Innovations in Indian finance

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Two levels of innovation

1. To do something new by Indian standards.
   Definition we are comfortable with: “do things differently today compared with what we did yesterday”.
2. To do something truly new by world standards.
   Definition of innovation: “crossing the frontier of pre-existing human knowledge”.

Doing new things by Indian standards

Mostly blindingly obvious

- Currency derivatives.
- Cash-settled interest rate derivatives.
- Call auctions.
- Stock-lending.
- Options on commodities.

Nothing really at the frontiers of knowledge in any of these.
Akin to adoption of global technological advance – e.g. like the first Android phone coming to India.
Currency derivatives was launched globally in 1972. We did it in 2008. Why did it take us 36 years?

What holds this innovation back?

- Central planning in finance.
- Embedded in the laws, and
- Enforced on the ground by RBI, SEBI and the others.

We broke away from central planning in the real sector, but not in finance.

Doing new things by world standards

A few success stories

- NSCC: intra-day real-time VaR calculation at the client level (the “PRISM” project, built in late 1990s, rolled out early 2000s)
- CCIL: netting by novation for OTC transactions
- Governance of exchange institutions: the three-way separation between shareholders / managers / securities firms.
- New Pension Scheme: A dramatic attack upon fees and expenses in fund management.

A failure story: Gold ETF by Benchmark

- Benchmark AMC proposed a true innovation in May 2002: to apply the ETF idea to gold.
- At the time, it would have been a first by world standards.
- They were given the run around by RBI / SEBI / FMC
- Others got the idea: Gold ETFs were launched at NYSE and on the Australian Stock Exchange
- Benchmark finally got through with a launch in February 2007. By that time, this was not an innovation by world standards.

Looking forward

Motivation for innovation

- Innovation is driven by incentives. These are:
  1. Competition
  2. Internationalisation
  3. Getting a temporary headstart
- If the system fosters competition, globalisation, and rewards first movers a (temporary) advantage, it will deliver more innovation.
  If there is lack of competition, insulated local economy, and does not reward first movers, it will see low innovation.

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The incentives of the firms

- Innovation does not happen in a vacuum
- Firms expend resources on R&D based on the costs and benefits obtained thereof
- If the policy climate is hostile to innovation, this is like a tax on R&D and it will deter R&D
- To the extent that competition is lacking, firms are comfortable earning profit and will expend less effort on innovation.
- Banks in India are sleepy.
- More generally, Indian households do not have a choice of taking their business away from the Indian financial system, so Indian finance is sleepy.

Role of the State

- Regulation, *not* central planning.
- Details of products and processes are best left to the market.
- Government/policy should focus on market failures, fairplay, laws to enforce contracts.

Overcoming the policy bottlenecks

Percy Mistry and Raghuram Rajan reports:

- Many innovations run afoul of the multiple-agency structure.
  Short term solution: FSDC
  Long term solution: Fewer agencies.
- The laws embed central planning.
  Solution: Better drafting of laws, go back to our common law tradition.
  Budget announcement of FSLRC.
- Bureaucratic incentives: Lack of knowledge, safety first attitude, biased towards “Just Say No”
  Solution: Better staff quality in financial regulators, agencies like FSDC that care about development.
- Do not fear experimentation, do not give up with one failure.

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