The Impact of Emotional Factors on Household Financial Decision-Making: An Exploratory study

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Abstract

This exploratory study investigates the role of emotions in the personal finance decisions of households. Personal finance management is often perceived as a rational process; however, emotional factors can significantly influence financial behaviours. The study explores how emotions such as fear, anxiety, happiness, and excitement shape the financial choices of households, affecting budgeting, saving, investing, and debt management. Through qualitative interviews and surveys, the research identifies emotional triggers that impact decision-making and financial well-being. The findings highlight the complex interplay between emotion and financial behavior, emphasizing the need for more emotion-aware financial education and policy-making. The study contributes to a deeper understanding of how emotions influence household financial practices, offering insights into the importance of addressing emotional factors in personal finance strategies.

Keywords: Emotions Factors, Personal Finance, Household Financial Decisions, Financial Decision Making, Emotional Triggers, Budgeting, Saving, Investing, Financial Education, Financial Well-being.

Introduction

In the context of personal finance, household decisions are often shaped not only by rational considerations of income, expenses, savings, and investments, but also by emotions. The role of emotions in personal finance has become a focal point of exploration in recent years, particularly as global economic shifts influence financial behaviors across various socioeconomic strata. While traditional financial theories have primarily emphasized rational decision-making and market efficiency, the modern theory of finance recognizes the significant impact of psychological and emotional factors on financial decision-making. This shift in understanding is especially pertinent when examining the diverse financial practices of households across different income groups—low, middle, and high.

The global economy plays a crucial role in influencing these emotional responses to financial decisions. Economic uncertainty, inflation, recession, or financial crises have profound emotional consequences, which in turn shape individuals' saving habits, investment decisions, and even their trust in financial systems. Financial decisions, whether it be purchasing a home, managing debt, or investing for retirement, are often influenced by an individual's emotional state, stress levels, and perceptions of security or risk.

Traditional finance theories, grounded in the assumptions of rationality, suggest that individuals make financial decisions based solely on logic and objective analysis of available information. However, the rise of behavioural economics and the modern theory of finance challenges this by incorporating emotional and cognitive biases into financial decision-making. These theories acknowledge that emotions, such as fear, greed, anxiety, or optimism, often drive financial choices in ways that deviate from the predictions of classical financial models.

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Household finance varies across different income levels, with low-income, middle-income, and high-income households exhibiting unique emotional responses to their financial environments. Low-income households, for instance, may experience heightened financial stress due to the constant pressure of meeting basic needs, while middle-income households may balance emotional considerations with aspirations of upward mobility. High-income households, though often more financially secure, are not immune to emotional responses such as overconfidence in investment decisions or excessive risk-taking.

This exploratory study aims to investigate the role of emotions in personal finance across different household forms, highlighting how emotional dynamics influence financial behaviors and decision-making within the broader context of the global economy. By exploring these emotional influences, we seek to provide a more nuanced understanding of personal finance that transcends traditional financial models and incorporates the complex psychological aspects of human behavior.

WHAT IS PERSONAL FINANCE?

- ✓ The term Personal finance refers to planning, implementing, and managing financial activities that impact individual households.
- ✓ These financial activities include income, spending, saving and investing, and borrowing.
- ✓ Thus, Personal Finance is that branch of finance which study personal and household financial resources which are considered important in attaining financial welfare of the family.
- ✓ It undertakes that how individual spend, save, protect, and invest their financial resources.

COMPONENTS OF PERSONAL FINANCE OF HOUSEHOLDS

RELEVANCE OF PERSONAL FINANCE IN DAILY ROUTINE OF HOUSEHOLDS

- ✓ It helps to meet money and security needs time to time.
- ✓ It helps in budgeting, saving, and spending estimation.
- ✓ It helps to increase cash flow of investor.
- ✓ It helps to keep set aside unmanageable debts.
- ✓ It helps to grow wealth.

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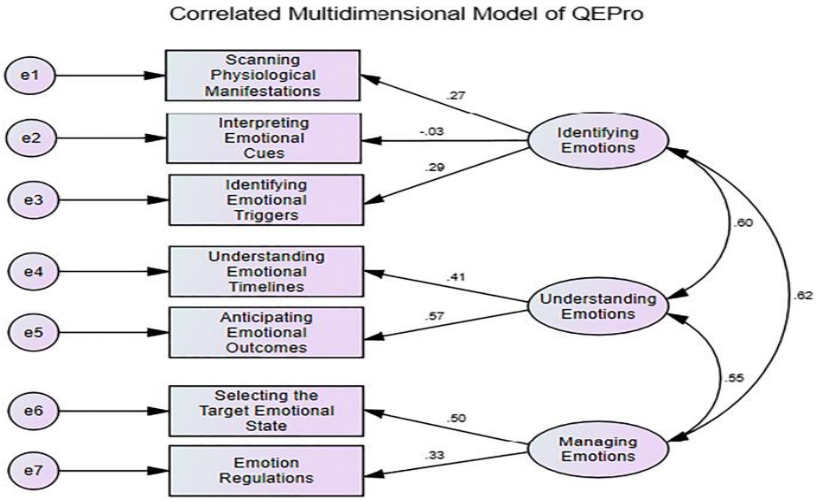
RELATIONSHIP BETWEEN EMOTIONS AND PERSONAL FINANCE OF HOUSEHOLDS

- ✓ Daniel Kahneman (Psychologist) a Nobel-laureate stated that people make personal financial decisions based on emotions that account to 90% whereas based on logic only 10%.
- ✓ Therefore, we cannot underestimate the significant role of emotion or emotional intelligence in financial decisions making of either individual or household investors.
- ✓ Many studies conducted in the past has proved that emotion have both positive as well negative impact on financial decision making of investors.
- ✓ Each component of EI directly or indirectly influences financial planning of investors.

No one can deny the role of Emotion because it has developed as one of the imperative elements of people' life.



Compelling Emotional Intelligence Statistics

- ✓ Nearly everyone (95%) thinks of themselves as self-aware, but only about 15% of people are.
- ✓ Peers were reported to be the most unaware co-workers.
- ✓ EQ is four times more reliable than IQ in determining success in your field.
- ✓ Leaders with empathy perform over 40% higher in employee engagement, decision-making, and coaching.
- ✓ Emotional intelligence has a 58% influence on job performance.
- ✓ 90% of top-performing employees have high emotional intelligence.
- ✓ 71% of hiring managers value EQ over IQ when looking for employees.

Literature Review

Emotional Intelligence

Emotional intelligence is the ability to recognize one's own and other people's emotions, to differentiate between different feelings and label them appropriately, and to use emotional information to guide thinking and behaviour. Thorndike and Stein (1937) proposed the existence of social intelligence for the first time which they define as the ability of a person to understand and manage people. According to them social intelligence is the process to identify one's own emotions and other people's emotions and internal states and because of act in a proper manner.

Emotional intelligence leads to effective decision making (Ladd & Chan, 2004). Social intelligence consists of social skills that are very crucial element, comprising of capabilities such as to involve oneself in social relations, to handle different situations, knowledge of social norms, team management, and individual problem resolving skills (Riggio & Reichard, 2008). In past, social intelligence was supposed to be a more important determinant than emotional intelligence to measure intelligence of individual. Today emotional intelligence is thought to be a more major factor to determine intellect than social intelligence. The focus of emotional skills is on emotions. Skills of both IQ and EQ are different from each other (Riggio & Reichard, 2008). The base of the idea of emotional intelligence is the idea of social intelligence (HjYunus & Hassan, 2012).

Investment decision is the determination of an individual to where and when to spend Capital and how much Capital to be spent in the search of making a profit. Investment decision making changes with the period in terms of diversification and trading frequencies. However, an effective decision-making strategy is essential for investment decision. Experienced and aged investors prefer high diversification, hold low risk portfolios, trade less frequently and this investment skill becomes worse at an age of 70 (Korniotis & Kumar, 2010). The reliability of investment decisions is based on effective investment return strategy development (Rutkauskas & Stasytyte, 2008). It is not necessary that agents behave rationally on several aspects of decision-making process that is not completely understood so far (Scalliet, Karoui, Jeanblanc, & Martellini, 2008). Investors need to know the combined distributions that show possible results of their investment decisions since they do not know the outcome of their investment decisions (Weber, 2005)

Emotional Intelligence and Investment Decision

Salovey and Mayer (1995) were the first who introduced the concept of emotional intelligence. According to them, emotional intelligence is the capability of identifying opinions and feelings of one and others and differentiating between these feelings to aid to run thoughts and actions. Their model of emotional intelligence faced a lot of censure. Later, Mayer, Caruso, and Salovey (1999) reported this censure in their paper; there is no proficiency to link emotions with intelligence as intelligence is more controversial area and emotions would be unable to measure the complete range of intelligence. They make a speech that emotional intelligence is a systematic mental phenomenon and this capability is a kind of intelligence. Emotional intelligence shows a discrepancy among people as some people have high while others have low emotional intelligence; some have more knowledge of their feelings while others have not and this familiarity gifts them with ability to control their own feelings and compare to other. There is a connection among emotional intelligence, personality, and clinical psychology (Mayer & Salovey, 1995). They categorize emotional intelligence into emotional orientation, emotional involvement, and emotional expertise. Later, Goleman (2010) categorizes them into four more elements such as self-awareness, self-management, social awareness, and relationship management. Self-awareness is the ability to understand the emotions that are disturbing our thoughts and subconscious in mind and lead us to think in some directions (Quinn & Wilemon, 2009). Self-management is the ability to control one's emotions and prevent one's self from acting on coercion without considering thought and emotional reaction (Quinn & Wilemon, 2009). Social awareness is the ability to have knowledge of people from different experiences or from different cultures (Barling, Slater, & Kelloway, 2000). Relationship management is the management of other people's emotions.

Different researchers have different opinions about emotional intelligence. People who are good at joining thoughts to their feelings are well knowledgeable about emotional intelligence; they have good understanding of their and others' emotions as well (Mayer & Geher, 1996). Emotional intelligence is identifying one's own and other's emotions and used to solve problem (Schutte, Malouff, Hall, Haggerty, Cooper, Golden, & Dornheim, 1998) and can understand the elements; how they vary, and as a result perceive about emotions (Mayer, Caruso, & Salovey, 2000). EI involves three different components such as assessment and appearance of emotions, regulations of emotions, and practice of emotional information in thinking and acting (Petrides & Furnham, 2000). The capability to identify emotions is one of the crucial elements of emotional intelligence and it is useful in forecasting the social success (der Zee, Thijs, & Schakel, 2002). It is a major factor of real-life result (Saklofske, Austin, & Minski, 2003) and success (Alon & Higgins, 2005). Emotional intelligence has four subdivisions: perceiving emotions, using emotions to enable thought, understanding emotions, and managing emotions (Y.-H. Yao, R.-T. Wang, & K. Y. Wang, 2009) and also identifies the relationship between feelings, thoughts, and behaviour (Ahang & Rooshan, 2010). The idea of emotional intelligence covers psychology and controlling of multiple features such as emotional perception and understanding of emotions (Lu, Bai, & Wang, 2011) and enhances the decision-making process (Scott-Ladd & Chan, 2004). Emotional intelligence is an important determinant in decision making process. People who have high EQ and have good management of their emotions could develop the skill to accomplish their goal and understand the outcome of causes that affects the results. Sevdalis, Petrides, and Harvey (2007) reported that decision makers presume their emotions before making a decision and they practice them when they receive the outcome of their decisions, and they recall their memory when they suppose former decisions as good or bad. The path of emotional intelligence goes to progressive results because it raises the confidence level of individuals (Gardner & Stough, 2002).

Emotions influence decisions making and are considered as a tool to solve problems in decision making (de Laar & Neubourg, 2006). This capability of emotional intelligence not only improves the system of decision making but also the consequence of the decision making. Individuals who are self-aware can make more effective decisions than other (Hess & Bacigalupo, 2011). Like other frameworks, emotional intelligence is also a major determinant of making optimal financial and investment decisions. As in other frameworks, emotional intelligence is also a good characteristic of investment decision making and is supposed as a major tool in increasing the effectiveness of individual in dealing their crossing point with participants (Quinn & Wilemon, 2009). From the above discussion we can conclude that individuals who have high emotional intelligence will have more chances to have successful results of their investment decisions than those who have less emotional intelligence. Emotional intelligence is positively related to investment decision making.

Financial Literacy and Investment Decision

Money is an important component in our social life and a source of finance. To make an effective utilization of money, one can save or invest it in financial market and should have important financial information to know the trading of financial product in market (Zvaríková & Majerová, 2013). Financial literacy is the combination of knowledge, skills, and confidence necessary to make liable financial decisions (Altman, 2012). There is a positive relationship between education level and literacy. There is a strong relationship between the general education and financial literacy (Duca & Kumar, 2014). Educated people know well the changing aspects of financial market than uneducated people. The need for financial literacy has become significant after the advancement in financial markets (Marcolin & Abraham, 2006). Social relations with colleagues, friends, and family members have significantly influenced individuals' financial knowledge and decision to actively take part in financial markets. Word-of-mouth communication conveys information effectively due to geographical closeness (Bönte & Filipiak, 2012).

The outcomes are different from high and low literacy of financial instruments. According to Rooij, Lusardi, and Alessie (2007), individuals who have low literacy level are less probable to take part in stock market and depend on their relatives for financial information. Lee, Yun, and Haley (2012) found that investors with low financial knowledge were probably giving less attention to advertised mutual funds than those with high financial knowledge. Investors with low financial literacy are likely to have low confidence when interpreting credit terms, and show mix-up over financial concepts. They also pause to involve in activities which could help them to enhance their cognizance of the financial market (Disney & Gathergood, 2013). The workplace activities and income level leading to better learning trainings have an impact on level of financial literacy of an individual (Al-Tamimi & Kalli, 2009). Literacy level of households is very weak as they don't know the basic concepts of bonds and stocks, connection between price and interest rates of bonds, and basic concepts of diversification (Rooij, Lusardi, & Alessie, 2007). They depend on savings as they believe that savings will benefit them in productive investment and will smooth their consumption (Karlan, Ratan, & Zinman, 2014).

Financial literacy plays an important role in planning and decision making. Generally, people who have low literacy and experience lead to poor planning. Literacy level affects the wealth of the holder because it influences the planning processes (Lusardi & Mitchell, 2007b; Jappelli & Padula, 2013). Financial literacy is the key determinant which effects the investment decision (Rooij, Lusardi, & Alessie, 2007; Al-Tamimi & Kalli, 2009; Rooij & Lusardi, 2009). Level of income and education influences level of financial literacy. Individuals who work in financial market generally have higher financial literacy level than others and those who have high financial position, hold high educational degrees (Al-Tamimi & Kalli, 2009). Financial education and financial consequence are linked with financial literacy (Huston, 2010). If individuals have positive attitude to take risky decisions that can be improved by participation in the decision-making process and it can also be corrected with a facilitation of quality information to decision makers (Altman, 2012). From the above discussion, we can conclude that financial literacy has a positive relationship with investment decision making.

Objectives of the Study

- ✓ To understand the concept of emotions in personal financial planning of households.
- ✓ To assess the personal financial decisions of households.
- ✓ To critically examine the role of emotion in personal finance of households.

Rationale of the Study

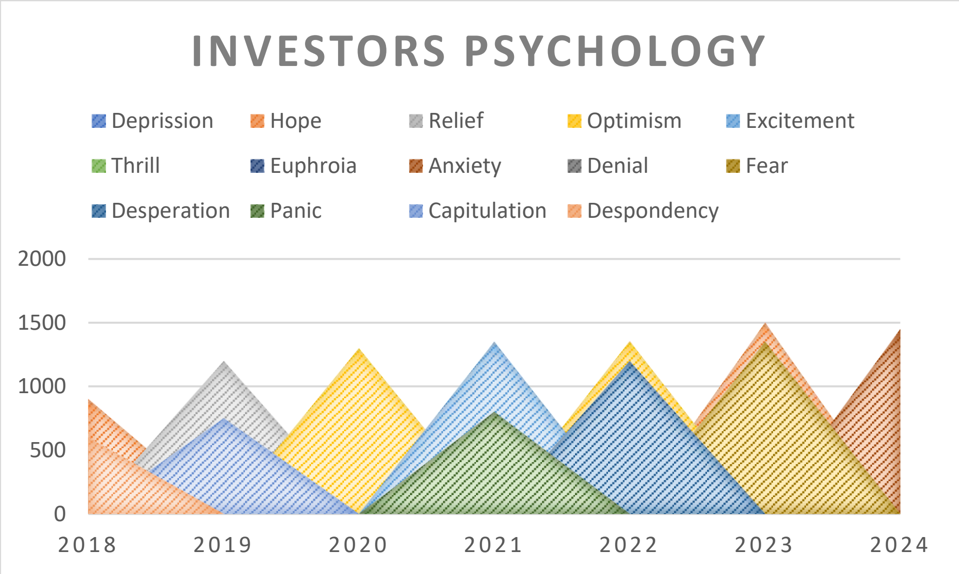
- ✓ Household investors generally do not behave rationally.
- ✓ Emotions play a significant role in their investment decision making process.
- ✓ Investor must consider influential factors that may affect their expected results prior to investment decisions.
- ✓ To establish a qualitative relationship between emotions and households personal finance decisions.
- ✓ To have fruitful results emphasis must be given on emotions of an investors.

Methodology

- ✓ The present study is primarily based on secondary sources of data collection method.
- ✓ Secondary data for this study has been collected through several platforms such as publications of various national cum international journals, magazines, newspapers, websites, and other sources.

Research Design

- ✓ Based on the research approach, the descriptive research design was preferred and applied for this study.
- ✓ To achieve objectives of study we must clear certain questions answer that is pertinent to this research.
- ✓ These questions are discussed below with its suitable answer.



LIMITATIONS OF THE STUDY

- ✓ Based on secondary sources of data.
- ✓ Empirical work is missing in the present study
- ✓ Entire study is descriptive by nature
- ✓ Data has not been analyzed using research tools.

CONCLUSIONS

- ✓ Proper knowledge of family investment behavior is increasing.
- ✓ Because many standard conventional finance theory's assumptions found unrealistic.
- ✓ Because gap between stated theory and its applicability in practical scenario.
- ✓ Obsolete theory of finance needs to be modified as per the current situation to tackle the financial issues in a most scientific manner.
- ✓ To explore household portfolio preferences.
- ✓ Focus shall be given to achieve stable financial structure to protect individual or households from future financial crisis.
- ✓ People should develop basic financial skill to enhance their financial knowledge to protect themselves from financial miss-happening or wrong doing.
- ✓ The main aim of personal finance is to determine a optimum personal financial mix between income, savings, investment, expenses, insurance, tax planning etc.

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