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AN OVERVIEW OF EMERGING FINANCIAL INSTRUMENTS IN INDIAN FINANCIAL SYSTEM

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Abstract

Financial instruments are assets that can be traded, or they can also be seen as packages of capital that may be traded. Most types of financial instruments provide efficient flow and transfer of capital all throughout the world's investors. These assets can be cash, a contractual right to deliver or receive cash or another type of financial instrument, or evidence of one's ownership of an entity. A financial instrument is a real or virtual document representing a legal agreement involving any kind of monetary value. Financial instruments may be divided into two types: cash instruments and derivative instruments. Financial instruments may also be divided according to an asset class, which depends on whether they are debt-based or equity-based. Foreign exchange instruments comprise a third, unique type of financial instrument.

Key words: *Reasons for innovation in financial instruments, emerging financial instruments*

Introduction

Financial instruments can be real or virtual documents representing a legal agreement involving any kind of monetary value. Equity-based financial instruments represent ownership of an asset. Debt-based financial instruments represent a loan made by an investor to the owner of the asset. *New financial instruments such as floating rate bonds, zero interest bonds, deep discount bonds, revolving underwriting finance facility, auction rated debentures, secured premium notes with detachable warrants, non-convertible debentures with detachable equity warrants, secured zero interest partly convertible debentures with detachable and separately tradable warrants, fully convertible debentures with interest (optional), differential shares, securitized paper, collateralized debt obligations, and inverse* *float bonds, perpetual bonds, and municipal bonds.*

IAS 32 and 39 define a financial instrument as "any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity"

Objectives of Study:

1) To know about various emerging financial instruments in financial system.

2) To know about the various reasons for innovations in financial instruments.

Research Methodology

This paper is prepared with the blend of theoretical knowledge consist of secondary data. In secondary data the main source of information will be carried out from Internet, which will be supported by the extracts from various newspapers, magazines, journal, and books.

I. Main Reasons for Innovations in Financial Instruments.

- Every product needs continuous re-engineering. Moreover, it has to be tailor-made according to the needs of the consumers. The investment environment does not get a boost if there are repeated offerings of the same product. Hence, new designs of financial products are always needed.
- The interest rates had dropped and this trend forced the corporate world to think of new financial instruments.
- Investors also prefer not to be saddled with long-term instruments. Hence, instruments with varying maturity periods and with various put and call options are preferred.
- The old trend of getting finance from financial institutions has changed. Now companies prefer the capital market as a source of finance. To successfully tap capital markets, companies are compelled to offer attractive terms even on debt securities, in order to raise funds.
- Investors have shied away from the equity market in the last few years due to various capital market scams. Attractive financial instruments are needed to lure these investors back.

II. **Let us discuss some financial instruments in detail**

1. Securitized Paper:-

It is a popular fund-raising technique in the developed markets such as the US and the UK. Asset securitization began in the US in the 1960s with the pooling of residential mortgages.

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Now, this concept extends to a whole range of financial assets such as receivables and mortgages held by businesses and financial firms.

Securitization is a process by which a company raises money by selling off its receivables. These receivables are sold off to cash-rich investors by converting them into securities. The receivables are sold at a discount to the investors which represent the yield. In securitization, the assets to be securitized are identified on the basis of their creditworthiness.

Factoring is quite similar to securitization as the factor buys the receivables of a company at a discount. However, there is no rating or creation of a secondary market in factoring. Moreover, factoring has evolved as a trade financing tool rather than for medium-or long-term financing.

2. Floating Rate Bonds: -

A floating-rate note is a bond that has a variable interest rate, vs. a fixed-rate note that has an interest rate that doesn't fluctuate. The interest rate is tied to a short-term benchmark rate, such as LIBOR or the Fed funds rate, plus a quoted spread, or rate that holds steady. Many floating-rate notes have quarterly coupons, meaning that they pay interest four times a year, but some pay monthly, semiannually, or annually.FRNs appeal to investors because they can benefit from higher interest rates since the rate on the floater adjusts periodically to current market rates.

3. Deep Discount Bonds:-

A deep discount bond is a zero coupon bond whose maturity is very high, say 15 years onwards and is offered at a discount to the face value. The Industrial Development Bank of India (IDBI) was the first financial institution to offer DDBs in 1992.

The issuers have successfully marketed these bonds by luring the investor to become a ‘lakhpati’ in 25 years. Moreover, these instruments are embedded with ‘call’ and ‘put’ options, providing an early redemption facility both to the issuer and the investor at a predetermined price and date. The issuer becomes free from intermittent cash flow problems and the funds can be deployed in infrastructure projects which involve long gestation periods.

Many variations of DDBs and zero interest bonds have come into the market. Some of them are as follows.

Zero Interest Secured Premium Convertible Bond The investor can convert his bond into an equity share at 30 per cent discount on average price at the end of one year. If the conversion price is lower than the face value, the issuer will redeem the difference. A similar option of conversion into two equity shares is available on the maturity of the bond. The bond may also have a warrant attached.

Zero Interest Fully Convertible Debenture The investors in these debentures are not paid any interest. However, there is a notified period after which, fully paid, fully convertible debentures (FCDs) will be automatically and compulsorily converted into shares. In the event of a company going for rights issue prior to the allotment of equity, resulting from the conversion of equity shares into FCDs, FCD holders shall be offered securities as may be determined by the company.

4. Auction Rated Debentures:-

It is a secured, redeemable (after 90 days), non-convertible instrument with interest determined by the market and placed privately with bids. ARDs are a hybrid of commercial papers and debentures. ANZ Grind lays designed this new instrument for Ashok Leyland Finance (ALF). This was a three-year instrument which had a zero coupon rate and was sold at a discount. The company repurchased the ARDs after three months of the issue and then re-issued them through fresh auctions. The interest rates were negotiated at quarterly auctions; this continued for three years. ALF raised Rs. 30 crore through this unique zero coupon instrument. ARD is technically a short-term instrument but it provides long- term finance for the company.

5. Non-convertible debentures with detachable equity warrants

The holder of this instrument is given an option to buy a specific number of shares from the company at a pre- determined price and time frame. The warrants attached to the NCDs are issued, subject to full payment of the NCDs value. There is a specific lock-in period after which the detachable warrant holders have to exercise their option to apply for equities. If the option to apply for equities is not exercised, the unapplied portion of shares would be disposed of by the company at its liberty.

Escorts, Bombay Dyeing, and Indian Rayon were among the early issuers of NCDs with warrants attached. Secured Zero Interest Partly Convertible Debentures with

Detachable and Separately Tradable Warrants

This instrument has two parts. Part A is convertible into equity shares at a fixed amount on the date of allotment. Part B is non-convertible, to be redeemed at par at the end of a specific period from the date of allotment. Part B carries a detachable and a separate tradable warrant which will provide an option to the warrant holder to receive an equity share for every warrant held at a price determined by the company.

6. Domestic Convertible bonds:-

These are hybrid securities that allow investors to separate the embedded equity portion from the bond and trade it separately. Because of the option to convert debt into equity, issuers can raise debt at a lower interest rate. These bonds were proposed by the Finance Minister in his 2008–09 budget speech to deepen the corporate bond market. However, this would require policy changes in different regulations and hence, the SEBI proposed an alternative instrument— Non-convertible debentures with detachable warrants. This instrument would help companies raise low-cost debt. It also allows the investors to detach the equity component from the instrument and trade on it.

7. Inverse Float bonds:-

These bonds are the latest entrants in the Indian capital market. Inverse float bonds are bonds carrying a floating rate of interest that is inversely related to short-term interest rates. The floating rate could be the Mibor (Mumbai inter-bank offer rate) or some other rate. If the Mibor falls, the return for the investor rises and vice versa. The actual rate payable on these bonds is arrived at by subtracting the floating rate from a fixed benchmark rate. Suppose the fixed benchmark rate is 12 per cent & the six-month Mibor is 6 percent, then the interest rate payable on these bonds is 6 per cent (12–6). These bonds enable investors to earn high returns in a low interest rate environment. As interest rates are highly volatile, the investor has to observe the interest rate behavior carefully over the entire bond period, else he could end up getting a poor return. Thus, both the investor and the issuer have to hedge the interest rate risk. If the interest rates go up, the issuer benefits as the coupon rate of his bonds will decline in spite of higher interest rates.

Inverse float bonds were introduced in the US market in 1990. In India, the Aditya Birla Group, Grasim, and Hindalco issued inverse float bonds in August 2002. The

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Cholamandalam Investment and Finance Company Limited (CIFCL) were the first non-banking finance company to raise funds through the issue of inverse floaters.

8. Municipal Bonds

They are debt securities issued by the municipal corporation of a city to raise funds for financing their growing investment needs for a host of infrastructure projects. The Indian municipalities need a sum of Rs. 28,500 crore to finance a number of basic projects. The financial health of municipalities is in a poor state. Till now, only the large municipalities were able to tap the market through issuance of such municipal bonds. Large municipalities issued bonds worth Rs. 1,500 crores. These bonds had limited appeal because the annual cumulative ceiling on municipal bond issues was a measly Rs. 150–200 crore and the tax-free status was available only for select issues. At times, these bonds were made saleable through government guarantee.

The Indian municipal bond market constitutes a mere 0.1 per cent of the total corporate bonds traded in India in contrast to the US municipal bond market which accounts for about 12 per cent of the total corporate bond market. The preference of Indian investors, including insurance companies and banks, to invest in securities with shorter maturity, regulatory restrictions on investment allocation, and a fewer number of tax-free bonds acts as constraints on the development of this market.

9. Perpetual Bonds

They are debt instruments which do not have a maturity date. The investors receive a stream of interest payments for perpetuity. The bonds can be issued to retail investors with market making to ensure liquidity. The oldest perpetual bonds that continue to be in existence are those issued by the British Government no maturity date in 1814 to fund the Napoleonic wars.

In case of liquidation, holders of perpetual bonds are paid second last, after all other depositors and creditors but before equity shareholders. Being permanent in nature, they qualify as Tier I capital (i.e., equity and free reserves) of banks.

Another hybrid instrument similar to perpetual bonds is perpetual preference shares.

10. Differential shares

Differential shares are shares with differential rights to voting and dividends. They are a class of shares which carry voting rights with varying rates of dividend. In fact, differential shares can be issued with no voting rights but high dividends or, with varying rights and dividends. If the voting right of the shareholder is taken away, the shareholder is compensated by higher returns. This concept originated in Canada and was highly successful. This concept was introduced in India through the Companies (Second Amendment) Act, 2000. According to this law, a company can issue shares with differential rights 'as to voting or dividend or otherwise.'

Companies are now allowed to issue shares with differential voting rights including non-voting shares, to the extent of 25 per cent of the total share capital, provided, they had profits that could be distributed, in the preceding three years. However, companies will not be allowed to convert their equity capital, with regular voting rights. Into shares with differential voting rights and vice-versa. Differential shares are positioned between ordinary equity shares and preference shares. The preference shareholders are entitled to certain assured dividends but no voting rights while ordinary equity shareholders have voting rights in proportion to the number of shares held but are not entitled to any assured return.

Conclusion

There are lot of Financial instruments in the market, as per the need and objectives of investor different innovative financial instruments are introduced by the companies in the market the only need is to create awareness about new and innovative financial instruments among the investors. Make legal amendments to protect the interest of investors and list them on stock markets.

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