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Behavioral Banking in India

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Abstract

The field of behavioral finance has its unofficial roots in Selden's Psychology of the Stock Market from 1912, Fessinger's study of cognitive dissonance from 1956, and Pratt's discussion of risk aversion and the utility function from 1964.

A branch of behavioral economics called "behavioral finance" contends that investors' and financial professionals' financial decisions are influenced by psychological factors and biases.

However, behavioral finance is only recently being applied in the banking industry. Officially, only one bank employs behavioral finance as its primary mode of operation.

There are so many areas which are untouched in the banking business that can make good use of behavioral finance.

With the use of the numerous Behavioral Finance principles, I'm attempting to investigate the notion of a business model that could help the banking sector.

I. Introduction

On my way to the train station, I struck up a conversation with a cab driver and he told me his tale. He had two housing loans and was a reputable labor contractor in the city. However, he suffered a severe financial loss during the pandemic and was forced to sell one of his homes to pay off his loan (even after the central bank’s relaxations). He then started driving an auto rickshaw and relocated to the outskirts of the city to cut costs.

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And now after recovering from the pandemic, the same person has established a transportation business with 3 vehicles. And also developed the habit of savings with an emergency fund and timely payments of his dues. He has developed the habit of savings and avoiding the over estimation of his financial condition.
In both pre and post pandemic situations we can conclude that the behavioral dilemma is very hard to overcome.

We are well aware of the terminology of behavioral finance meaning [as per Wikipedia] "the study of the influence of psychology on the behavior of investors or financial analyst."

When it comes to behavioral banking, we can consider educating society financially using the latest banking and financial technologies, and adhering to sound financial practices, such as saving, investing and borrowing within our means and avoiding overestimating our financial position. You can think of encouraging decisions. Improving overall banking behavior.

According to a sample survey by the NCFE (National Centre for Financial Education), only 27.18% of Indians are financially literate.
Consequently, just about 27% of the nation's population possesses financial literacy. Financial literacy is therefore urgently needed in relation to the banking sector, which now offers all financial services like savings, investing, insurance, and borrowing. through behavioral banking, enhancing the healthy habits of saving, investing, insurance, and borrowing for the entire generation.

There are several concepts in the field of behavioral finance that can be easily integrated into the banking industry and used to improve the financial health of large customer bases.

The only official example of behavioral banking is South Africa's Discovery Bank. The bank teaches and encourages good financial behavior among account holders in order to improve the financial health of the nation as a whole by encouraging good financial behavior among its customers. The bank achieves its goals through its core banking product, Vitality Money. This is a behavior change program that changes customers' financial behavior to improve their financial health (Discovery Bank 2018a).

Here, I have described the basic concepts of behavioral finance and its application and effectiveness in the banking sector.

2. Basic concepts of Behavioral finance and their application in banking

Financial decisions often depend on an investor's mental and physical health. As an investor's general health improves or deteriorates, so does their mental state. This affects decision-making and rationality for all real-world problems, especially those related to finance.

Behavioral finance typically includes five key concepts:

a. **Mental accounting**
b. **Herd behavior**
c. **Emotional gap**
d. **Anchoring**
e. **Self-attribution**
f. **Social Influence**

a. Mental accounting:

Mental accounting refers to people's tendency to allocate money to specific ends. This is a behavioral bias that causes someone to put money into different categories based on different mental accounts. The origin and purpose of money make us think about money differently. Take the following citation as an example inspired from — Richard H. Thaler (2008):

"Mr. and Mrs. Jadhav went on a fishing trip and spent 3,000 rupees catching some surmai. They packed the fish and sent it to their home by courier, but the fish got lost in transit. They received 3,000 rupees from the courier company as compensation. The couple takes the money, goes to dinner and spends 2,500.00 rupees. They have never spent so much money in a restaurant before."

The 3,000.00 rupees was considered a gift coupon and the money was never ours so we treated ourselves to a free dinner and enjoyed our meal.

This is how funding sources affect mental accounting. Both 3,000.00 rupees are worth the same, but they are derived differently, so we treat them separately. One is hard work and the other is free.

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Another example related to banking. Imagine that parents have set up a special savings account for their child's future education. The interest on this savings account is 2% per annum. They conscientiously donate 20% of their salary to this special savings account. At the same time, they have a loan liability that the bank charges them at 15% per annum.

A wise decision is to focus on paying off your debt and using the interest you save to pay for your children's education. However, most parents would put their child's future ahead of personal debt. Money spent on children is more important than money spent paying the bank. Therefore, more money will flow into the special savings account than it will pay off the debt. This is how money intentions affect the way our minds calculate and make decisions.

To avoid mental accounting, each rupee should be considered fungible and of equal value. It does not depend on the source of funding or the intent of the funding. Money is money and shouldn't be treated differently because of biased thinking. It all starts with recognizing that mental accounting can lead to poor financial decisions.

The banking industry now offers the full range of financial market possibilities, including investment services in the stock market, mutual funds and various other investment opportunities. Investors should not allow mental accounting to get in the way of maximizing returns from wise investment and diversification.
Parents investing in their children's future.

As explained in the example above, one should consider the net interest margin while investing and repaying debt. If the investment yields more interest than the debt, it is a good idea to invest. However, if the debt requires more interest than the amount invested, it is better to pay off the debt first. A person needs to control his emotions and mental calculations and not allow them to cause loss.

b. Herd behaviour:

Herd behaviour states that people tend to imitate the economic behaviour of the herd majority. Herd behaviour is known to cause dramatic rises and falls in stock markets.

Herd behaviour can be seen everywhere. When you line up for some errands, everyone is lined up together. The queues are long, so the food must be good or the prizes worth it. Herding behaviour also occurs in financial markets. If everyone is buying something, and you think the stock must be good, then nothing should go wrong because everyone is buying. Herd is often the cause of booms, overvalued assets and bubbles.

Information asymmetry can also be the cause. Quantities and prices are increasing because people know things you don't know. However, such behaviour is sometimes compared to the greater Fool theory. Everyone buys without knowing why, but there will always be bigger fools willing to pay more than today's prices.

Herd behaviour is like the collective intelligence of the crowd. Everyone thinks the same way and shares the same optimism, which makes you feel safe and secure in the crowd. Investors who make a lot of money are enemies against the herd. Herd is right most of the time, but sometimes wrong.

Large banks tend to breed more herds than smaller banks. For example, banks tend to be reluctant to make decisions to lend money to borrowing companies without sufficient information about profitability. In other words, they follow the lending activity of other banks because their decisions seem to indicate the profitability of the company.

In the case of a consortium loan or syndication, a bank may rely on the lead bank's credit risk assessment without each bank in the syndicate performing the assessment individually.

Herd behavior is not necessarily irrational, but sometimes it is rational. According to RBI Press Release – Bank Credit Sectoral deployment of bank credit November 2021:
The volatility of loans to the social infrastructure sector almost quadrupled from 24.4% in 2019-2020 to 82.2% in 2020-2021, and decreased for the tourism, hotels and restaurants sector from 18.7% in 2019. Did. 2.8% in 2020, almost 6 times in 2021. While these fluctuations are clearly due to the COVID-19 pandemic, but they can be considered an example of rational herding behaviour in bank lending.

c. Emotional gap:

Decisions that are influenced by extremes of a person's emotions, such as excitement, anger, fear, and restlessness, are known as emotional gaps. Most of the time, that is the reason for the irrational decisions we make. Emotional gaps refer to decisions based on extreme emotions such as fear, anger, fear, excitement, and emotional distress. Emotions are often the primary reason people fail to make rational decisions. It's related to emotions, but we won't get into that topic in this introductory session. Emotions, in behavioural finance, basically refers to making decisions based on your current emotional state. Our current mood can cause decision-making to deviate from rational thinking.

Accenture's research highlights another problem. An emotionally connected customer offers 52% more value than a very satisfied but emotionally disconnected customer. Clearly, emotions influence bank behaviour, which in turn influences earnings.

The greatest example of the emotional gap in India's banking sector was when chaos erupted during the demonetization period with so many rumours about the old and new currency circulating across the country on a daily basis. And people's decisions were influenced by them.

Everyone, rich and poor alike, experienced fear, and anxiety during the demonetization period, making most of their financial decisions irrational.

a. Anchoring:

"Anchoring is a special form of the priming effect, where the first exposure to a number acts as a reference point and influences subsequent decisions." For example, buying a house in a particular area. If there is an anchor price set in the market, or in people's minds, the sales price or price negotiations for a particular property start at the anchor price.

Anchoring is a heuristic in behavioral finance that refers to the unconscious use of irrelevant information, such as the purchase price of a security, as a fixed reference point (or anchor) for subsequent decisions about that security. So if the recommended sticker price is 100 rupees for it than if it's 50 rupees, people are more likely to appreciate the same item. Prices such as 9.99 rupees and 199.00 rupees anchor at 9 rupees and 190 rupees respectively instead of 10.00 rupees and 200 rupees respectively.

Price anchoring technique in India has a long history and can be seen used by one of the most trusted shoe companies that everyone knows.

In banking, banks can take advantage of customers' previous spending and saving habits patterns to improve their financial decisions. For example, set a certain amount of money that customers save on a regular basis so that it becomes a savings or spending habit sooner.

b. Self-attribution:

The self-attribution bias is a cognitive bias that allows us to acknowledge our achievements and blame external factors when things go wrong. You can easily find it among all other humans.

Consistent profits in financial markets often lead investors to become overconfident, believing they are in control of the market. This leads to improper conduct and investments. Behavioral finance states that emotions and behaviors play an important role in the decision-making process of investors and traders, and that there is always a "card of bad luck" available as a scapegoat.

"What makes the bias particularly pernicious is that we all recognize this bias in others but not in ourselves." - Richard H. Thaler.

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c. Heuristic Simplification:

Heuristics are mental shortcuts that help people solve problems and make decisions quickly and efficiently. These heuristic strategies reduce decision-making time and allow people to function without having to constantly think about their next course of action.

In complex situations where time and resources are limited, heuristics use shortcuts and approximate calculations to help companies make quick decisions. Most heuristic methods use mental shortcuts to make decisions based on past experience.

Some of the most common basic heuristic techniques include trial and error, historical data analysis, guesswork, and elimination. Such methods typically include readily available information that is not problem-specific but generally applicable. It provides an opportunity to make imperfect decisions that can adequately solve problems in the short term.

However, heuristics have both advantages and disadvantages. Heuristics are useful in many situations, but they can also introduce cognitive biases. Awareness of this may help you make better and more accurate decisions. Heuristics are neither inherently good nor bad, but there are pros and cons to using heuristics in decision making. They help us find solutions to problems faster, but they can also cause us to make inaccurate judgments about other people and situations.

Heuristics will be available on internet banking websites and mobile banking apps to facilitate customer navigation. The menu options that are most useful to customers are displayed on the first page or frontmost for example Balances, preferred deals, bill payments, etc.

d. Social Influence:

Social influence refers to any change in behavior, feelings, or thoughts caused by others, even if its existence was imagined, expected, or implied. It also includes interpersonal processes that lead to changes in behavior, feelings and thinking. In a nutshell, how people change their minds.

Many factors influence how we interact with the environment, and social influence processes include sales, marketing, peer pressure, socialization, persuasion, submission, and even large-scale political and social change.

Social influence includes majority influence (conformity) and minority influence:

- **Majority influence** is how a larger group influences an individual or a smaller group. Because psychology focuses on the individual, most research on social influence deals with majority influence.
- **Minority influence** occurs when an individual or smaller group influences a larger group. This is also studied in psychology, but this kind of large-scale social change is more the realm of sociology.

Use Cases:

No one can predict, anticipate, or predict events such as pandemics, global financial crises, and recessions. But those who did the math and did it successfully made their fortunes. Both situations are described in the following use cases.

Use Case-1(Behavioral Banking):

Example of Mr. auto rikshaw driver in the introduction.

Use Case-2(Herding):

In the 2005 movie The Big Short, Michael Barry discovers that subprime mortgage financing is extremely dangerous. He wanted to short them, but there were no derivatives instruments at that time. Everyone considered mortgage payments to be 100% safe, they were AAA rated, and mortgage bonds were selling like hot cakes

He then turned to investment banks to propose the first-of-its-kind credit default swap (CDS) product, like insurance against bond defaults. He saw what the whole world did not see. Investment banks mocked him because they believed the odds of default on mortgage bonds were virtually zero. Banks took advantage of these CDS premiums to make easy and free money. The company quickly lost its capital and customers threatened to sue him. In 2007-2008 there was a crisis. He bet against the crowd, lived up to his beliefs, and made a profit of \$2.69 billion.

Some Key fact about financial health of Indians as per The global Findex database 2021 by World-bank:

The report has shown positives and negatives of financial literacy and banking in India

Sr. No.	Negatives	Positives
1	In India, about one-third of account owners had an inactive account in the past year. India has the highest share of people who have accounts but do not use them	In India, a government workfare program that reached over 100 million people showed that paying women their benefits directly into their own account (and not into the account of a male household head) increased women's financial control, influenced gender norms preventing women from working, and incentivized women to find employment, compared with those paid in cash.
2	In India, distance to financial institutions, lack of trust, and lack of need were the most commonly cited reasons for account inactivity	In India more than 80 million adults made their first digital merchant payment during the pandemic
3	Globally, 1 billion adults who have an account made no digital payments— including 540 million in India	In India, account ownership more than doubled in the past decade, from 35 percent in 2011 to 78 percent in 2021. This outcome stemmed in part from an Indian government policy launched in 2014 that leveraged biometric identification cards to boost account ownership among unbanked adults.
4	In developing economies, 1.6 billion adults with an account made merchant payment only in cash—including 670 million in India	In India, internal fraud and leakage from pension payments dropped by 47 percent when the country transitioned from cash to sending payments to biometric smart cards.
5	Meanwhile, despite having relatively high rates of account ownership, China and India (43%) claim	In India, for example, the introduction of a widely accessible

	large shares of the global unbanked population (130 million and 230 million, respectively) because of their size	digital identifier (Aadhar number) contributed to a significant increase in financial inclusion, driving account ownership up to 80 percent of adults in 2017 from 35 percent in 2011.
6	In India, a reduction in microfinance was associated with significant decreases in wages, income, and consumption.	
7	In India only about 12 percent of adults—fewer than 20 percent of account owners—made a digital merchant payment, In Egypt and India, for example, about 70 percent of account owners have not used payment cards nor a mobile phone or the internet to make a digital payment.	
8	In India, where a third of adults (33 percent) would mainly use family or friends to raise emergency money, two-thirds of those adults say it would be very difficult to get the money.	
9	In Bangladesh, Brazil, and India, for example, over half of adults who would rely on work also said that it would be very difficult to raise the money in 30 days.	
10	In India and Kenya women are over 10 percentage points more likely than men to say school fees are their biggest financial worry. Men in India and Kenya, on the other hand, are more	

	likely to say that medical expenses worry them the most.	
11	Economies with high rates of account ownership, such as India and Indonesia, still have room to increase the share of account holders that use digital channels	

As we can observe from the above tables, facts indicate that there is still lots of scope for improvement in overall financial health of the population of the country and behavioral banking is one of the most important methods to achieve it.

Even though India has a good start with its financial inclusion program, but still there is a long way to go.

Conclusions:

The aim of the study was to explore the potential use of the basic concepts of behavioral finance in the Indian banking sector. India still has a long way to go in the field of financial literacy, as can be seen from the Findex Global Database figures for 2021, and the basic concept of behavioral banking can make this long way a little smoother.

These behavioral banking concepts allow our country to reach the vast majority of citizens whose banking is just a savings account and nothing more.

In a developing country like ours where the economy is growing, behavioral banking will open up a wide range of investment and credit opportunities to anyone who is not want to be financially literate but also to take care of their financial well-being.

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