1. Introduction

1.1. Motivation

Financial market development is often considered to be relevant for economic growth and related to a reduction in poverty and inequality in particular in developing economies (Rajan and Zingales, 1998; Levine and Zervos, 1998; Honohan, 2008). While a large amount of literature examines the determinants of banking supply and the presence of financial services (Beck and Ross, 2005; Rajan and Zingales, 1998; Bekaert et al., 2005), more recent studies take into account the effect of private investments on financial market development. Honohan (2008) for instance argues that private households are important consumers of financial products and that their investments influence the scale and asset mix of finances. Burgess and Pande (2005) find that bank branch expansion in rural areas in India is related to poverty reduction. They explain their results by the increase in deposit mobilization and credit disbursement by banks in rural areas.

Hence, a low level of financial market participation among the general population might have essential drawbacks for the economy as a whole, but also for the individual himself. Individuals who participate in the financial market might be better able to save and prepare for financial needs in the future, and thereby they ensure themselves against risks. In many developing economies, financial market participation, within the general population, is still low. Globally, more than 2.5 billion adults do not have a bank account at a formal financial institution, and most of them are found within developing economies. In 2011 about 40 percent of individuals living in East Asia and Pacific had an account at a formal financial institution (Demirgüc-Kunt and Klapper, 2012). Therefore, it is an important question to answer: *Why do some individuals participate in the financial market while others do not?*

One reason for the limited demand for formal financial services in developing economies might be due to high fixed costs of the financial services (Cole et al., 2011). Using cross-country data Beck et al. (2007) show that the use of deposits and loan services is higher in countries with more developed financial systems, and he also argues that this is related to lower fixed transaction costs resulting from better financial access. Campbell (2006) argues that, in particular, less educated and poorer households make significant mistakes in financing and - being aware of this - they avoid possible investment. He further argues, that these mistakes lead to an increase in welfare cost of the economy and also that economists should offer remedies that reduce the incidences in order to decrease welfare cost of investment mistakes.

Lusardi et al. (2011) find that financial literacy affects the financial decision making process and that individuals with a low level of financial literacy are more likely to stay away from risky investments like stocks. Lusardi and Mitchel (2008) shows that financial illiteracy is widespread among individuals with specific demographic groups in the US like individuals with low education, women, African-Americans, and Hispanics. Cole et al. (2011) tries to disentangle the effects of fixed transaction costs and financial literacy on the decision to make an investment. In doing so, they combine survey data with a randomized field experiment among unbanked households in Indonesia. Their results suggest that financial literacy alone does not lead to a greater demand for financial services among the general population and that rather financial subsidies might be more relevant (Cole et al., 2011). Nevertheless, studies on financial literacy in developing economies are scarce, and new findings might add new insights into this field of research and complement the existing empirical results .

Another important factor is the role of social boundaries, which are often strong among individuals in developing economies. Munshi and Rosenzweig (2006), for instance, show that lower castes families in India tend to send their sons into local language schools in order to follow traditional occupations. The caste system in India is still prevalent and might determine social interaction of individuals within India. Strong social relationships might also affect the financial decision of an individual. Hong et al. (2004), for instance, show that social interaction and financial market participation are positively related because social investors learn about financial matters via word-of-mouth communication and observable learning. Therefore they argue that social individuals are more likely to invest in risky assets more so compared to non-social investors. While their results are based on a sample of US-investors, little is known about this relationship in developing economies.

The literature on financial development provides also alternative explanations for a low level of financial market participation of individuals, and points for instance, to the evidence of trust (Dearmon and Grier, 2009; Guiso et al., 2004, 2008). Guiso et al. (2008) show that trusting individuals are more likely to make risky investments and have higher preference to invest a larger amount of their money. Their empirical analyses are based on a sample of US - investors and customers of a large Italian bank. Their findings suggest that trust is an important determinant for the individual and his investment decision. Calderon et al. (2002)

provides empirical evidence that the general level of trust and financial market development are positively related. Because it is difficult to measure, the individual subjective level of trust in an investment or a financial institution has often been left out in economic analyses.

Karlan and Morduch (2010) as well as Demirgüc-Kunt and Klapper (2012) argue that the importance of savings and investments of individuals in developing economies has remained mostly unconsidered in the past years and that more research in this field is needed. Demirgüc-Kunt and Klapper (2012) study non-participation of households using cross-country data. They investigate why individuals do not possess a formal bank account and detect different self-reported barriers e.g. high account cost, not sufficient income to invest, lack of trust, or a large distance to the bank. However, they conclude that reasons of non-participation vary, and that a better understanding of the individual characteristics associated with certain financial behavior is still needed (Demirgüc-Kunt and Klapper, 2012).

The above shows the importance of the relation between different determinants of financial behavior of individuals in developing economies and financial market participation. Despite the considerable interest from financial institutions and public policies, there has been little research on these topics until now. The relevance of investigating this in more detail includes the following. First, a better understanding of the individual's decision making process in a developing economy might lead to insights on why some individuals make use of certain financial products while others choose not to. Second, knowing about individuals' characteristics and preferences for certain financial products may improve the response rate of banks and other financial institutions, and allow for a better fit between supply and demand. Third, knowledge about the individuals' financial knowledge on different investment settings offers valuable insight on how to link financial programs to certain investments. In this thesis, we will focus on this importance in analyses on various aspects of Indian households and their financial behavior.

India is very well suited for the analyses of financial market development and the investigation of financial market participation of households because it provides certain particularities which allow for a profound investigation of the selected topics of this thesis. The Indian financial market offers a variety of different financial products e.g. Indian specific instruments like chit funds or group savings, as well as shares and bonds. These different products can be used for comparison in order to investigate the preferences for certain financial products among individuals in India. Moreover, the particularities like the Indian caste system allow for the investigation of social networks because social boundaries seem to be stronger within certain castes more so than between castes.

Moreover, in India, as well as in other developing economies characterized by a higher level of corruption, public institutions often are mistrusted by the population Hakhverdian and Mayne (2012). This, however, may not only be true for public institutions but also might be an issue for financial institutions in India as well. Trust plays an important role in many economic decisions in India. Hence, investigating the role of individual trust in the context of the Indian financial market, will add new insights to the existing literature of trust and financial market participation of individuals. The Reserve Bank of India (RBI) has undertaken many policies aiming at increasing financial market participation among the population but the demand for financial services is still low. This is particularly interesting since Indians are known as one of the largest savers in the world. This allows for analyzing the reasons of non-participation of potential investors. The Indian financial market experienced radical changes in the past decades. After financial market liberalization in 1991, new financial institutions as well as financial products have emerged. This is similar to many other developing economies. Hence, some results might be applicable to some extent, in a much broader sense.

1.2. Aim

This thesis aims to shed light on different determinants of financial market development in India. In particular this thesis investigates different determinants of financial market participation of individuals. In doing so, relevant and less considered topics like financial literacy, household trust in financial institutions, and the role of foreign banks in customer retail banking in India are investigated. More specifically, the thesis aims to investigate some possible reasons of non-participation of Indian households and their interrelation with other important determinants. Figure 1.1 shows the conceptual framework of the thesis. In order to introduce the reader to the topic of the Indian financial market, chapter 2 provides an overview of the Indian financial market and sheds light on aspects of supply and demand for financial services. The following chapters refer to selected issues discussed in chapter 2.

In order to reveal the relevance of financial literacy for financial market participation in a developing country like India we want to show that determinants like social interaction and the caste system play an important role (chapter 3). The corresponding article "Financial Literacy, Information Flows, and Caste Affiliation: Empirical Evidence from India" is coauthored with Werner Bönte and published in the Journal of Banking and Finance, Volume 36, Issue 12 in 2012.

Further, we aim to illustrate that although the number of financial institutions and their branches in India has increased remarkably over the past years, access to a financial institution is still very important, particularly for establishing trust

Figure 1.1.: Conceptual framework of the thesis