Behavioral and Personal Finance
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Module – 02
Personal Finance
Lecture – 34
Consumer Credit Decisions

Hello dear, welcome back to the course Behavioral and Personal Finance. If you have made this far, I am sure you have understood a lot of factors that affect our behavior in terms of financial decision making and how we make decisions related to our personal financial management.

If you follow business and economic news, you must have come across issues and news related to industrial slow down and how the country is progressing towards a possible recession. Well one of the factors that was attributed in the news reports was the availability of credit for individuals as well as for industries.

In fact, one specific example if you would like to cite here is the slow growth in sales of automobiles. Well news report cited that the manufacturing companies associated with automobile sectors are facing slump because of a low demand from the consumer side.

Whereas some other reports suggested that the availability of credit has been attributed to the slow in demand coming from the consumers. Well this session will focus on how consumer credit is an important issue in terms of personal financial management and how these factors relate with a general economy as well as the specific financial goals and objectives that we want to achieve.

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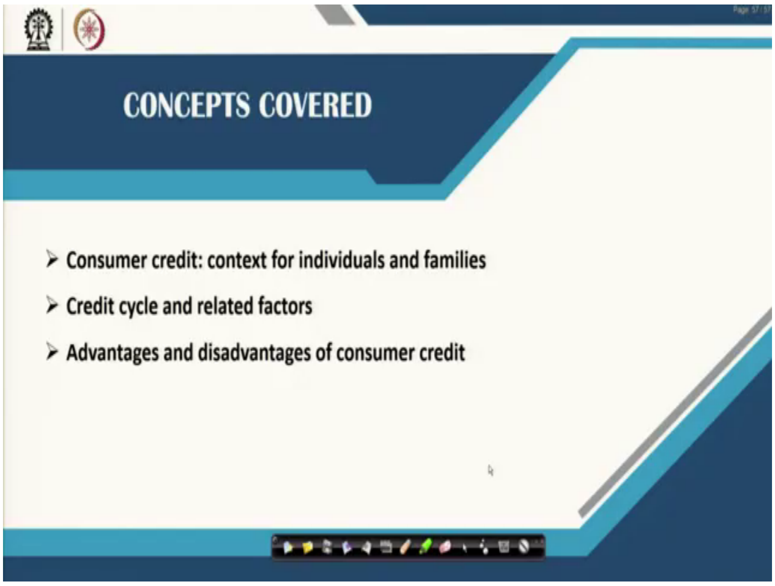

This particular session focuses on the following issues, we discussed briefly about the basics of consumer credit and in the consumer credit examples in the context of individuals and families. We also try to understand credit cycle and the factors that affect this credit cycle specifically for individuals. And the advantages and disadvantages of consumer credit in terms of personal financial decision making.

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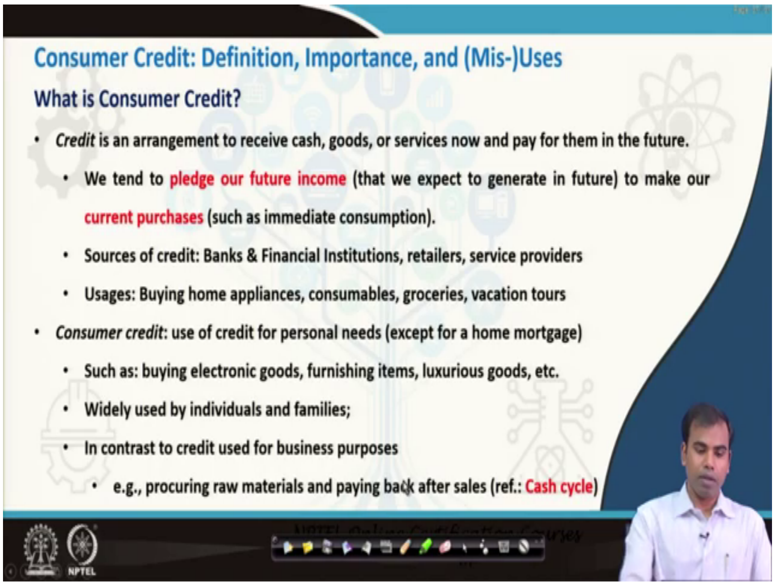

When we try to talk about consumer credit, we first understand the definition of credit. Basically, credit is an arrangement where individuals, or families, or entities receive some cash, or goods, or services for now and they are liable to pay back in future. Basically, the individual or entities that offer such facilities of credit in terms of cash goods or services are known as lenders.

Whereas, the individual's household families and entities that avail this services or this facility are known as borrowers. Typically, the borrowers tend to place their future income that they expect to receive in future against the purchases and the uses of the facilities of or goods or services in present time.

So, essentially it is about present consumption or immediate consumption in return for a portion of their future income. The lenders include the banks, financial institutions, retailers, service providers these are the providers of credit. Whereas, the individuals who borrow or the set of borrowers include individuals, or families, or household.

Typically, the facility of credit is availed by individuals or household for purchases of appliances, consumables, groceries, sometimes vacation tours. And other consumable items in term including goods and services. When we try to focus more on consumer credit basically this is the line of credit or the arrangement of credit for personal needs except for a home mortgage. For example, individuals or household would like to borrow money or avail the credit facility for buying electronic goods, furnishing items in their houses, luxuries goods, and other related items.

Basically, this type of credit arrangement or the facility to avail goods or services for now in return for a future payment is widely used by individuals and families with different strata of society. In contrast to credit use for business purposes where business houses or organizations procure raw material or other input material on credit. And pay back after sales which typically is known as cash cycle.

The credit cycle or credit available for consumers or individuals has a different structure. If we try to understand the cash cycle related to business organizations, we can see that the cash cycle for businesses begin with cash. It passes through different phases of cash and then it converts cash into some more amount of cash in the process.

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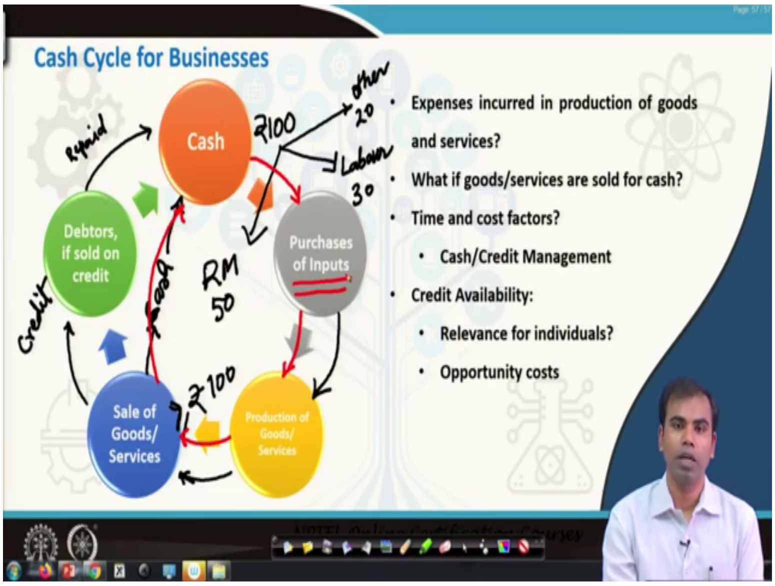

If you try to understand business cash cycle this follows certain pattern, where cash is availed by businesses from different sources of money. And then cash is used for purchasing of inputs which is put into production process for manufacturing of goods and services. In the process cash is consumed for raw material, and labor, and other expenses.

And once the production process is complete the production of sales or goods or services are available for sale. And the sales can be made for credit or cash and subsequently the business organization generate further cash. Basically, this is a process where cash is converted into cash. If we look at more specific examples, we can see that suppose a business organization starts with an amount of 100 rupees of cash, this cash is used for purchasing raw material and labor and other expenses.

So, let us say raw material is consumed for 50 rupees, and labour is used for 30 rupees, and other expenses is for 20 rupees. So, this these three inputs are put into production process and then the cash is converted into product or service which is worth sale sales for more than 100 rupees. So, this particular cash cycle when it is moved from raw material to production process and to finished goods which are ready for sale is sold to and credit.

Or it can be sold for cash which is directly converting the cash into cash or if it is sold on credit is finally, recovered and repaid by a repaid by the buyers who have bought or availed your goods or services. And subsequently it is converted into cash, this is a typical cash cycle for businesses. If goods and services are sold only for cash which is basically this particular phase of cash for example, cash is converted into raw material, raw material is converted into production process.

Production generates goods or services and then goods and services directly converted into cash because there is no credit sale. Here, the credit availability is not a concern, but we understand that most of the businesses function on credit.

So, they buy raw material on credit, they try to sell the final product or the goods or services that they manufacture or produce on credit. And in the process they consume lot of credit availability. Similarly, if you try to contextualize this particular cash cycle in terms of individuals, we know that individuals also have limited sources of cash.

But there are more than multitude of output where they have to utilize their cash sources. And in the process, they may find some conflicting utilities for cash. Now, availability of credit makes it very easy for them to make any purchasing or consumption decision.

For example, if they have to buy a home appliance such as a television and they have to spend a lot of money a big part of their monthly salary on purchasing that particular television. They will not be left with sufficient amount of money for spending on other expenses such as groceries, education, rent, and other expenses.

In such cases the availability of credit becomes very important and that is why this cash cycle in the context of individuals becomes even more critical. Where for every purchases they have certain credit availability and when they have to buy certain items on credit they have to make sure that the repayment of that items or goods that they have purchased on credit should be done in timely manner. So, that it does not accumulate and create a burden on their future income.

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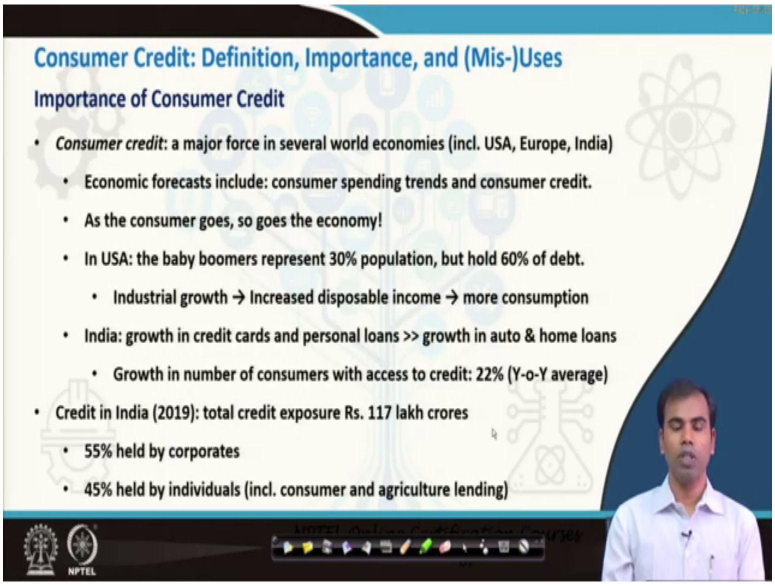

Now, that we understand the importance of credit let us try to focus on importance on consumer credit. Basically, consumer credit is considered to be a significant force in any economy. When you talk about the US economy, or European economy, or an emerging economy such as India we know that consumer credit has become very important to force the overall economic growth in these countries.

We know that several economic forecasts given by agencies like world bank or, international monetary fund, or any other economic think tanks. It includes that consumer spending and the trends in consumer credit and availability of credit for other stakeholders in the economy basically drive the growth of the economy.

In fact, there is a metaphorical saying that suggests that as the consumer goes, so goes the economy which implies that if the consumer is borrowing a lot of money. Basically, economy also drives towards that particular direction. And if you look at some examples in USA the baby boomers represent almost 30 percent of the population. But, on a on an average basis they hold almost 60 percent of debt which is basically a result of industrial growth in late forties and early fifties.

And that subsequently led to in more disposable income for those families who were benefited from industrial growth. And later on their consumption pattern has changed and subsequently they used their money or their resources on buying and consuming more and more goods and services.

When it comes to India, we have seen that growth in credit card and personal loans has substantially increased. And we have noticed that the percentage growth in credit card and personal loan is substantially higher than the percentage growth in automobile and home loans. Basically, it indicates that growth in number of consumers with access to credit has exceeded 20 percent on year on year basis.

And if we look at some more numbers here credit in India as a as of 2019 has been to the extent of 117 lakh crores out of which almost 55 percent that is more than 65 lakh crore rupees of loans and credit were held by corporates. Whereas, 45 percent of this credit exposure was held by individuals that includes consumer and agriculture and other prime sector lending.

These data suggest that for any economy, the growth is driven by the consumption pattern of its population. As well as how the population or the people living in the economy are spending their money and whether they are driven by the availability of credit for their consumption.

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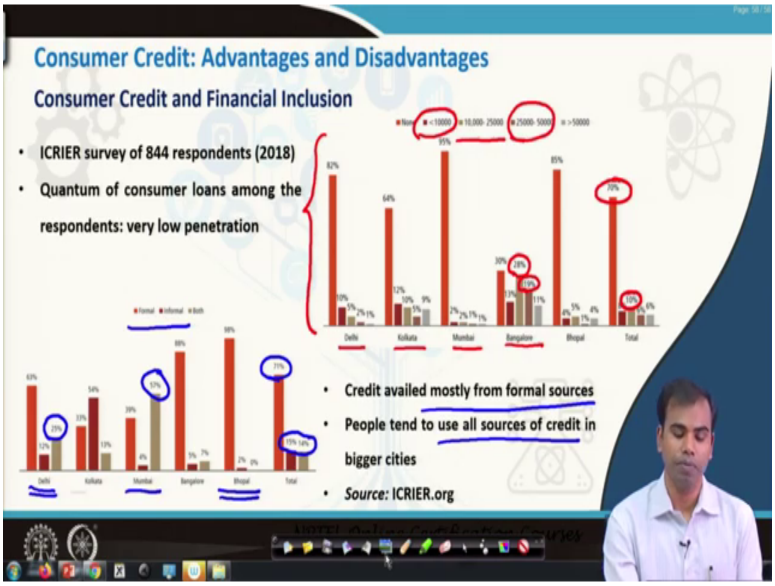

If you look at some more numbers here, we know that the emerging economies have always focused on financial inclusion. And in a recent survey conducted by Indian council for research in international economic and resources. They conducted a survey of almost 850 respondents and their findings are very interesting.

If you look at the graph shown at the screen, we see that in first graph the quantum of consumer loans among the respondents very is very low. And the growth or the amount of loans that has been disbursed or that has been availed by the individuals who have been part of the survey is varying from one city to another city.

So, basically the loans which are of lower value for example, if you look at this graph. The loan which are of a well lower value such as less than 100 rupees are very low in terms of penetration for cities like Delhi, Mumbai, Kolkata, and Bangalore. Whereas the loans which are in the range of 10000 to 25000 they are also low in Delhi, Kolkata, and Mumbai.

But, in cities like Bangalore the amount of loan amount of consumer credit or consumer loans to the extent of 10000 to 25000 is substantially higher. In terms of higher amount of loan which is 25000 to 50000 again a city like Bhopal has substantial amount of exposure towards a loan of that quantum. So, overall we know that people who have no loans on an average are basically comprising to the larger part of the survey respondents.

Whereas, people who have taken loan of 10000 to 25000 are basically falling in this category where they have almost taken a loan of a range between 10000 to 25000. This indicates the credit availability for consumption purposes, basically the respondents are middle class working people who have availed the loan of the range between of between 10000 to 25000.

And this these loans are taken for immediate consumption or consumption of the home appliances or home furnishing or any such immediate consumable goods. If you look at the other side of the survey the other graph that is shown on the left side of the screen. In these 4, 5 cities we know that the source of these loans that have been availed by the respondents in the survey are basically mixed in terms of the sources of credit.

And mostly are coming from formal sources whereas, city in bigger cities they use all sources of credit available. What all sources include is formal and informal sources such as banks and other sources of credit. So, if you see in cities like Bhopal most of the people have availed loans from formal sources. Whereas, in a city metro city like Delhi people have availed loan from both a formal and informal and almost 25 percent of the respondents have availed loan from both sources.

In a city like Mumbai people have taken loan from both formal and informal sources and the participant percentage of participant availing these loans are substantially higher than other cities. So, on an average the most of the people have taken loan from formal sources. Whereas, people who have taken loan from both formal and informal as well as people who have taken loan from informal sources are more or less same.

These numbers indicate that the people's tendency to avail credit for their immediate consumption is totally dependent on the geography and the economic development of the area and locality. And it is also directly related to the amount or the quantum of loans that are available and that are accessible to them. When we look at some more summary statistics or some summarized finding of the survey.

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We can see that the objective of financial inclusion can be achieved through availability of consumer credit. And we have seen that in this survey almost 89 percent of respondents are those who have their regular bank accounts. Which means they have understand, they have understood the availability of banking services and the availability of consumer credit through formal and informal sources and they maintain their bank account,

75 percent of respondents are open to consumer finance which means for buying items such as television or mobile phone, they know that they can have access to formal and informal sources of credit. So, consumer finance is easily available for them and then they can make purchase decisions. 55 percent of respondents are those people who have bought at least one product or goods or services in last one year which has some exposure of consumer finance or consumer credit.

And only 38 percent of people in the survey have used financial apps for availing these financial services such as consumer loans or consumer finance services through mobile apps. The finding of the survey indicate that financial inclusion as an objective in the economy can be achieved with the help of more availability of consumer credit. And alternate channels through which people can avail these consumer credit alternatives.

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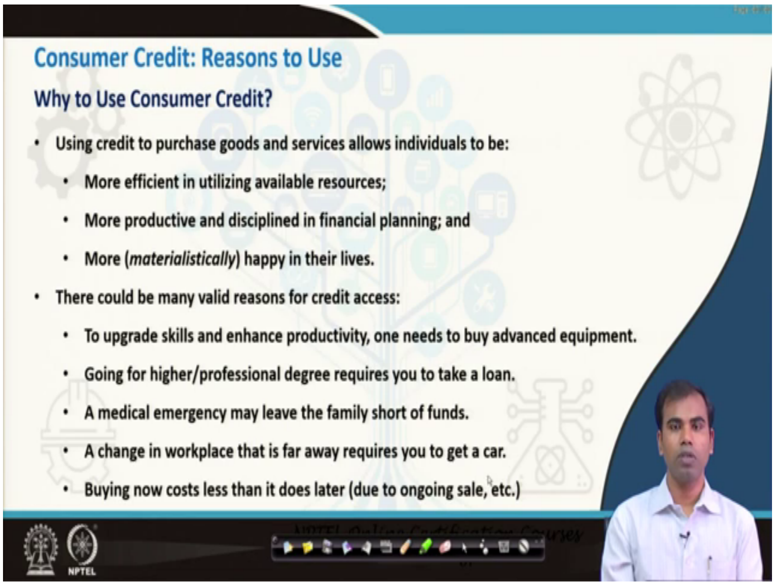

Now, when we talk about consumer credit and its advantages and disadvantages, we must understand why is it important to use consumer credit as a source of finance. Now, we know that consumer credits are meant for marginal consumers or those who have limited access to credit or alternate sources of credit. Basically, these people are middle income group who have limited access to formal channels of finance. And they have very stable and regular source of income although not in high quantum.

But they can use this source of income as a guarantee for availing consumer credit. So, the reasons for which consumer credit can be made available to them include the basic purchases of goods and services. Because, when they use credit for purchasing goods and services these services or these facilities of consumer credit allows individual to be more efficient in terms of utilizing the available resources.

So, by using consumer credit alternatives they can utilize the resources in a more effective way. They can be more productive and disciplined in terms of financial planning, because once they borrow money to purchase some goods or services, they can be more disciplined in terms of paying the amount that they have borrowed from their future income. In some cases, they can be moved they will be more materialistically happy because they will be able to consume what they want to consume.

For example, if an individual wants to own a smart phone or a better smart phone that person can avail consumer credit to buy a smart phone and more happy and productive at the same time. There are several reasons for which credit access is an important factor for any society, we know that credit access makes people help to upgrade their skill set and enhance productivity.

For example, if a person is going for a higher education or professional degree, he or she needs to access consumer credit or any such facilities which require him or her to upgrade their skill by buying let us say a computer that might be required for technical education or a software that might be required for his educational degree.

At the same time access to consumer credit will help people in medical emergency where they may have shortage of resources. And access to credit will save them from medical emergency. It also make people change their workplaces depending on their skill set and upgraded skills and sources of income can be improved.

Because, if they can avail consumer credit the change in workplace if it is very far they can easily buy a car and commute to their workplace, so they can be more effective and productive. We all understand that buying now will might cost less compared to buying in future because the prices might go up. And it is always wise to buy at a lower price that is current time.

If you buy at a later stage may be we have to pay a higher price that is why consumer credit makes it possible for individuals to buy at a lower price. If available in present time compared to the product same product or service that might be available at a higher price in future.

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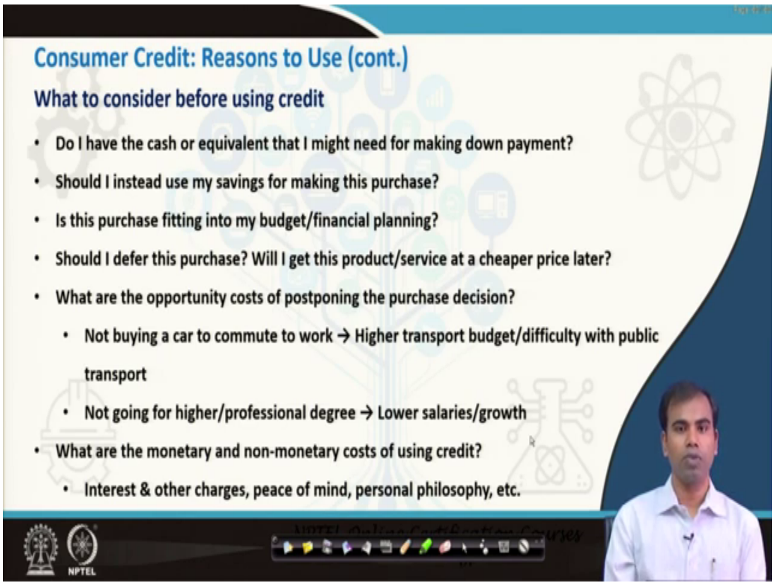

There are certain things which we need to consider before we access consumer credit. The questions that we must always ask ourselves or those who are availing consumer credits are as follows. First of all, we must ask whether I have the sufficient amount of cash or equivalent resources that I might need for making the down payment. For example, if I want to buy a car and that requires me to pay upfront certain amount of money.

If I have that much amount of money or not, then only I can decide whether to go for a consumer credit access option or not. Similarly, we can also ask if I should instead use my savings for making this purchase. For example, if I want to buy a smart phone, I can use my savings that I have made over previous months. And that can be used to buy that particular commodity instead of going for consumer credit option.

Similarly, if I have to make a purchasing decision I will think if the purchasing fits into my budget or financial planning. Because, sometimes we might end up buying things that are not fitting into our budget or that are beyond our financial planning and that will be a bad financial decision. We can also ask if we should deter this purchasing decision for future maybe in future the prices of that particular commodity go down and i can get it for a lower price.

This happens most of the time when the technology of up gradation happens the product with product manufactured with better technology are available for a lower price, it may happen vice versa as well. So, there are certain issues such as opportunity cost, and time value of money. Because opportunity cost makes it makes it easy for us to decide whether to go for a particular purchasing decision or not. For example, if I have to buy a car for commuting to my work.

I will consider buying or not buying a car to commute to work if I know that the higher transport budget or difficulty with public transport is going to be a big deterrent or very difficult for me to handle. In that case, I would rather buy a car even by accessing consumer credit. For example, similarly if we have been unhappy with our lower salaries or growth in our job we would like to go for a higher professional degree or a skill up gradation. In that case accessing consumer credit will makes it possible for me to go for it.

There are certain monetary and non-monetary cost of using credit. For example, interest and other charges are monetary cost if we avail consumer credit, we have to make certain interest payment and other charges. At the same time non-monetary cost include peace of mind, personal philosophy because some people might not like to borrow money to consume.

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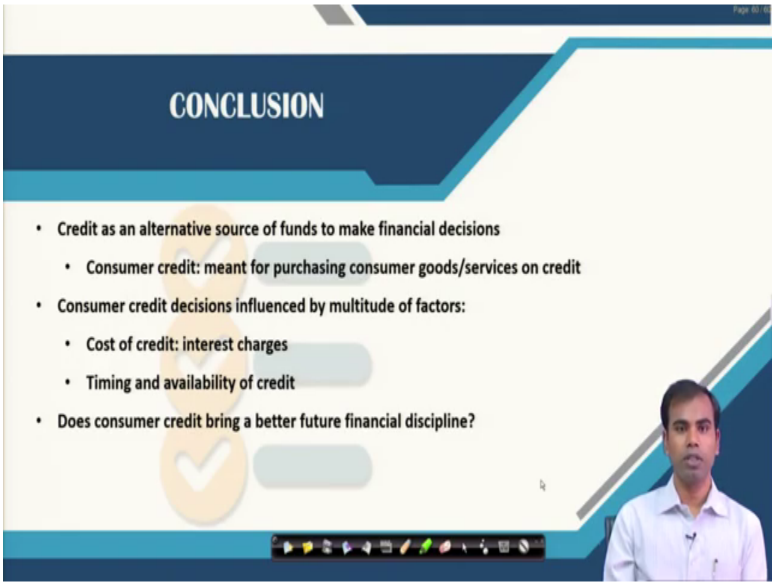

So, these are some monetary and non-monetary factor that we must consider. As a whole we must understand that consumer credit is a mean for purchasing consumer goods or services on credit. Unlike organizations or business entities that have several lines of credit for buying or selling of their product.

Individuals have very limited sources of credit for example, banks, and financial institutions, retailers, service providers, offer them some consumer credit for a very short term duration that can be availed for purchasing decisions. mainly consumer credit decisions are influenced by factors such as cost of credit that is basically the interest rates, or interest charges, and other expenses.

Timing and availability of credit are other factors such as the availability of credit immediately at a lower cost, by vis a vis availability of credit later on at a higher cost and vice versa. These factors affect the decision to go for consumer credit for individuals and households. Another question that we must understand and try to answer whether consumer credits brings a discipline in financial future planning.

Because, if we borrow money we might end up paying part of our future income as a payback to the money that we have borrowed. At the same time we might be motivated to earn more, so that we can reduce the burden of loans or consumer credit and improve our livelihood. These are the factors that must be considered while considering or deciding about the consumer credits; for now, this is it.

Thank you very much.