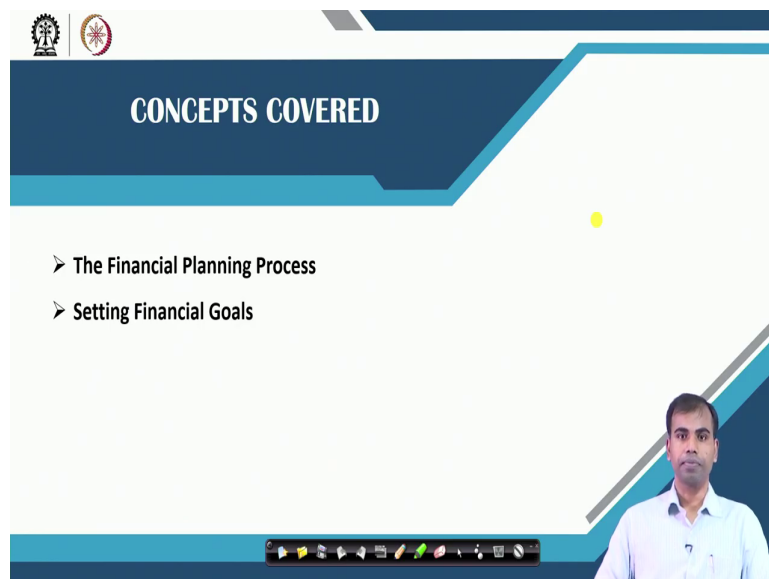


Behavioral and Personal Finance
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Module – 02
Personal Finance
Lecture - 24
Planning Personal Finances

Hi, there welcome back to the course Behavioral and Personal Finance. How often do you feel that you have worked hard, but you did not achieve the goals that you have started for? Well the reason could be the lack of planning. In the second module of this course behavioral and personal finance we will discuss more about financial planning and how personal financial decision making can be improved with the help of behavioral finance theories.

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The slide features a dark blue header with the text "CONCEPTS COVERED" in white. Below the header, there is a list of two items, each preceded by a right-pointing arrowhead: "The Financial Planning Process" and "Setting Financial Goals". In the bottom right corner, there is a small video inset showing a man in a light blue shirt. At the bottom of the slide, there is a navigation bar with several icons for presentation control.

This session is focused on two objectives; first we will discuss the personal financial planning process where we will see how different steps can be undertaken to achieve the personal financial goals. And second we will discuss briefly about how financial goals should be set in order to achieve the goals or the objectives of financial decision making.

Well, this session is mostly based on a narrative. I will start with a simple example where I will showcase how a person is in the need of financial planning, and then I will take you through a case where you would see at different stages of personal financial planning process, how different factors should be undertaken to achieve the goals that a person has desired for.

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Got some money? Now what to do...?

Lakshmi discovered a pleasant surprise: a gift of ₹100,000/-!

Lakshmi (F, 25)

Ganesh has his suggestions that Lakshmi doesn't like at first place!

Lakshmi came up with following uses for the money.

Lakshmi needs financial planning and advisory.

- Pay off bank loan
- Buy a gold bangle
- NPTEL Certifications for career
- Donation to an NGO
- Buy an insurance policy
- Savings

What to do?

NPTEL

Well, let us start with a simple case. The case is if you have got some money what should be done what needs to be done? So, that the money should be optimally utilized and the utility and the benefit of that money can be achieved in a most suitable way. So, the case here today I

am presenting is an individual name Lakshmi. Lakshmi is an individual a female of 25 years of age and on one fine morning she was surprised to receive a gift from her maternal aunt.

Now, see this was a pleasant surprised that she has got a gift of 100000 rupees. Now what should be her reaction? Of course, she would want this money to be used for most of her needs and she might need some advice and that is when her friend came into the picture and started giving some advice. Now, that advice the friend was trying to give was not liked by Lakshmi, because she herself considered that she is competent enough to understand the utility of the money and the decision making process.

Well, what all choices does Lakshmi have? If you try to put yourself in the situation in which Lakshmi is currently, she came up with the following situations where she can use this money that she has got suddenly as a gift, and then she can achieve some goals of utilizing this money for the personal financial process. Now, the options that she has got are as following; she can start by paying off the loan that she has taken from the bank, so a part of the money that she has received can be used for paying of the bank loan.

Then being an being a modern lady she would want to get some jewelry for herself and she would buy a gold bangle for herself. Since she in the beginning of her career she wants to spend some of the money that she has received on some certification and career training program for example, any online course she can enroll for.

She can also use some money to donate into a charity for example, she can donate some money to the nearby NGO, she would also want to buy an insurance policy because that would cover her from some unwarranted risk in future and then if left with some more money she would be saving that money in some bank account.

Now, these are some indicated choices that Lakshmi might have. Well, each of the choices for example, buying an insurance policy, to buying a gold bangle or paying of the bank loan or paying for a career training program, the choices that are presented here include a different

characteristics in terms of risk and return. So, Lakshmi would want to make best of the money that she has received and that is why she is in the need of some financial advice.

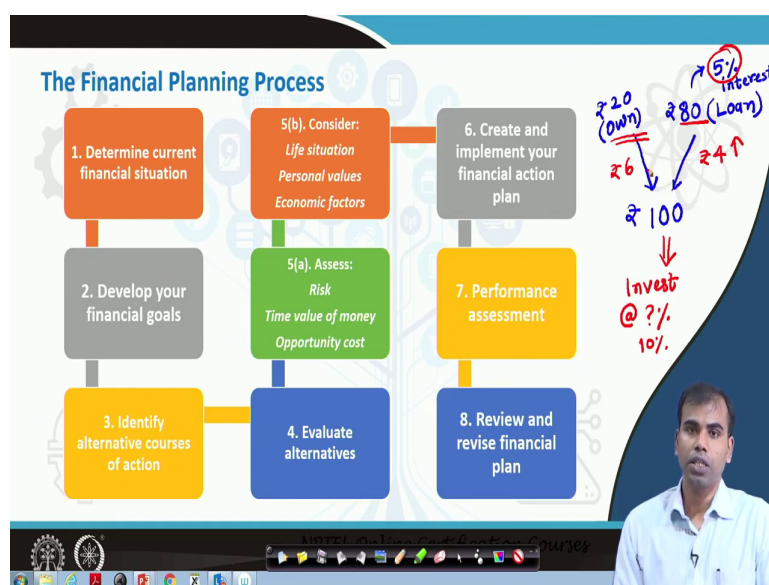
Now what could be the advice that you can offer to her? Well if you try to analyze the potential options that Lakshmi has for example, the first choice of paying of the loan, since she has already taken the loan and loan has a cost, so cost need to be borrowed by Lakshmi.

Now, if Lakshmi chooses to pay off the loan, she would reduce the cost for future and if she does not choose the option of paying loan back then the cost would continue to increase. If she choose to buy a gold bangle she is trying to create an asset for herself that she can utilize for wearing on different occasions so if she is in the process creating an asset which would be used in future in under any contingent situation. If she buys an insurance policy, she would probably be covering herself from some risk which might occur at a later point of time.

Similarly, if she enrolls for an online course or any career training program she is creating more opportunity for herself in future so, that her income in future can be increased. So, to summarize the choices that are presented to Lakshmi here are including all sort of assets and reducing the liabilities essentially mean that she can best utilize the money that she has received as a gift.

Now, this kind of situation where you have got some money and you need to make decisions regarding the money that you have received so, that you can utilize the money in productive output. Well this type of decisions require a process which we call personal financial planning.

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Now, personal financial planning is a process involving different steps where you try to understand the background of the money that you have received and their individual for which you are making the personal financial planning, also the situations which in which you are living in and the situations that you are going to get in future should be considered before you make a personal financial planning process.

Here I am going to discuss briefly the indicative steps towards effective personal financial planning process. So, when you have got some money before we discuss the sources of money let us try to understand what should be the steps next. So, the first step towards making a better personal financial decision is to determine the current financial situation, which implies that the money that you have got at this point of time before you make any financial decision for future.

Now, if you have borrowed some money or you have taken some loan from some institution or some individual and you have got that money, you need to be careful that particular money coming as a loan carries some cost and you have to invest that money in such a way that you get a return which can be utilized for paying of the cost, as well as you get some money out of it for yourself.

If you try to understand in a very subtle way here probably you would like to know that, if you have got 100 rupees of money from as current financial situation and this money is actually coming in as a loan. So, for example, you have got 80 rupee as loan and 20 rupees of your own, and this 80 rupee of loan requires you to pay 5 percent of interest. So, for example, if you have borrowed money from bank you have to pay some amount of money as interest and then you need to keep whatever you are earning for yourself.

So, here if you try to invest this 100 rupee in some financial decision or in some investment avenue, so this investment should give you some money which is going to cover not only this cost of loan, but also something for yourself. So, whatever suppose; if you earned some money at let us say 10 percent, which is basically 10 rupee of this 100 rupee. So, this out of this 10 rupee, 4 rupee will go towards the interest payment for the loan and remaining 6 rupee will be going towards your own income.

So, this is what you have to consider when you are considering the current financial situation, what it means is the money that is coming from different sources need to be invested in such a way that, the return that you are earning out of that investment should be able to cover the cost of the money that you have borrowed, as well as some money that is available for yourself.

So, once you are able to take care of the current financial situation; which means you know where the money is coming from and where you want to invest in you should try to develop a personal financial goal. So, personal financial goal should be developed in order to understand the needs and objective of the financial decision making, and then it should be taken forward for decision making. Once you are ready with the personal financial goal you can identify

different alternatives, which means the courses of action that you have to take before you go further.

So, you need to identify several alternatives for which you can take the decision. For example if Lakshmi has got 100000 rupees as a gift, she need to understand what are the course alternative courses of action that she has before she makes a decision. Once you are able to identify different courses of action; which means different investment avenues that you have you should evaluate the alternatives. Now, evaluation will comprise of two steps basically; first is assess certain attributes of the alternatives for example, the risk the time value of money and the opportunity cost.

So, if you have come up with certain number of alternative courses of action for each course of action you need to assess the risk, which is basically the uncertainty with known probability or the possibility of losing the money in the process or the fraction of money that you might lose in the process. So, you need to consider the risk part. Second component is time value of money, we have already discussed that time value of money matters among the most in terms of financial making, because money as cash flows occur at different points of time and rupee today is not equal to a rupee tomorrow.

So, when we consider the evaluation of alternatives, we need to consider time value of money as well. Third thing that you need to consider while making decision is the opportunity cost. Basically, the opportunity cost implies that, if you have not taken a decision what should be the next best alternative or the decision that you can go for. For example, if Lakshmi does not want to invest her part of her money that, she has received as a gift into buying a gold bangle what is the next best alternative that she can use this money for that is the opportunity cost.

Once you are able to understand the risk time value of money and opportunity cost in the process you need to understand the different attributes that we have discussed in last session. For example, the life situation which means; the basic demographic characteristics for example, the age, the educational background, the need of the money in future and so on. Also we need to consider the value which is basically the value system a person is coming from that

is also important before you take a decision and then you consider the assessment of economic factors.

So, these three things life situations personal values and economic factors, are to be considered before you move on to the next step of the personal financial planning process. The next step is to create and implement a financial action plan; for example, if you have evaluated different alternatives and decided that Lakshmi should invest some amount of money in insurance policy, some amount of money in upgrading her skill set by taking up any online certification or career training program, and some amount of money should go for paying off the loan.

Then you need to decide how to implement this plan, like what part of money should be going for paying of the loan and what part of money should be spent on career training and what part of money should be used for buying insurance policy. Now, that action plan has to be designed in such a way that it is optimally utilized. Once you have taken the decision you need to assess the performance of the decision that you have taken for example, if she has bought an insurance plan after some point of time she should see whether her insurance plan is going according to her wishes that she started with.

Similarly, if she has spent some money on career training program she can understand by assessment of the performance that career training program is going to be helpful in her advancing career in future or not, and similarly other investment plans or other action plans should be evaluated for the performance measurement.

And finally, once you have measured the performance and assess their evaluation you can review and revise the financial plan according to the feedback or the input that you have received after assessment. This is a broad picture of personal financial planning process. Now, I will try to take you through an example where each of these steps are discussed or indicated in a very direct way for an individual who is let us say a student.

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The Financial Planning Process

Determine your current financial plan

- Within the next two months, I will complete my undergraduate studies with a major in business studies. I have completed some projects and internships. I have a small savings fund (₹25,000) and over ₹4,00,000 in education loans. What additional information should be required to plan my personal finances?

Develop your financial goals

- I have several goals, including paying off my education loans, obtaining an advanced degree in business management, and working in a metro city for an MNC. What other goals might be appropriate for me?

Assets

Liabilities

NPTEL

So, from here I am trying to show and the example of an individual who is a college students. So, let us assume that I am the college student and I am trying to understand how personal financial planning process can be designed for me. Now, let us assume that in another two months I will be graduating my undergraduate degree so, I will be completing my undergraduate course with a major in business studies. So, I would be a student of B COM or BBA or similar courses even engineering and I have a degree in with a major in any subject domain.

Now, I have completed some of the recent research projects and internships in during my program of undergraduate studies, I have a small savings account for example, let us say I have some 25000 rupees of money in my savings bank account; however, I have an education

loan to the extent of 400000 rupees, this number could be anything these are just arbitrary numbers.

So, I have an asset of 25000 in terms of savings bank account. I have so, basically this is my asset and this is my liability. So, if you look at the first step of the personal financial planning process, the first step is to determine the current financial status. So, here the current financial status is, I have an asset of 25000 and a liability of 400000 rupees in terms of education loan. What more information should be needed? So, the other information that might be needed is what should be the next course of action or what are the alternatives that I have.

I do not have any of anything else in my hand currently so, my asset and liabilities are completely mismatched. So, I have 25000 of assets 400000 rupees of loan and I will be graduating in another two months from the college so, the choices that I have can be as follows. So, first I need to define or I need to understand my personal financial goals. So, the personal financial goals could be quite a few; for example, I should be targeting to pay off the education loan because for education loan, the moment I graduate I will have to start paying the education loan, otherwise I will have to incur cost in terms of interest payment and the principal payment repayment as well.

So, my first target or first financial planning goal should be to pay off my education loan, then I would also want to obtain an advanced degree in business management for example, I may go for an MBA or a masters in finance or any other similar domain so, that would be my next financial goal. And then one of the major financial goals that I should be targeting for is to work in a big city for an MNC or a reputed company so, that I can improve my living standards. What could be the other goals that you may consider? Maybe you can think for it, but these are three major goals that I can start with.

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The slide is titled "The Financial Planning Process (cont.)" and is divided into two main sections. The first section is "Identify alternative courses of action" and lists three options: working full time and saving, taking an additional education loan, or going for a part-time MBA and working simultaneously. The second section is "Issues with finding alternative courses of action" and lists three issues: status-quo bias, (non-)availability heuristics, and "Financial planning is too complex." Handwritten notes in red and blue ink are present, including "Assets 25,000" and "Liabilities 4,00,000" with various plus and minus signs. A video feed of a presenter is visible in the bottom right corner of the slide.

The Financial Planning Process (cont.)

Identify alternative courses of action

- I have several options available for the near future:
 - I could work full time and save for my MBA.
 - I could go to a business school full-time by taking an additional education loan. Or,
 - I could go for a part-time MBA and work simultaneously. **What else?**

Issues with finding alternative courses of action

- Status-quo bias: continue the same course of action or taking the least risky option;
- (Non-)availability heuristics: information availability and bounded rationality
 - "I don't know enough."
 - "I don't know whom to trust with my financial decisions."
 - "Financial planning is too complex."

Once we are able to assess the current financial status and develop my financial goal for near future, I can go ahead with next step that is; identifying our alternative courses of action for myself. Now, the courses of action that I have for myself are as follows. So, the first choice I have is upon graduation, I could work full time and save some money.

So, that I can pay the fee for my MBA so, that is my first choice that I have. Second choice that I have is I could go for a business school and in order to fund the education fee, or the cost of education in terms of MBA fees, I can take an additional loan so, that is my second choice.

I the third choice that I have is I could go for a full time part time MBA and work simultaneously. So, I can go for a job, and in the evening or some other mode of education I can take the part time MBA program. Now, if you try to understand this the implication of this

these choices or these alternative courses of action, you can try to understand in terms of the amount of money that I have currently and the amount of money that I will be needing.

So, as discussed earlier I have a savings account in terms of assets of 25000, and then I have liabilities which is basically the education loan, 400000 rupees for my undergraduate education loan. So, if I go for either of these alternative courses of action, the moment I go for first action which is working full time and waiting for some more years to go for an MBA, meanwhile I could save some money.

So, in that case I will be adding more money towards my asset side because I would be earning and saving some money. At the same time part of this money can be used to reduce this liabilities, which is basically paying of the education loan. If I go for second option for example, if I go for business school by taking an additional loan, I would need more education loan so, I will be increasing my liabilities by taking an additional loan, and at the same time I need to spend some money on my living.

So, I would be reducing my assets as well which is basically spending my own money on livelihood. If I go for third option which is basically part time MBA and work simultaneously, that could probably be add some money towards asset side and reduce some money some liability by way of paying some loans off and then adding some liabilities because, I will be doing some MBA simultaneously, so, I will have to pay the fee and so on.

So, these are the choices that I have if I go for either of these alternative courses of action. Now, there are there could be several other courses of action, but maybe you can think of more courses of action here for now, I can discuss the next step which is, what are the issues and challenges or factors that would be considered before you take these courses of action? Now, first issue that is coming from the behavioral economics and finance part is the status quo bias.

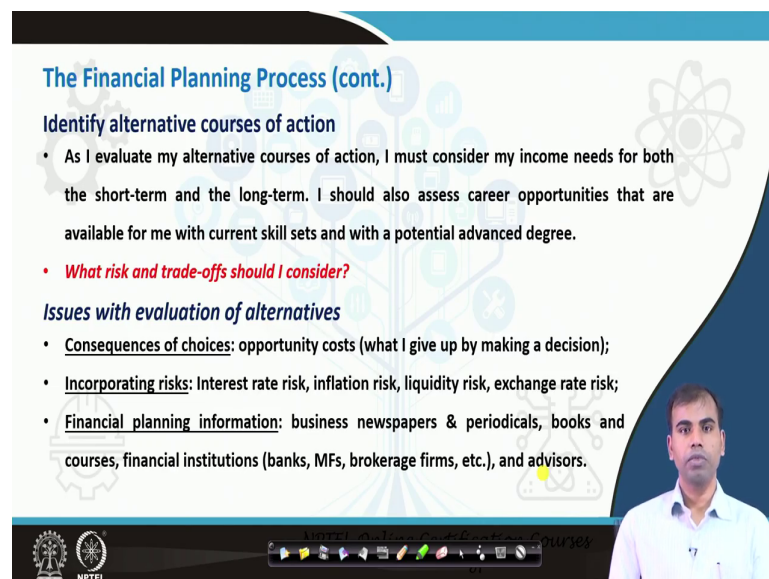
Most of the time we are stuck with our status quo and we do not want to continue with a new decision at all, and that could be the reason why we continue the same course of action for a long time because we do not want to take any risky outcome. Another issue that we need to

understand or we need to consider is the availability heuristics which is basically the information availability and the limitations of individuals processing the information.

So, the issues that you might come across when you are evaluating different alternative courses of action is; people would say that come on I do not know this enough. And maybe someone would say that you know I do not know whom to trust for taking my financial decisions or maybe they will say personal financial planning is too complex so, I do not want to take any decision on my own.

So, these are certain issues which one person might come across while taking financial decision making in fact, identifying courses of action would require to address these issues and for which personal financial planning is even more important.

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The Financial Planning Process (cont.)

Identify alternative courses of action

- As I evaluate my alternative courses of action, I must consider my income needs for both the short-term and the long-term. I should also assess career opportunities that are available for me with current skill sets and with a potential advanced degree.
- *What risk and trade-offs should I consider?*

Issues with evaluation of alternatives

- Consequences of choices: opportunity costs (what I give up by making a decision);
- Incorporating risks: Interest rate risk, inflation risk, liquidity risk, exchange rate risk;
- Financial planning information: business newspapers & periodicals, books and courses, financial institutions (banks, MFs, brokerage firms, etc.), and advisors.

The slide features a blue and white color scheme with a background of faint icons related to finance and technology. A small video feed of a man in a white shirt is visible in the bottom right corner. The NPTEL logo is in the bottom left corner.

Once you are able to identify alternative courses of action you can go ahead with the next step which is basically the evaluation of alternative courses, so, a while evaluation of alternative courses we must consider the requirement of funds, for both short term and long term. So, this step basically indicates that what are the requirement of funds in future for short term and long term as well?.

And at the same time I should also assess what are the career opportunities that could be available if we go for the different courses of action. For example, if we go for an advanced degree in business management let us say MBA, the courses of action this course of action would require some additional education loan, but it will increase my employability and career opportunities in future, substantially and thereby I can increase my income generation capabilities in future to large extent.

If I go for let us say part time MBA and work simultaneously, I should be working for a lower pay and my job employability or the career opportunities in future might not go as planned. So, there are certain issues and of risk and return trade off or the economic trade off that we need to consider, and these issues are as follows.

So, first of all we should be ready to consider or evaluate the consequences of choices, and which is basically in one term the opportunity cost that is if we give up something for taking a decision that thing is basically the opportunity cost in economic terms, which is as discussed earlier the next best opportunity or the alternative that you have for making a decision is your opportunity cost.

So, if you are making a choice of going for an MBA, the next best alternative that you have is to for doing the job full time, which means the money that you will be making in the process of doing job full time is the opportunity cost for doing an MBA. If you go for a part time MBA probably, that would reduce the opportunity cost; however, there will still be opportunity cost associated with the decision. Second issue that you need to consider as a trade off is incorporating risk into your decisions.

Now, risk could be of different types for example, the interest rate risk such as if you go for an MBA right now the rate of interest on education loan would be lower than the rate of interest on education loan that might happen 2 years down the line. So, that would be the simple example of interest rate risk. Which means the cost of money that you are spending today would be different from the cost of money that you would be spending 2 years hence.

So, interest rate risk is one such factor, there are other risks such as inflation risk, liquidity risk and exchange rate risk more particularly when you are going abroad for education or career then exchange rate risk is very important. Third factor that we need to consider while taking personal financial decision in terms of evaluation of alternative courses of action, is per financial planning information.

Now, the factor here is the sources of information that we are considering for making our decision typically are business newspapers and magazines, books and courses that we attend in different institutions and organizations. And personal financial institutions such as banks, mutual funds, brokerage firms, and trading firms are also financial advisors. So, now you should also always consider a trusted source of information for making your financial decision or evaluating your alternative courses of action.

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The Financial Planning Process (cont.)

Create and implement financial action plan

- I have decided to work full-time for a few years while I:
 - *Pay off my education loans;*
 - *Save some money for business school; and*
 - *Take a couple of courses online and in evening/weekend classes.*
- *What are the benefits and drawbacks of this choice?*

Review and revise financial action plan

- Over next 6 to 12 months, I should reassess my financial, career, and personal situations. What employment opportunities or family circumstances might affect my need or desire to take a different course of action?

The slide features a background with a blue and white color scheme, including a stylized atom icon and various business-related icons like a laptop, bar chart, and gear. The presenter is a man in a light blue shirt, visible in a small video window at the bottom right. The NPTEL logo is in the bottom left corner.

Once, we are done with our identifying alternative courses of action the next step is to create an implement financial action plan, which means in the case of the student that has just graduated or is about to graduate. The case that I was starting with is that the individual has taken a decision to work full time and wait for a few years before going for an MBA.

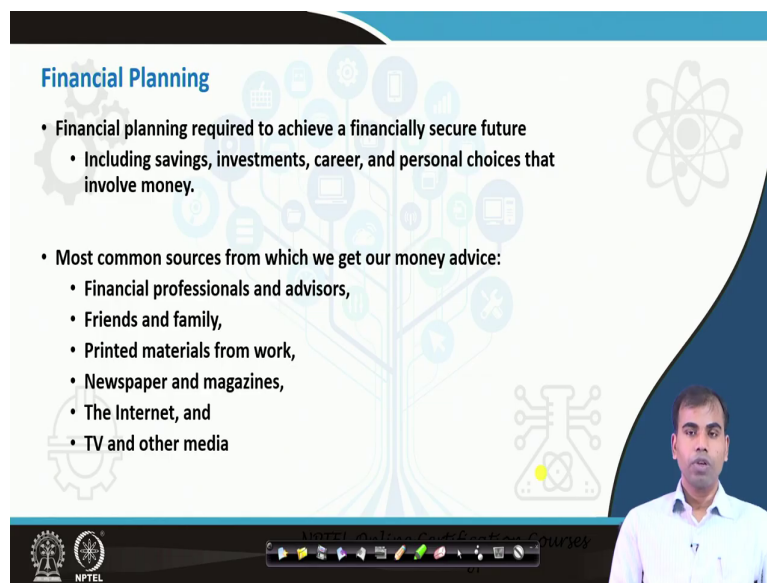
So, the choice that I have as an individual is I will be able to pay off my education loans, I will be able to save some money for business school education which is for MBA and I can simultaneously take a couple of courses online and in evening or weekend classes so, that the chances to improve my career alternatives or career opportunities in near future could be improved.

So, these are the three associated tradeoffs that I have, what could be the other benefits or drawbacks that you can think of maybe we will see. Finally, once we have taken a decision

maybe in 6 month or 12 months we should always reassess my personal, financial and career situations just as the beginning. And in the process we need to consider the employment opportunities that we will be getting in future or the family circumstances that we are living in because all these factors might affect my needs and desires to take a different course of action.

For example, if I start decided to work for a few years before I go for an MBA maybe if the job market is really bad probably, I would not like to continue with the job rather try for an MBA by taking an additional loan, and hope that in next 2 years the job market would improve and then my career would take a better direction. So, these are some things which one should consider before making the personal financial planning.

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Financial Planning

- Financial planning required to achieve a financially secure future
 - Including savings, investments, career, and personal choices that involve money.
- Most common sources from which we get our money advice:
 - Financial professionals and advisors,
 - Friends and family,
 - Printed materials from work,
 - Newspaper and magazines,
 - The Internet, and
 - TV and other media

The slide features a background with various financial icons like a tree, gears, and a person. At the bottom left, there are logos for IIT Bombay and NPTEL. At the bottom center, there is a video player interface with a speaker icon. On the right side, there is a video inset showing a man in a white shirt speaking.

We have just discussed how personal financial planning can be done in a systematic process, and what factors one should consider while making personal financial plans. So, we have

already discussed how different sources of information for personal financial planning can be utilized for making a better decision. We know that a successful personal financial planning is required to achieve a secure financial future, and it also involves not only savings, but investments, career decisions and personal choices that might involve money. That is all for now.

Thank you very much.