Financial Innovations to Support Savings: Development and Its Challenges

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ABSTRACT
In recent time, household savings are low as families are finding it hard to save. There are massive numbers of program that emphasize on different elements of human behavior and address different impediments of savings some of which require changes in government regulation and some are completely market or social-network driven. A country’s economic growth is directly related to the state of development of its financial sector and it’s only since 1990s that the role of the financial sector has gained importance. To address the challenges of missing markets by providing appropriate insurance, hedging products, to deepen liquidity in existing markets and to raise the quantity and quality of investment to increase the efficiency of the economy it is necessary to innovate the conventional financial products. The goal of this paper is to lay out the range of innovations that meet the needs of heterogeneous potential savers. This study principally looks at the relationship between financial innovations and savings in India. The other subsidiary objectives focus on identifying the extent of financial innovation development and the challenges it is confronting in India.

KEYWORD: Financial innovation, potential savers.

FULL PAPER
The development of financial sector has been considered as a major driving force for economic growth of any country. In today’s financial world, market participants and potential investors are constantly looking for new ways to earn higher returns on their investments with a corresponding low level of risk. To achieve this objective, it is necessary to bring some innovation in the conventional financial products that can meet the needs of heterogeneous potential savers. Financial Innovation can be introduced in the form of a new product or the production of an existing one in a new manner in the market.

The financial industry across the world has undergone phenomenal changes in recent years. With the progressive liberalization of regulatory framework and technological barriers, financial institutions are facing intense competition among themselves. There has been an introduction of a series of new financial products and techniques by which investors can save and helps in financing useful social projects. During 1960s, there were a few basic savings avenues – saving or time deposit at banks, equities, etc but now with the introduction of new avenues, more and more market participants are encouraged to save which contributes majorly towards the development of the country. Due to LPG norms, competition among financial institutions has increased incredibly and they were forced to maintain their profit margins. Thus, most of the banks got engaged in providing non-banking financial activities while non banking financial institutions started offering a wide range of financial products and services which contributes in growing share of their profits. Being the leading capitalist economy in the world, US banks took the lead in financial market innovation which later on spilled over to other countries.

Presently, there has been a wide variety of programs that support savings by families, focusing more on low and moderate income families. Some of these programs literally compel families to save; some provide financial incentives to induce savings, e.g. tax benefits. These programs are innovated by a number of stakeholders, which includes government organizations, NPOs, financial institutions and various social intermediaries.

This paper elaborates that innovation of financial products in the recent past have improved saving, investment and risk-bearing capacity of the market participants and in ways are convenient and economically beneficial. This paper also describes the various kinds of savings innovation, gives an
overview of the success of these programs and challenges that these innovations came across during their introduction stage.

CAUSES OF FINANCIAL INNOVATION
A large number of factors contributed for the initiation of the process of financial innovation. Some of the important factors can be classified as:

(a) Changes in regulatory framework: Introduction and abolition of ceiling on capital flows and segregation of difference sectors gave a path to devise new financial products.

(b) Alteration in the lending capacity of banks and downward shift of the profit margins of the bank: The main reason of poor credit rating of banks in past was that market participants were diversifying their portfolio which did not include any banking deposits rather they park their money in highly profitable commercial papers. Banks tried to cover all these losses through high commission and brokerage charges but soon they realized that introduction of new financial products that can meet the needs of customer can cover up their losses.

(c) tech-saviness of market participants: The positive attitude of market participants towards technological development has facilitated the creation of new, easy and more reliable payment systems which includes online payment; buying, selling and transferring of securities, introduction of Debit and credit cards. Now, an investor just sitting at home can do financial transactions in one go without going anywhere.

Following are the instruments which came into existence as a result of the process of innovation of financial products.

(a) Financial innovation and mutual funds: The birth of mutual fund through financial innovation comprises of the characteristics and benefits investing directly in share market. It is an investment tool through which investors can diversify their risk by investing only a small fraction of investment with lower cost of fund management. Generally, investing in one sector is always considered as very risky but mutual funds have diversified investments spread among securities of various economic sectors. Few examples of mutual funds are: equity oriented mutual funds, debt-equity mutual funds, fixed dividend mutual funds, etc. In today’s financially driven environment, some of the mutual funds provide life insurance cover to the investors.

(b) Financial innovation and insurance: In the past, only endowment and money back polices were available for retail customers while for corporate sector group insurance, gratuity and superannuation plans were available and were too at high premium. But after liberalization, many new and private insurers came with innovative products which focused on providing customized products to the customers. ULIP is one such product which has come about as a result of financial innovation where part of the premium paid is used for insurance and the other part is used for investment to give a certain amount of return to the investor on the money invested. Most of the private life insurance companies have introduced the children’s education plan, retirement and pension plan to meet the specific need based upon the time frame. Moreover, to get the benefit of capital market investment, ULIPs came into existence, which is an important outcome of the financial engineering in the insurance segment. Insurance companies along with banks started the task of insuring various risks like weather, mortality, emissions, environmental shocks etc. Under the general insurance policy, the marriage insurance policy has been innovated, wherein the insurance companies would insure the cost of weddings against the postponement or cancellations wedding ceremonies for certain reasons, under which claims would be entertained only for losses due to external factors like accidents, catastrophes or unintentional man-made disasters or disruptions.

(c) Financial innovation and banks:
Banking sector has introduced not only the product innovation but also brings technological innovations, which has replaced the traditional working scenario of the banks. Today, customers are asking for anytime-anywhere delivery of financial services along with an increased variety in deposit/investment and credit products. Severe competition forces the banks to focus on customer
relationship management by delivering the sophisticated services with the use of technology. E-banking services, mobile banking, electronic mode of payment methods, ATM, platform automation, PC banking, reverse mortgage etc. are the revolutionary innovations which can be termed as financial process engineering, have taken place in the banking sector.

(d) Financial engineering and Stock exchanges:
With the increased awareness and increased participation of direct investment in the capital markets, stock exchanges have brought in innovation in terms of technology, processes and introduction of trading of new securities. To overcome the limitations of physical handling of the securities, dematerialization of the securities has been done. With the introduction of the same there was a need to create another financial institution/body, which can take the custody of the securities, facilitate the trading between the parties etc. As a result of these, NSCCL, Depositories, Depository participants and other intermediaries came into existence and which has replaced traditional brokers. Exchanges also started the trading of the new investment tools like ETFs, Gold ETFs, and REITs.

(e) Financial Engineering and derivatives:
Derivative instruments are an outcome of financial innovation which helps in quantifying, allocating and managing the risk. Under which the currencies, futures, options, swaps and commodities are traded on the exchanges. Derivatives require less amount of capital to purchase a bulk of shares as compared to the case where one is buying individual shares where whole amount has to be paid.

(f) Financial engineering and equity and debt products:
Non-voting shares, differential voting rights, employee stock options, sweat equity shares, callable and puttable common shares, ADRs GDRs, IDR, warrants, World Equity Benchmark Shares (WEBS) etc. are the innovative financial products came into existence through financial engineering in equity class. Whereas, convertible bonds, zero coupon bonds/ debentures, deep discount bonds, secured premium notes, floating rate bonds, catastrophic bonds, dual currency bonds, foreign bonds and euro bonds, Triple Option Convertible Debentures (TOCD), index bonds, Indian Corporate Collateralized Debt Obligation Fund (ICCDOF Fund) are come under the debt category. There are hybrid instruments too like convertible preferred shares.

The major financial innovations taken place in India and principal motivating factors for the same are listed below.

(a) Equity linked saving schemes of mutual funds: To offer the benefits of stock market

(b) ATM Technology: Screen based trading Technology and to bring transparency

(c) Dematerialization: To overcome the risk relating to physical handing of a security and faster settlement

(d) Depositories: To make the transaction speeder and transparent electronic fund transfer Technology

(e) Gold ETFs: To channelize the fund from traditional investment alternative of household to financial market

(f) REITs: To enable investors to have an economic interest in real estate assets without the need to buy the physical property

(g) Direct Market Access (DMA) Facility: To enable broker to offer their client direct access to the trading system of the exchange through the broker infrastructure without manual intervention of the broker. It offers a direct control of the client over orders, reduced time lag in execution of client orders, reduced errors caused by manual order entry, greater transparency, enhanced liquidity, lower cost for large orders and gainful use of speedily executed arbitrage strategies.

(h) Reverse Mortgage: To offer the fixed income to senior citizens against the mortgage of their residential/ real estate property

(i) Marriage insurance: To insure the cost of weddings against the postponement or cancellations wedding ceremonies for certain reasons.

COST-BENEFIT ASPECTS OF FINANCIAL INNOVATION
While calculating the cost-benefit aspects of financial innovation, it is necessary to see their overall role in improving the efficiency of the financial systems while performing their fundamental functions.
FOUR BROAD GROUPS OF FINANCIAL INNOVATIONS

(a) First group consists of new payment systems, recording and sophisticated information systems, etc, brought on by the application of advanced technology to financial business. The notable examples are the sophisticated payments and clearing systems, systems like the Euro-clear and CEDEL for eurobonds and SWIFT in respect of international fund transfers. These innovations helps in reducing transaction costs and facilitates speedy transfer of large funds.

(b) The second category of innovation includes financial futures, options, swaps, index based trading etc. They generally shift risk from risk averse to risk takers. But the main question is whether the process of redistributing risks through new products really left them in the hands of those who understand and are capable of handling them. The answer is definitely a no. First, the assessment of risk itself is complicated by the changing nature and complexity of these financial products. The problem with hedging products is that they do not stretch very far into the future and besides this they create new risks which are not understandable to all the investors.

(c) The third category of innovation consists of products and techniques intended to enhance the liquidity of particular class of instrument. The growth of secondary maker and a wide range of listed shares comes under this category. The main limitation is that though they may enhance liquidity at micro level, at the macro level the liquidity of the system cannot be enhanced.

(d) The fourth type of innovation consists of instruments intended to provide investors and borrowers with better terms, wider choices, etc. The preference of customers in terms of yield, maturity, liquidity, risk exposure, etc, are met more by the innovative instruments and borrowers also enjoy a wider range of maturity time, repayment options etc. But the primary issue in this regard is whether investors and borrowers are able to judge the risks correctly and make proper decisions about the relative merits of the wide array of financial instruments and institutions. A major disadvantage of the growing securitisation of financial market is the loss of the traditional banker-customer relation- ship which helps not only in imposing financial discipline on borrowers but also offers the customer 'a friend in need'. The securitised markets have no such loyalty.

FINANCIAL INNOVATION AND EFFICIENCY OF FINANCIAL SYSTEMS

The basic purpose of a financial system is to promote savings, mobilise such savings and allocate them to socially productive uses. The other criteria are the cost of financial services and the flexibility of the system to meet the changing requirements of the economic agents. The other complementary functions of the financial system include the provision of adequate networks of payment and transfer mechanisms to facilitate financial transactions and also insurance or hedging facilities to protect economic agents against risks in financial contracts.

Another issue of concern is the overall cost of multiple and often duplicate financial services. There is considerable waste of financial resources and manpower inputs due to the tide of innovation sweeping the financial markets. There has always been speculation in the financial markets. The professional investors have a short-term horizon and it is impractical for them to take investment decisions based on long-term expectations. However, the degree of speculation in the present market environment has accelerated, because of the facility of information technology, particularly the simultaneous availability of electronic wire price quote services and wire transfer systems. The enormity of speculative transactions has increased the fragility of the system Short-term investments with an eye on daily, monthly and quarterly returns, are unlikely to lead to an investment profile appropriate for economic growth or stability of the economy.

CHALLENGES OF FINANCIAL PRODUCT INNOVATION:

Severe competition and faster growing financial markets resulted into introduction of new products and services with the complex features. Sometimes, investors find it very confusing and feel ill-equipped to cope up with the market to park their savings. Even, on the opposite side, market players cannot get the first mover advantage after introducing the new product or services because after
introduction of new products, within a small duration of time, competitors starts copying their products and add them in their existing product portfolio. Thus, there should a provision of patents and copyrights to the financial services institutions, so that they can get the benefit of first mover for a longer period and will prevent competitors from offering similar or related financial products and services.

FUTURE:
One cannot say with surety that whether the present pace of financial innovation will continue in future or not, but financial practitioners are of the view that with the growing number of financial institutions and institutional investors, securities market (cash and derivatives market) will soon become common to all. Moreover, special training should be given to market participants to understand the newly introduced financial products like currency and interest rate futures, interest rate swaps, etc. The wave of mergers, acquisitions and takeover is spreading to the entire world and encouraging many banks to open a separate department to handle this complex business.

A few other types of innovation will be eliminated by the market forces themselves because of lack of demand or a new perception of investor’s risks. Much of the technology already adopted in the financial services sector has become the basic infrastructure of the industry. Those who have the financial means to incur the enormous expenditure for sophisticated infrastructure and also the volume of business to justify such expenditure will have a competitive edge. Small banks and non-bank financial institutions merge with other financial institutions or may be taken over by stronger ones.

As per expert opinion if each step of financial liberalization and innovation is properly planned and discussed, the disruption caused to the competitive ability of different types of financial intermediaries can be minimized. Government policy should now focus on the steps to reduce excessive speculation and to guarantee the stability of the financial system.

LESSONS FOR INDIA
India has learned lots of lessons from recent changes and innovation in foreign markets. For innovation, it is necessary that market forces should play a greater role in determining interest rates, allocation of resources, broader product range, financial decision-making at individual institutional level, greater competition among financial institutions and free exit and entry of financial institutions. All the countries that joined the innovative wave have deregulated interest rates in order to provide greater scope for competition among financial institutions. In the initial stages of the innovative change, regulatory authorities tolerated considerable extent of abolition of regulation by the financial institutions. Financial policies in most of the countries are rooted on the conviction that free market allocation of resources is more efficient than the allocation effected through official interventions. The stability and soundness of the financial system are now being sought to be ensured through measures that enhance the ability of financial intermediaries to bear adversities (higher capital ratios, profit margins and skills), rather than measures intended to prevent or reduce adversities.

In the absence of clear official policy statements regarding what our financial system should be in the medium and long run, and in the context of the economic liberalisation initiated in the latter half of the 80s, stop-go measures in the financial markets have been interpreted by some financial analysts and practitioners as signaling a change from an interventionist financial approach to a more free market oriented financial system.

Considerable developments in terms of institutional diversification, range of financial services, geographical coverage, etc, have taken place in India during the last two decades. The distinguishing features of this transformation are that it is an evolutionary process and that it is initiated under close official guidance and association taking into account the feedback from economic agents. The basic intention bringing about the changes is to fill the gaps and deficiencies whenever they become apparent and thereby help evolve the financial system to meet the changing requirements of a growing and diversifying economy. Interest rate regulation and credit allocation are two basic planks on which
the Indian financial system is built as the financial system is required to play a vital role in the planned development of the country.

The Indian financial system has also discharged with considerable degree of success allied functions like providing adequate financial transfer mechanism. Though the functional profile of commercial banks in India has continued to be a replica of each other, there is considerable competition among them in respect of deposit mobilisation, lending activities, trade financing and in a growing range of off-balance sheet activities. A few commercial banks have also entered new activities' such as merchant banking, mutual funds, leasing, house financing, etc, by setting up subsidiaries. These activities, though growing, are still relatively small and do not constitute the 'bread and butter' of commercial banks.

India also has an array of specialised financial institutions which include the IDBI, ICICI, NABARD, EXIMBANK, IFCI, SIDBI (Small Industries Development Bank of India), TFCI (Tourism Finance Corporation of India), Housing Development Finance Corporation of India, several state level finance corporations, co-operative societies, regional rural banks, etc. In more recent period, a few private finance companies have also emerged. Financial infrastructure agencies such as Securities and Exchange Board of India, Discount and Finance House of India, the Credit Rating and Information Services of India and the Stock Holding Corporation of India, have been established recently to facilitate the smooth functioning of the financial system. New financial instruments such as CDs, CPs, short-term treasury bills (and refinancing TBs), interbank participation certificates, etc, are aimed to improve the liquidity management by financial institutions, apart from making the implementation of monetary policy more effective. Mutual Fund Scheme operated by subsidiaries of commercial banks, the UTI and the LIC have been introduced, according to the RBI, with a view to enabling savers to avail of tax benefits under Section 80 cc of the Income Tax Act.

The stock markets of India has also registered considerable growth and diversification. The application of information technology to banking and finance, though has begun in India, is still to make head way.

The recent abolition of Credit Authorisation Scheme has also given some extent of flexibility to banks to decide the quantum of lending to individual customers. The changes effected so far, except in a few cases are intended to strengthen the financial system by filling up gaps and deficiencies. There are several reasons why the kind of innovative instruments popular overseas markets are unlikely to flourish in the Indian markets.

Similarly, the exports sector will require greater support from the banking systems at subsidised rates in view of the acute balance of payments situation, which is likely to persist in the foreseeable future. Due to various reasons the quantum of savings available to be tapped by financial and non-financial institutions through innovative financial instruments is going to be limited.

In other words, the deregulated financial sector is meant to be mainly a support not substitute for traditional financial intermediation. This strategy, however, requires careful balancing of the traditional activities with the new activities, lest the latter adversely affect the banks' access to funds and also the cost of funds for priority sector financing.

For small savers from the low income and lower middle income groups, bank deposits and postal saving schemes carrying relatively lower rate of interest will continue to the only avenue.

If such innovative financing techniques-are allowed to proliferate, finance will no longer remain a handmaiden of the real economic sectors but a tool in the hands of speculators to 'play the markets'. Another substantive distortion introduced by the 'dynamic' financial activities of non-bank financial institutions is the subsidised financing, on a large scale, of the private corporate sector's capital investments and the disincentive such financing creates for internal savings. To sum up, the following are the main lessons India can learn from the recent financial changes and innovations in foreign markets:
(1) The financial system and financial markets must be economy specific.
(2) Allocation of resources determined by profit considerations will not necessarily result in socially desirable resource allocation.
(3) Though gaps and deficiencies in the financial system need to be filled in, the country cannot afford a proliferation of financial products.
(4) A wise choice of investors and borrower's does not necessarily ensure greater resource mobilisation or efficient productive investment.
(5) The systemic risks arising from uncontrolled financial innovation is significant not to be ignored, and
(6) Financial innovation, though gives opportunities for hedging risks and reducing individual transaction costs; but also adds additional costs and risks by creating new risks and also by encouraging the ballooning of transactions.

Financial sector reforms that were initiated by the government in early 90s ensured that the new emerging face of Indian financial sector will result in a strong, transparent and reliable system. Financial reforms in 1985 focused mainly on increasing productivity, new technology import whereas reforms of 1991-92 focused mainly on strengthening the banking system, upgrading technology and structural changes in the system. The last decade witnessed the broadening of financial markets with the introduction of new instruments and products and its opening to the new private players. The new players adopted best practices to offer a wide range of financial services to different class of investors which brought in innovation, better customer service and efficiency in financial sector. Today, the financial regulatory system in India is far better equipped and more conscious and laying norms for protection of the users of the system as well as for the credibility of the system.

CONCLUSION:
Products providing value added benefits should be introduced and these innovative products should be understood by regulators, sellers and prospective buyers. Investors should be able to calculate the associated risk without being relying majorly on credit rating agencies or advisors. Proper attention should be given to educate market participants regarding disclosure policies. Moreover, while introducing new products, interest of all the participants should be kept in mind.
It can be observed that financial liberalization is more of a problem than financial innovation. Moreover, various financial innovations like venture capital and leveraged buyouts have a significant effect. Despite the current difficulties and challenges, financial innovation will continue to play an important role in uplifting the development of the countries.

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