The economics of the household balance sheet

It is well known that financial assets play a limited role in the Indian household balance sheet. Higher preference for physical assets, among other things, has resulted in lower penetration of insurance products and the near absence of retirement savings. A committee headed by Tarun Ramadorai, professor of financial economics at Imperial College, London, which submitted its report recently, has taken a comprehensive look at these issues and made recommendations in order to increase the role of formal finance in the household sector.

The committee notes that an average Indian household has 77% of its total assets in real estate, 11% in gold, 7% in other durable goods and just 5% in financial assets. While households in other developing countries such as China also have a higher preference for physical assets, this is significantly different from developed countries where financial assets play a much bigger role in household finances. Interestingly, even households that move towards the top of the wealth distribution do not increase allocation to financial assets—they just shift gold holdings towards real estate. The committee has also found a strong link between lower take-up of insurance products and reliance on non-institutional sources of credit. This basically shows that lack of insurance pushes households to take debt from non-institutional sources. The report highlights that 69% of households depend on informal sources of funding to deal with medical emergencies. Funding from informal sources such as moneylenders comes with higher interest burden and affects household finances.

There are various reasons why households at different levels of wealth distribution prefer physical assets over financial assets. For instance, wealthier households may find it easier to divert their illegitimate income towards physical assets to avoid taxes, as investments in the financial sector are easier to track. For others, as the report notes, “High transactions costs and bureaucratic impediments to efficient participation create a high ‘nuisance factor’ for households hoping to engage in formal financial markets.” Lower- income households often believe that the formal financial sector is only for the rich. The other important reason why households prefer physical assets could be persistent high inflation over the decades.

However, at a broader level, the reluctance of households to engage in the formal financial market shows that the institutional architecture has not worked as desired. If people are reluctant to go to a bank or a financial institution, it suggests that the system requires design changes to be able to serve the needs of an average Indian household. This will not only increase the financial well-being of households, but will also help channelize savings into productive investments. In this context, the government has done well by starting the Pradhan Mantri Jan-Dhan Yojana as well as schemes in the insurance and pension space. It is important to understand that with physical assets, households have only optimized their balance sheets in the given circumstances. Therefore, if the operating environment changes, it is possible that Indian households will adjust accordingly—maybe with some amount of hand-holding by the state.

The committee has made several sector-specific recommendations to address issues on both the asset and liability sides of the household balance sheet. For instance, to improve access to financial products, the committee has recommended end-to-end digital distribution networks, and making the know-your-customer requirement completely paperless. Better use of technology should be able to increase the access to financial products. The committee has also recommended the formation of a regulatory sandbox. This is an idea worth trying. It will allow testing of innovative financial products and monitoring of possible risks. This will help in developing innovative low-cost financial products. It will also enable regulators to adapt to innovation and technology. Financial products in India need to be more flexible so that people working in the economy’s large informal sector, with irregular income, can participate. The

committee has made a number of other recommendations to improve the overall market structure for different products, including the way interest rates should be set in the home loan market.

One big issue that influences the household preference for an asset class—and not just in India—is awareness. The state and other stakeholders will have to work together to improve financial awareness. However, it will not be easy to change the asset mix of Indian households and a shift will undoubtedly be a long drawn out process. The government and regulators would do well to create an enabling environment where households are able to access simple financial products, backed by a strong mechanism to redress grievances, with ease. Households will only move to financial assets in a big way if products are easily available and they trust the overall financial architecture with their savings.

Will households benefit from moving to financial assets? Tell us at views@livemint.com

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