 ISBN: 978-93-86171-02-3

EMERGING TRENDS IN FINANCIAL INNOVATION TOWARDS NURTURING THE GROWTH OF INDIAN ECONOMY

Smt. Ch. Karuna[1], Ms M. Rukmini[2]

[1]*Sr. Asst. Professor, Head of the Department of Commerce, M.R.P.G. College, Vizianagaram*

[2]*Asst. Professor, Department of Commerce, M.R.P.G. College, Vizianagaram.*

ABSTRACT

Financial innovation is the true engine of economic prosperity. India is on board towards robust growth to achieve the position within top 5 economies of the world. In order to achieve that benchmark, India requires massive development in infrastructure, industrial & manufacturing front. Hence there is a significant need for financial innovation in the Indian industries, which is a key to the development. Financial innovation can be defined as the act of creating and then popularizing new financial instruments as well as new financial technologies, institutions and markets. It includes institutional, product and process. The modern economy cannot exist without the efficient financial system that is defined as the collection of markets, institutions, instruments and regulations through which the financial securities are traded, interest rates are determined and financial services are produced and delivered around the world. Financial innovation has been a continuous and integral part of growth of the capital markets. Greater freedom and flexibility have enabled companies to reinvent and innovate financial instruments. Many factors such as increased interest rate, volatility, frequency of tax and regulatory changes etc. have stimulated the process of financial innovation.. The present paper aims to spotlight the essence of financial innovations and also the various innovative financial products that have great impact on the capital market and also focuses on key drivers and implications. financial innovation will continue to play an important role in promoting global growth, especially in emerging markets and developing countries like India.

Key words: Financial innovation, financial instruments, capital market

I. INTRODUCTION

Financial innovation has been one of the determinants of the growth of trade in financial services, notably the cross border supply of these services. Consolidation through mergers and acquisitions particularly in the banking sector has boosted cross-border trade in financial services. Financial innovation is a continuous, dynamic process that entails the creation and subsequent popularization of new financial instruments, as well as new financial technologies, institutions, and markets. Financial innovation has experienced steady growth in the last decades and has arguably transformed the once relationship focused financial intermediaries. With the advent of technology and deregulation of capital market there is a huge scope for bringing in innovative financial products in the Indian capital market. Indian capital market is largely characterized by the equity

market with debt market and derivatives market lurking far-behind. Financial markets are a part of the changing business paradigms, across the globe. In fact, the financial markets are the first to unleash the creativity and imagination and lead the revolution. Today, globalization of competencies, thinking and perspectives has been the part of strategic action plan of all the major players in the financial markets, globally. The cut throat competition across the market operators and the pressure to perform by the stakeholders has resulted in competition being fiercer than ever before. It goes without saying that the future health of any economy rests on its ability to innovate. The key to growth and progress has always been innovation-a process of churning from the old to the new.

1.1 Objectives of the study

- To study the concept and types of financial innovation
- To know about the categories and significance of financial innovation
- To study about various financial innovation products that have impact on capital market
- To study about the key drivers and their implications
- To give suggestions for better performance of the financial innovations for nurturing the growth Indian economy

II. CONCEPT OF FINANCIAL INNOVATION

Financial Innovation is something that is seen by an individual as a new way by which finance can generate returns, redistribute risk and fuel the economy. Among all the adventures of the mankind, financial innovation is the one which is very unique. Financial innovation like innovation elsewhere in business is an ongoing process whereby private parties experiment to try to differentiate their products and services, responding to both sudden and gradual changes in the economy. Financial innovation can be defined as the act of creating and then popularising new financial instruments as well as new financial technologies, institutions and markets. It includes institutional, product and process

2.1 Types of Financial Innovation

Financial innovation enhances sustainability of institutions and their outreach to the poor. A useful distinction between different types of financial innovations include:

a. ***Financial system/institutional innovations:*** Such innovations can effect the financial sector as a whole, relate to changes in business structures, to the establishment of new types of financial intermediaries, or to changes in the legal and supervisory framework. Important examples include the use of the group mechanism to retail financial services, formalizing informal finance systems, reducing the access barriers for women, or setting up a completely new service structure.

b. ***Process innovations:*** Such innovations cover the introduction of new business processes leading to increased efficiency, market expansion, etc. Examples include office automation and use of computers with accounting and client data management software.

 ISBN: 978-93-86171-02-3

c. ***Product innovations:*** Such innovations include the introduction of new credit, deposit, insurance, leasing, hire purchase, and other financial products. Product innovations are introduced to respond better to changes in market demand or to improve the efficiency of product markets.

2.2 Significance

Financial innovations help reduce agency costs, facilitate risk sharing, complete the market, and ultimately improve a locative efficiency and economic growth, thus focusing on the bright side of financial innovation. Countries where financial institutions spend more on financial innovation are better able to translate growth opportunities into GDP per capita growth. Financial innovation is associated with higher levels of economic growth. Innovative activity of financial intermediaries, which helps countries grow faster at high levels of income. Financial innovation has been shown to increase the material wellbeing of economic players. Positive innovation has helped individuals and businesses to attain their economic goals more efficiently, enlarging their possibilities for mutually advantageous exchanges of goods and services. Financial innovation, by increasing the variety of products available and facilitating Financial innovation may also help to moderate business cycle fluctuations. Innovations such as credit cards and home equity loans allow households to keep their consumption smooth, even when their incomes are not. The increased availability of credit to businesses allows them to smooth their spending across short periods when revenues do not cover costs.

Functions of Financial Innovations: The financial innovations help in

- Moving funds across time and space;
- Pooling of funds;
- Managing or reallocating risk;
- Extracting information to support decision-making;
- Addressing asymmetric information problems;
- Facilitating the sale or purchase of goods and services through a payment system;
- Reducing agency cost, and enhancing liquidity

III. TECHNOLOGY DRIVEN FINANCIAL INNOVATIONS

Advancements in Information Technology have facilitated a number of innovations, such as new methods of underwriting securities

- Assembling portfolios of stocks
- New markets for securities
- New means of executing security transactions

Many new forms of derivatives have been made possible because business people could have some confidence in the methods of pricing and hedging the risks of these new contracts. Various forms of innovations such as

new risk management systems and measures, on-line retirement planning services and new valuation techniques were clearly facilitated by both intellectual and information technology innovations.

3.1 Categories of Financial Innovation

Category of Financial Innovation	Explanation
Market-broadening Instruments	Those instruments which increase the liquidity of markets and the availability of funds by attracting new investors and offering new opportunities for borrowers
Risk-management Instruments	Those instruments which reallocate financial risks to those who are less averse to them, or who have offsetting exposure and thus are presumably better able to shoulder them
Arbitraging Instruments and Processes	Those Instruments and processes which enable investors and borrowers to take advantage of differences in costs and returns between markets, and which reflect differences in the perception of risks, as well as in information, taxation, and regulations.

Source: Fabozzi, Frank J., Frranco Modigliani, Frank J. Jones and Michael G. Ferri, Foundations of Financial Markets and Institutions, 2002 (p.21)

Some of the innovative financial instruments used by the companies in the Indian Financial Market are explained as follows:

1)Triple Option Convertible Debentures (TOCD):

- First Issued by Reliance Power Limited with an issue size of Rs. 2,172 Cr.
- There was no outflow of interest for first five years.
- Equity increase was in phases.
- No put option to investors and no takeover threat.
- Reduced dependence on the financial institutions.
- The expenses for floating the issue was just 2.62% of the issue size which was very less when compared to the 10-12% for a general public issue.

2) Deep Discount Bonds:

- The investor got a tax advantage and could eliminate the re-investment risk.

 ISBN: 978-93-86171-02-3

- From the issuer's point of view also, the issue cost was saved as it involved no immediate service cost and lower effective cost. The refinancing risk was also eliminated.

3) Floating Rate Notes:

- First issued by Tata Sons with a floor rate of 12.5% and a cap of 15.5% and a reference rate of 364 T-Bill yield, which was 9.85% at the time of issue.
- The investors would get a minimum return of the floor rate and the maximum return was the cap rate. They would get higher than floor rate depending upon the fluctuations in the reference rate.

4) Zero Coupon Bonds:

- It did not involve any annual interest on the bonds. But it had a higher maturity value on the initial investment for a particular time period.

5) Convertible and Zero Coupon Convertible Bonds:

- Similar to the zero coupon bonds except that the effective interest was lower because of the convertibility.

6) Secured Premium Notes (SPNs):

- First issued by TISCO in July, 1992.
- These financial instruments were secured against the assets of the company but the investors had to pay a premium over the market price for these types of instruments.

7) Equity with Differential Voting Rights:

- Issued by Tata Motors, in which the shares were classified as "Ordinary Shares" and "A Ordinary Shares".
- The ordinary shares were issued at Rs. 340 per share, had a voting right of one vote per share.
- On the other hand, the A ordinary shares were issued at Rs. 305 per share but the voting rights were limited to one vote for every 10 shares and extra dividends of five percentage were paid.

Key Drivers of Financial Innovation:

There are a numerous factors that have lead to financial innovation on the markets. Few of the key ones are listed below:

- **Economic Crisis:**

  Economic crisis has led to reforming the regulation of the financial sector, and this may have some impact on financial innovation. Deregulation in the financial markets had led to the development of new instruments. New instruments developed, led to further regulation in the financial markets. This had led the financial institutions to compete in the international markets.

- **Uncertainty:**

  With the growing market developments, there has been established a relationship between the risks associated with the assets and the interest and exchange rates. Asset values have become volatile and in order to protect them financial institutions have developed variety of products to hedge risks. Increased volatility of interest rates, inflation, equity prices, and exchange rates are therefore major factors.

- **Advancement in IT Sector:**

 ISBN: 978-93-86171-02-3

The advancements in the information and telecommunication sector have led to new financial innovations, the protection and the management of which are challenging and require closer examination. IT revolution has drastically reduced the cost of financial transactions. It has led to the development of certain financial products where pricing is needed on real time basis which is not possible without advanced data processing software. In short, advances in computer and telecommunication technologies have contributed a lot in financial innovation.

- **Development of social networks :**
  Twitter, Facebook and You Tube are all being used to offer new financial services, increase the interaction with the customer and collect new ideas from outside the financial institution. These media allow collecting, in real time, feedback and ideas that can be used to start a company's innovation processes. There is very much data traffic, so there is an urgent need to create new organizational structures to effectively coordinate the various inflows of information and the tracking of the external idea towards absorption or rejection.
- **Globalisation & Securitisation:**
  With international trade and investment, demand for international financial services has increased. Due to this development, a number of new financial products have emerged.

In addition to above factors, other factors are also major drivers such as financial intermediary competition, greater sophistication and educational training among professional market participants, incentives to get around existing regulation and tax laws and changing global patterns of financial wealth.

IV.IMPLICATIONS OF INNOVATION ON FINANCIAL MARKETS:

Financial innovations have a direct impact on the financial markets. It majorly impacts the asset prices, international price relationships, and market behaviour. The major implications of innovations in financial markets are as under:

- Lower transaction costs.
- More liquidity.
- Diversification of risk.
- More competition in financial markets.
- Increased opportunities for making investment.
- More financial product to select for investment.
- International markets relationships and capital mobility.
- Greater integration of international markets.
- Significant impact of changes in currency rates and exchange rates

4.1 Indian Markets and Financial Innovation:

Modern era is the era of globalisation. Globalisation has brought the various countries of the world closer than before. As a result of globalization cross-border exchange of goods, services, capital, technology, ideas, information and people has taken place. Now as a result of globalisation, the world has become a global village. MNCs have started operating in a number of countries and mobility of labour and capital has increased manifold. India too is affected by Liberalisation, Privatisation and Globalisation (LPG).It has led to the integration of the Indian economy and the financial markets with the global markets.

As the recent Rajan report noted, "India's financial sector is at a turning point. There are many successes—the rapidity and reliability of settlement at the NSE or the mobile phone banking being implemented around the country indicate that much of the system is at the Internet age and beyond. There is justifiable reason to take pride in this. Yet much needs to be done." The Indian financial markets are not fully developed yet; there is great scope of growth and expansion. Limited financial instruments availability has affected the investors' ability to hedge against risk. Several steps have been taken by the RBI and other organisations like SEBI, to meet the growing needs of the Indian markets and to promote innovation.

V. MAJOR ACHIEVEMENTS

1. Reliance Industries became the first Asian company to issue a 100-year Yankee Bond in the US.
2. India also introduced its own version of the Depository Receipt, the IDR which has however, not taken off well with only Standard Chartered Bank issuing its IDR.
3. RBI was awarded the 2012 Dufrenoy Prize for its precautionary approach in regulating the derivatives market, and thus facilitating financial innovation in a responsible manner. This prize was instituted by the Observatory for Responsible Innovation (ORI) – an independent international think tank with the purpose of thinking and debating on new measures, concepts, and methods to foster responsibility in innovation.
4. India survived during Global Financial Crisis in 2008. On April 15, 2015 Lord Adair Turner, Chairman of the Financial Services Authority, United Kingdom praised ex- RBI Governor, Mr. Y. V. Reddy for his decisions during his tenure as the RBI chief in 2003-2008, for being cautious.

No doubt, our country has made significant changes in its economic policy management in recent years, and that has been reflected in the economy's impressive progress. RBI's adept handling of monetary and regulatory policy in the current financial crisis is a testimony to the professional qualities of the RBI's skilled professional staff. India is well positioned to continue on its path of strong and inclusive growth due to the RBI's stewardship.

5.1 Suggestions for developing nations to realize the benefits of financial innovation

- New financial products should be very straightforward and simple.
- Investors should be able to calculate the risks being undertaken without undue reliance on credit ratings agencies or other outside advisors.
- There should be adequate disclosure. For example, as per one report, Rs. 1.56 trillion was lost due to lapsation linked to mis-selling of insurance over 2004-05 to 2011-12. On February 12, 2013, then Finance Minister, P. Chidambaram in his public speech said that 'if you want to sell insurance to India, you must sell simple products and must make it absolutely clear to agents and other officers that they should not mis-sell'.

- Interests of the originators of loans and securitized assets should be aligned with the interests of investors.
- Ensure that banks' risk management systems and the regulatory system keep up with the pace of innovation.
- A robust resolution scheme should be developed so that governments will be able act promptly and effectively when an institution becomes troubled.

VI. CONCLUSION

Financial innovation is truly welfare enhancing if it brings about a reduction in the cost of capital and improvement in the financial intermediation process without a commensurate increase in financial risk. The benefits of emerging capital markets can be measured in terms of factors such as lower pricing , reduced cost of capital, mitigated risk exposures, broader access to capital and increased liquidity. Financial innovation ought to make the movement of capital more efficient, risk management more targeted, hedging better matched, and trading less costly. Financial innovation also ought to contribute to better management and transfer of credit risk, the unbundling and trenching of risk, improved liquidity, more optimal portfolio diversification, and broadened credit risk dispersion.

REFERENCES

1. Chakrabarty, K.C 2009. "Global Crisis: Genesis, Challenges and Opportunities unleashed." RBI Bulletin, October.
2. Gopinath, Shyamala. 2009. "Some Reflections on the Recent Global Financial Turmoil –An Indian Perspective." RBI Bulletin, February.
3. International Monetary Fund. 2009. World Economic Outlook, various issues.
4. Lipsky, John. 2009. "Finance and Economic Growth." Remarks at the Bank of Mexico Conference, Challenges and Strategies for Promoting Economic Growth, Mexico City, Mexico. October.
5 .Prasad, Eswar S., Kenneth Rogoff, Shang -Jin Wei and M. Ayan Kose. 2003. "Effects of Financial Globalization on Developing Countries: Some Empirical Evidence." IMF Occasional Paper No. 220, September.
6. Reserve Bank of India, Monetary Policy Statements (various statements 2007, 2008 and 2009). Mumbai.
7. Reserve Bank of India, Annual Report, 2009-10.
8 . Subbarao, D. 2009. "Emerging Market Concerns: An Indian perspective." RBI Bulletin, November.
9. 1. Annual Report : Ministry of Finance , Reserve Bank of India , Securities and ExchangeBoard
10.http//:www.finmin.gov.in
11.http//:www.rbi.gov.in
12.http//:www.sebi.gov.in