M.Com, Semester-IV, Subject: International Finance
Module II, Topic-(10) Recent Developments
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Capital Account Convertibility

Before understanding the concept of *Capital Account Convertibility*, let us first try to understand the meaning of *Currency Convertibility* because whether it will be *Current Account Convertibility* or *Capital Account Convertibility*, in both the cases, home currencies get converted into foreign currencies or vice versa at the market determined exchange rate without any restriction/foreign exchange control. It is so done to offer freedom or ease to convert domestic currency into foreign currency and vice versa to the various international traders such as exporters, importers, foreign investors and corporate houses etc., to satisfy their cross border business transactions. Now, in case of *Current Account Convertibility*, domestic currency get converted into foreign currency and vice versa involving current account transactions i.e. trade in goods and invisibles like services, transfers or income from investments etc. Alternatively, *Capital Account Convertibility* infers such freedom to execute capital inflows and outflows. It offers the opportunity to transact financial assets such as shares, bonds etc. It is a bit complex than *Current Account Convertibility* as it involves the inflow or outflow of foreign capital. Developing nations, like ours, always encourage *Capital Account Convertibility* transactions to have the advantages of getting additional foreign capital and invest in financial assets of other countries without any restriction, as well and that is why it is often termed as *Capital Asset Liberation*.

In the year *1997*, a committee, formed by the Reserve Bank of India, worked under the chairmanship of Dr. S.S. Tarapore, added valuable contributions to the theory of *Capital Account Convertibility* in terms of defining it as *"the freedom to convert local financial assets into foreign financial assets and vice versa at market determined rates of exchange. It is associated with changes of ownership in foreign/domestic financial assets and liabilities and embodies the creation and liquidation of claims on, or by, the rest of the world"*.

Innovative Financial Instruments

Innovation in financial instruments is a dynamic process that aims at developing new financial instruments and new financial technologies as well, over time. In recent times, financial instruments have witnessed a massive popularization in India and thus given birth to a number of new avenues of investment such as *"new credit, deposit, insurance, leasing, hire purchase, and*

other financial products". Some of the innovative financial instruments which have gained momentum over the past few decades, in India, are nicely portrayed in a number of Indian researches and among those, *Sethi (2013) and Gaurav (2016)* are very informative. According to *Gaurav (2016),* following are the innovative financial instruments in Indian context. A brief description on such instruments is given below:

1) *Triple Option Convertible Debenture (TOCD)*

It was issued by the Reliance Power Limited for the first time in *1993*, in the market with an issue size of Rs. 2,172 Cr. Unlike a conventional debt instrument, the *TOCD* was structured differently. It was issued with a face value of Rs 60 each with a convertible portion of Rs 20 which could be converted into two shares of Rs 10 each. During the first five years of operation, there was hardly any outflow of interest though it witnessed some increase in equity.

2) *Deep Discount Bond (DDB)*

Deep discount bond is a kind of bond that is offered at a price below its face value and it uses to carry a lower rate of interest during its tenure. Here, the coupon rate is significantly less than the market rate. From the investor's perspective, it yields tax advantage and eliminates re-investment risk and on the other hand, from the issuer's side, it eliminates the risk of re-financing as it does not involve any after sale service cost.

3) *Floating Rate Note (FRN)*

It is a debt instrument having its coupon rate tied to a benchmark rate such as LIBOR and due to the floating or variable nature of its coupon rate, it is called as floating rate note (FRN). In India, it was first issued by the Tata and wherein, the investors could expect to get a minimum return of the floor rate. The maturity period of FRN's generally ranges in between two to five years. Presently, FRN's are being offered by the government and financial institutions, as well.

4) *Zero Coupon Bond (ZCB)*

Zero Coupon Bond is like a fixed investment where one-time investment is done at the beginning and at maturity, the principal amount along with the interest accrued, becomes receivable. A zero-coupon bond behaves in that way and it does not offer any yearly return. The discount, representing the interest on the bond is usually paid at the maturity of the bond.

5) *Convertible and Zero Coupon Convertible Bond*

It differs with *Zero Coupon Bond* in the sense that its interest is effectively lower as it provides the option of convertibility into stock in the issuing agency.

6) *Secured Premium Note (SPN)*

These are secured financial instruments as these notes are secured against assets of the issuer and redeemable after a certain period. In India, the first SPN was introduced by the TISCO in *1992*. SPN may have a lock in period ranging from four years to seven years. It can only be offered by the listed companies. It embraces the role of a hybrid kind of instrument as it brings the features of equity and debt instrument, together.

7. *Credit Derivative (CD)*

A credit derivative is a negotiable bilateral contract between two parties who exercise a debtor and creditor relationship and are willing to minimize the risk of their contract through a third party. *Gaurav (2016)* has mentioned Credit derivatives as *"off-balance sheet financial instruments that permit one party (beneficiary) to transfer credit risk of a reference asset, which it owns, to another party (guarantor) without actually selling the asset"*. It is of three categories viz. Credit Default Swap (CDS), Credit Linked Note (CLN) and Credit Linked Deposit (CLD).

The other common forms of financial instruments in operation presently, are weather derivatives, mortgage backed securities, pension funds, Indian depository receipts and economy growth futures.

References:

Gourav (2016). Financial Innovation in Indian Capital Market: Concept and Implications, *IJARIIE*, Vol-2, Issue-4.

Sethi, P. (2013). Financial Innovation in Indian Capital Market, *IIJRD*, Vol-2, Issue 11.

Other e-resources like Wikipedia, Investopedia etc.