investors to maintain overly positive expectations about future market performance. This often interacts with a general **underestimation of risk**, causing them to overlook potential downsides or allocate insufficient capital to risk management.

b. **Outcome:** Portfolios that are not adequately prepared for market downturns, leading to larger-than-expected losses during volatile periods when the bubble bursts.

Intermediate Outcomes (The Mediators)

Biases don't directly produce outcomes in a single step. Instead, they influence a series of intermediate outcomes – internal states, thought processes, and immediate actions – that then cascade to shape the final result. These intermediate outcomes can include:

1. **Information Gathering and Interpretation:**

a) **Selective attention:** Biases can lead individuals to selectively pay attention to information confirming their beliefs, ignoring contradictory evidence (e.g., Confirmation Bias).

b) **Misinterpretation of data:** Information that is considered might be misinterpreted to fit a pre-existing narrative or assumption.

c) **Limited search:** Biases might limit the scope of information sought, leading to an incomplete picture.

2. **Perceptions and Beliefs:**

a) **Distorted risk assessment:** Overconfidence bias can lead to underestimation of risks, while availability bias might overstate the likelihood of vivid, recent events.

b) **Formation of inaccurate assumptions:** Biases can cause individuals to make assumptions about situations or people not grounded in objective reality.

c) **Skewed self-assessment:** Overconfidence or self-serving bias can lead individuals to inaccurately assess their abilities or the quality of their decisions.

3. **Decision-Making Processes:**

a) **Reduced consideration of alternatives:** Confirmation bias or anchoring bias might limit exploring different options or solutions.

b) **Premature closure:** Biases can lead to jumping to conclusions or diagnoses too early without considering all possibilities.

c) **Irrational choices:** Emotional biases like loss aversion can lead to decisions that protect against small losses, even at the cost of larger potential gains.

4. **Communication and Interaction:**

   a) **Miscommunication:** Biases in perception can lead to misunderstandings in communication, both in sending and receiving messages.

   b) **Reinforcement of stereotypes:** Implicit biases can manifest in subtle (or not-so-subtle) ways that reinforce existing stereotypes in interactions.

Final Outcomes

The intermediate outcomes, shaped by biases, ultimately lead to tangible outcomes. These can be positive or negative, and their impact can range from individual to societal levels.

1. **Poor Decision-Making:** This is a direct and common final outcome. Whether in personal finance, healthcare, legal judgments, or business strategy, biased intermediate steps can lead to suboptimal or even disastrous decisions.

   Example**:** A doctor affected by **premature closure bias** might arrive at a diagnosis too early, leading to an incorrect treatment plan (final outcome) and potentially adverse patient outcomes.

2. **Ineffective Problem Solving:** If biases lead to incomplete information gathering or a narrow consideration of solutions, the final solution to a problem may be ineffective or address the wrong issue.

3. **Unfair Treatment and Discrimination:**

   a) **Implicit bias** in hiring can lead to certain demographic groups being overlooked or undervalued, resulting in a lack of diversity in the workplace (final outcome).

b) **Attribution bias** can cause individuals to judge others' actions wrongly, leading to unfair disciplinary actions or missed opportunities.

c) **Financial Losses:** In investment, overconfidence bias or anchoring bias can lead to poor financial decisions, resulting in monetary losses.

d) **Damaged Relationships:** In interpersonal contexts, biases can lead to misunderstandings, mistrust, and conflict, negatively impacting relationships.

e) **Reduced Innovation:** In organizational settings, conformity bias or the "curse of knowledge" (overconfidence bias) can stifle creative thinking and new ideas, leading to a lack of innovation.

f) **Negative Societal Impacts:** Systemic biases can perpetuate inequalities in education, justice, and public policy. For instance, outcome bias in policy evaluation can lead to the continuation of ineffective policies if their initial results are perceived positively, regardless of the process that led to them.

By understanding how financial biases interact and reinforce each other, investors can become more self-aware and implement strategies to make more rational, disciplined, and, ultimately, more successful financial decisions.

Dealing with Biases.

Investors must first recognize that biases are natural and often subconscious influences on decision-making. Understanding how these biases operate is the foundation for making more rational and objective financial choices.

Overcoming the Biases

Recognizing and actively working to overcome these biases is crucial for improving financial well-being. Here's a detailed description of various widely accepted methods to achieve this:

The first step in overcoming behavioural biases is understanding their existence and how they manifest in your financial decisions. This involves:

- **Financial Literacy and Education:** Gaining knowledge about common biases like loss aversion, overconfidence, present bias, confirmation bias, and herd mentality is fundamental. Understanding these biases' psychological underpinnings helps individuals identify them in their own thinking.
- **Self-Reflection and Decision Journaling:** Keeping a record of past financial decisions, including reasoning, emotional state, and outcomes, can help identify recurring patterns of biased thinking. This self-assessment fosters metacognition – an awareness of one's own thought processes.
- **Seeking Feedback and Diverse Perspectives:** Actively soliciting opinions from others, especially those who may hold contrary viewpoints, can help challenge assumptions and expose blind spots. This is particularly effective in mitigating confirmation bias.

Practical Strategies to Overcome the Biases

Once biases are identified, various strategies can be employed to mitigate their impact on the decision-making process. Broadly, the methods to deal with biases fall under three categories: Systematizing Decisions and Rule-Based Approaches, Cognitive Strategies, and External Assistance and Environmental Changes.

A. Systematizing Decisions and Rule-Based Approaches

- **Creating a Financial Plan:** A well-defined financial plan based on long-term goals and risk appetite acts as a disciplined framework, reducing the likelihood of impulsive decisions driven by short-term emotions or market fluctuations. This helps to combat present bias and loss aversion by focusing on the bigger picture.
- **Automating Financial Actions:** Setting up automatic transfers for savings, investments, and bill payments removes the "human element of noise" and enforces consistency, effectively bypassing present bias and inertia.
- **Exit Strategies:** An exit strategy is a planned approach to leave or withdraw from an investment, business, or financial position. It helps reduce risk, secure profits, or limit losses. In Personal Finance, an exit strategy outlines when and how an investor will sell their asset or investment. It avoids emotional decisions during market volatility.[15]
- **Diversification:** Spreading investments across various asset classes, sectors, and geographies reduces the emotional impact of an asset's underperformance, thereby mitigating loss aversion and overconfidence bias.

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[15] Examples of exit strategy:

- Selling stocks when a target price is reached (profit-taking)
- Setting a stop-loss order to avoid significant losses
- Exiting a mutual fund after a specific period or goal is achieved

- **Dollar-Cost Averaging:** Investing a fixed amount of money in a target security at regular intervals, regardless of market price fluctuations, reduces the risk of volatility in their investment portfolios.

B. Cognitive Strategies

- **"Consider the Opposite" or "Pre-Mortem" Analysis:** Before making a significant financial decision, imagine that the decision has already failed. Then, work backwards to identify all the potential reasons for that failure. This encourages critical thinking and helps to uncover hidden risks and biases. Similarly, actively seeking disconfirming evidence to challenge your initial beliefs can help counter confirmation bias.
- **Taking the "Outside View":** Instead of focusing solely on the specifics of your situation (the "inside view"), consider similar past projects or decisions (the "reference class"). This helps in making more realistic forecasts and avoiding over-optimism.
- **Framing and Re-framing:** Understanding how the presentation of information can influence choices (e.g., highlighting potential losses versus potential gains) can help you consciously re-frame decisions to promote more rational thinking.
- **Slow Thinking:** Deliberately slowing down the decision-making process, rather than relying on quick, intuitive judgments, allows for more thorough analysis and reduces the impact of emotional responses and cognitive shortcuts. Implementing "cooling-off periods" before making major financial commitments is a practical application of this.

- **Setting Realistic Expectations:** Recognizing the limitations of your knowledge and ability to predict market movements can help temper overconfidence. Regularly reviewing performance against objective benchmarks rather than personal expectations can also help.

C. External Assistance and Environmental Changes

- **Professional Financial Advice:** A qualified financial advisor can provide an objective, data-driven perspective, helping clients to identify and overcome their biases. They can guide clients toward rational decisions that align with long-term goals, particularly during volatile market conditions where emotions run high. A strong, trusting relationship with an advisor is foundational to effective debiasing.
- **Incentives and Commitment Devices:** Structuring incentives or creating commitment devices can help individuals stick to their financial plans. For example, some programs offer financial rewards for healthy financial behaviours or penalties for failing to meet savings goals.
- **Default Options:** "Nudges" in the form of default options (e.g., automatic enrolment in retirement savings plans) have been shown to have a significant increase in participation and savings rates by beneficially leveraging inertia.
- **Structured Decision-Making Tools:** Using decision matrices or checklists with predefined criteria can help systematically evaluate alternatives and reduce the influence of biases by promoting objective assessment.

Addressing Specific Biases

While the above methods are broadly applicable, some specific techniques can target individual biases:

1. **For Loss Aversion:**
    - Investors should develop a long-term investment plan rather than short-term gains or losses.
    - Should have a predetermined exit strategy (selling the investments when they reach a certain price).
    - Assess investments based on current market value rather than initial purchase price.
2. **For Present Bias:**
    - Set clear, motivating long-term financial goals.
    - Automate savings and investments.
    - Use commitment devices that make it harder to deviate from future-oriented plans.
3. **For Overconfidence Bias:**
    - Seek out contrary viewpoints and actively look for disconfirming evidence.
    - Keep a record of past predictions and compare them with actual outcomes.
    - Limit speculative bets and diversify investments.
    - Consult with financial professionals.
4. **For Herd Mentality:**
    - Conduct independent research and analysis before making investment decisions.

  - Challenge popular opinions and seek alternative views.
  - Stick to a well-thought-out personal financial plan.
5. **For Confirmation Bias:**
  - Actively search for information that challenges your existing beliefs.
  - Question your assumptions and hypotheses.
  - Engage with diverse sources of information.
6. **For Anchoring Bias:**
  - Reassess investments based on their current market conditions and intrinsic value rather than initial reference points (like purchase price).
  - Use valuation metrics and objective data for analysis.
7. **For Recency Bias:**
  - Focus on long-term historical trends and market cycles rather than recent performance.
  - Maintain a long-term investment horizon.

Debiasing refers to the systematic process of reducing or eliminating the influence of cognitive and affective biases on human judgment and decision-making. It aims to help individuals and groups make more rational, objective, and accurate choices by counteracting the systematic deviations that biases introduce.

Techniques to Lower the Impact.

We can employ various techniques to lower their impact. These techniques generally fall into awareness, introspection, structured processes, and exposure.

Here are key techniques to lower the impact of biases:

1. Acknowledge and Understand Your Biases:

- **Self-Awareness is Key:** The first and most crucial step is recognizing that everyone has biases. Denial can be a significant barrier to mitigation.
- **Take Implicit Association Tests (IATs):** Tools like the IAT can help reveal unconscious biases you may not be aware of.
- **Learn About Different Bias Types:** Understand common cognitive biases (e.g., confirmation bias, affinity bias, halo effect, availability bias, groupthink) to identify them in your own thinking and in others.

2. Cultivate Mindfulness and Reflection:

- **Slow-Down Decision-Making:** Biases are more likely to influence us when we are rushed, tired, or distracted. Taking time to reflect before acting or deciding can help.
- **"PAUSE" Model:**
  - **P**ay attention to your own judgments and assessments.
  - **A**cknowledge your assumptions, reactions, and interpretations.
  - **U**nderstand other perspectives, positions, and viewpoints.
  - **S**eek for empowering and productive techniques for the situation.
  - **E**xamine and execute your options and make a decision.
- **Question Your First Impressions:** Don't automatically trust your "gut feelings." Deliberately challenge your initial reactions and assumptions.

- **Reflect on Past Decisions:** Look for patterns where biases might have influenced your choices and identify areas for improvement.

3. Seek Diverse Perspectives and Information:

- **Widen Your Social Circle:** Actively engage with people from different backgrounds, cultures, and viewpoints. This builds cultural competency and helps challenge stereotypes.
- **Think of Counter-Examples:** When you notice a stereotypical thought, consciously bring to mind examples that defy that stereotype.
- **Seek Disconfirming Evidence:** Actively look for information that challenges your existing beliefs rather than just seeking information that confirms them (confirmation bias).
- **Solicit Feedback:** Ask others for input on your decisions or reactions, as they may spot blind spots you miss.
- **Practice Perspective-Taking:** Imagine what it would be like to be in another person's situation and try to understand their thoughts and feelings.

4. Implement Structured Decision-Making Processes:

- **Use Objective Criteria:** When making decisions (e.g., hiring, performance reviews), define clear, objective criteria and benchmarks beforehand. Avoid vague or subjective measures.
- **Standardize Processes:** Standardize procedures for critical processes like hiring or performance evaluations to ensure fairness and consistency.

- **Blind Reviews/Auditions:** Where possible, remove identifying information that could trigger biases (e.g., blind résumés, blind auditions).
- **Diverse Panels:** Utilize diverse hiring committees or review panels to bring a wider range of perspectives and reduce the impact of individual biases.
- **Track and Monitor Data:** Collect and analyse data related to outcomes to identify potential patterns of bias and hold yourself/teams accountable.

5. Foster a Culture of Accountability and Openness:

- **Open Dialogue:** Create environments where people feel comfortable discussing biases and challenging them constructively.
- **Accountability Mechanisms:** Establish ways to hold individuals and organizations accountable for addressing bias.
- **Inclusive Leadership:** Leaders must promote diversity, equity, and inclusion and model unbiased behaviour.
- **Apologize When You Err:** If you realize you've acted on a bias, acknowledge it and apologize. This fosters a culture of learning and growth.

6. Continuous Learning and Development:

- **Bias Training:** Participate in workshops and training programs focused on unconscious bias. However, ensure these trainings are well-designed and effective.

- **Improve Cultural Competency:** Continuously learn about diverse cultures, histories, and perspectives to broaden your understanding and challenge assumptions.
- **Embrace a Growth Mindset:** Believe that you can always learn and improve, even when addressing your biases. This makes you more open to feedback and change.

By consistently applying these techniques, individuals and organizations can significantly reduce the negative impact of biases and foster more equitable and effective outcomes. By consciously employing these methods, individuals can significantly improve their financial decision-making, move closer to their financial goals, and build more robust and resilient financial lives.

Identification of Potential Bias (PIBF Focus)

Recognizing potential biases is essential for making rational personal investment decisions. Biases can distort how we perceive risk, interpret data, and choose investments.

1. Personal Awareness in Financial Contexts

- **Decision Journals**: Track past investments, the reasoning behind them, the emotional state at the time (e.g., panic, overconfidence), and outcomes.
- **Financial Mistake Audits**: Review poor financial decisions and analyze if bias (e.g., herd mentality, anchoring) was involved.

2. Tools to Uncover Biases

- **Investor Behavior Assessments**: Many brokerages and financial apps offer quizzes or tools to assess risk tolerance and bias tendencies.

- **Implicit Bias Checklists**: Identify patterns like frequent overtrading, ignoring diversification, or panic selling.

3. External Checks

- **Consulting a Financial Advisor**: Professionals can help identify when emotional or irrational reasoning drives financial behaviour.
- **Peer Reviews of Investment Plans**: Sharing your strategy with a knowledgeable peer can highlight confirmation bias or overconfidence.

Evaluation of Debiasing Techniques (PIBF Focus)

Evaluation is key to ensure that debiasing efforts help improve financial decision-making.

1. Investment Outcome Analysis

- **Return Consistency**: Check if post-debiasing decisions result in more stable, goal-aligned returns.
- **Volatility in Decision-Making**: Monitor whether emotional investment behaviour (e.g., panic selling, speculative buying) has reduced.

2. Behavioral Shifts

- **Reduced Impulsive Trades**: Evaluate whether investment frequency has become more disciplined.
- **Increased Portfolio Diversification**: Check if the portfolio is better diversified over time, indicating reduced overconfidence or home bias.

3. Feedback from Tools and Advisors

- **Robo-Advisors or Portfolio Tools**: Many platforms show behavioural insights, comparing your activity to ideal long-term investor profiles.
- **Advisor Check-Ins**: Periodic reviews with a financial advisor can track whether your financial behaviour has become more rational.

4. Consistency with Financial Goals

- **Goal Alignment Review**: Assess whether your decisions move you closer to long-term financial goals instead of reacting to short-term market events.

Conclusion

Module 5 of Personal Investment and Behavioural Finance focuses on understanding and overcoming behavioural biases that affect financial decisions. It explains how biases like overconfidence, confirmation bias, loss aversion, and herd mentality interact and lead to poor investment outcomes. The module outlines these biases' intermediate and final effects and presents practical strategies to overcome them, such as financial planning, automation, diversification, and critical thinking techniques. It also emphasizes the importance of identifying potential biases through self-awareness and feedback and evaluating debiasing efforts by tracking improvements in decision-making and alignment with financial goals.

REVIEW QUESTIONS

Part A – Very Short Essay

1. What is exit strategy?
2. Explain final outcomes with example.
3. State the outcomes of biases.
4. Briefly explain the effect of bias on the risk tolerance of investors.
5. How do cognitive and emotional biases interact to amplify poor investment decisions? Provide examples.

Part B – Short Essay

6. Enumerate the possible remedies to deal with the biases.
7. Which are the biases normally exhibited by normal investors? Explain the ways to overcome the biases.
8. Explain interaction between biases

TACKLING ANALYTICAL QUESTIONS

5. How do cognitive and emotional biases interact to amplify poor investment decisions? Provide examples.

Points to Develop the Essay:

1. Introduction

   Cognitive biases are mistakes in thinking, such as overconfidence, confirmation bias, and anchoring.

2. Emphasize the Interaction

   These biases don't act alone. They often work together and make the effect stronger. Examples:

   - Overconfidence + Loss Aversion
   - Anchoring + Confirmation Bias
   - Loss Aversion + Regret Aversion + Disposition Effect

3. Discuss the Outcome of the Interactions.

   When biases combine, they lead to wrong risk judgment, rushed decisions, and bad investment choices. This can result in weak portfolio performance, high ups and downs, and not reaching financial goals.

4. End with a Note on Importance

   Knowing how these biases interact helps in finding better ways to avoid them and make smarter investment decisions.