

P E R S P E C T I V E

Understanding the Financial Product Life Cycle



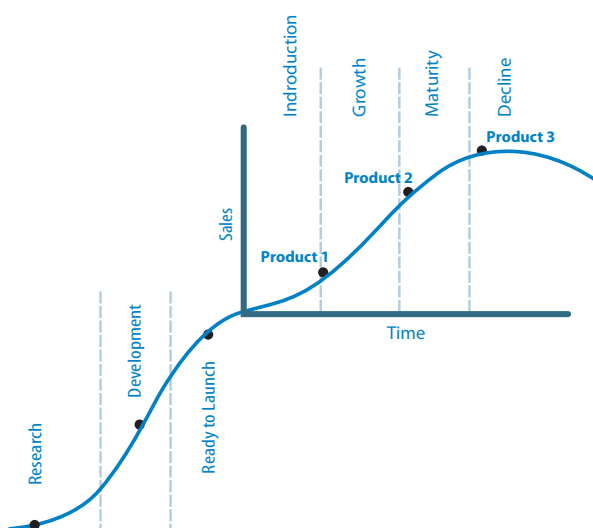
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Some financial and investment products have been around since decades. The most successful ones have attracted investor attention by providing consistent returns or maintaining a favorable balance between risk and reward. There are a host of financial products available in the market, issued and guaranteed by government / quasi-government institutions or corporate entities.

All products, including financial ones, go through a lifecycle; however, the stages of a financial product lifecycle are slightly longer because they mirror the life stages of their users. Each investor tries to achieve the right mix of products in his portfolio - by picking those that are designed to fulfill his specific needs - from a wide range of options including, but not limited to, savings bank accounts, fixed term deposits, mutual funds, equities, fixed income securities, derivatives, structured deposits and hedge funds.

Traditionally, the product lifecycle has been categorized into the following four stages:

- Development and Introduction
- Growth
- Maturity or Stagnation
- Decline or Death



The financial services industry saw the development and introduction of many products in the last quarter of the twentieth century due to a number of reasons including market globalization, changing investment trends, etc. A more detailed look into each stage would

provide insight into the various factors influencing the financial product lifecycle.

Factors Leading to Development of New Financial Products

Risk diversity is the most important reason for the development of different financial products. If every individual had the same attitude towards risk or a similar appetite for it, there would be only one financial product in the entire market. Return on Investment is the underlying principle of any financial product and since the rate of return is always linked to inherent risk, financial products available in the global market can be differentiated on the basis of risk-reward ratio.

Because risk is linked to a number of dynamic environmental factors arising from geopolitical and economic conditions, financial products are continuously evolving with changing risk characteristics. Over the last fifty years, individual risk capacity, and even the definition of risk, has changed drastically. Each of these changes has provided an opportunity to design a new financial product, which in the present day, is achieved through financial engineering.

Another major reason for the introduction of new financial products is economic reform. For example, liberalization initiated in 1992 took the Indian mutual fund industry to a different level. The number of mutual fund companies grew steadily to its present count of thirty-three. Assets Under Management, which stood at Rs. 470.04 billion in 1993¹, rose to Rs. 1218.05¹ billion within ten years as private sector players increased market penetration with a flood of new fund offers.

Although knowledge is vital to the enhancement of a financial product in the growth stage, it also plays a definite role when the product is being introduced. As investors become financially savvy and begin to appreciate the different product models, banks must seize this opportunity by designing improved complex products, using all the knowledge at their disposal.

Channel proliferation has encouraged the development of new products by improving banks' access to customers and consequently, customers' access to products. This has

triggered the introduction of many innovative financial products like structured deposits and bancassurance, to name a couple, which are sold as bundled products.

Technology advancement has also played a vital role in product development by creating a robust backend platform that not only facilitates product design but also reduces time to market for new launches.

From a financial institution's perspective, the factors giving rise to a new financial product are:

- Customers' need to invest disposable income
- Customers' desire for a higher return than that offered by traditional investments
- Customers' need to achieve financial milestones at different life stages
- Their own need to stay competitive
- Their need for higher revenue
- Their desire to be a complete service provider to their customers.

Typically, the birth phase of a new product sees consumer awareness take off slowly. In this phase, the organization incurs high costs, especially towards selling and advertising, but earns low revenue. Structured products and deposits – relatively new to the Indian markets and still undergoing evolution – fall into this category. Although several institutions are promoting these products, they haven't yet attracted mass participation on account of insufficient awareness.

Factors Influencing Growth of Financial Products

Once a product has been launched in the open market, its growth depends upon multiple factors. Although return is the most important of these, other factors can also propel or hinder its progress. That being said, a product that provides consistent return at reasonable risk (in relation to return) is likely to succeed quickly.

Reach / accessibility is one of the other factors impacting growth. Globalization has made it both easy and necessary to take products originating in one part of the world to other corners. Therefore, in order to succeed, a financial product must be designed to satisfy global markets needs. This

is the reason why the mutual fund is so successful – it has diversity and can be tailored to the needs of investors in different geographies.

Transparency is important too, although it takes a back seat in the case of complex, high-risk high-return products like hedge funds. But, when two products offer the same return, investors will always prefer the one that is more transparent, regulated and controlled. And while promotion plays a role, too much of it might lead to overkill. In fact, financial products respond less to advertising than do many others, the main reason being that their purchase is influenced more by the risk-return equation than any other consideration. This is illustrated by Systematic Investment Plans (SIPs), which owe their success not to marketing support, but rather to their ability to reduce risk and provide stable returns despite market volatility.

Factors Precipitating Maturity of Financial Products

As mentioned at the outset, the stages of a financial product lifecycle are longer compared to those of other products, which means that there could be a long growth phase before the product enters maturity. Since a mature product is well established in the market, there is no longer a need for financial service providers to promote it actively. While a mature product is likely to be part of every investor portfolio, it is equally likely to have a small or declining share in it. There are many reasons for this, the foremost being the risk-return ratio. When a new product promises similar or higher return for the same amount of risk as a mature one, the latter seems less attractive to investors.

Take endowment insurance plans for instance, which have been part of almost every investor portfolio in India in the last three to four decades. But, the last five years have seen a decline in asset allocation due to the rising popularity of mutual funds combined with life insurance, which provide higher returns.

The evolution of new products with huge reach also forces some old products into maturity. For example, economic progress and liberalization combined with the adoption of technology by stock exchanges and active distribution by

banks enabled Indian equities and mutual funds to grow strongly in the last twenty years, mainly at the cost of fixed deposits. In particular, when interest rates hit a low at the start of this century, the demand for fixed deposits started to flag.

But sometimes, changing economic conditions can rejuvenate a product that is on the wane. Hence, a financial product need not always progress through the different stages of its lifecycle; at times, it can also reverse direction. This is exactly what happened during the recent financial crisis, when an increased focus on safe investment avenues brought banks deposits back in favor.

Factors Leading to Death of Financial Products

Regulation is the leading cause of death of financial products. Should a product be found to have significant negative impact on the investor community, it is likely that the regulator will ask financial service providers to desist from offering it to customers. In other cases, regulation does not allow certain products to take birth. For example, some countries prohibit short selling, thereby preventing the introduction of a number of related products; and then there are others, which don't allow products that do not comply with Islamic banking laws.

At times, a financial product may die a natural death when it finds no takers. This might be due to a less favorable risk-return equation or lack of push by intermediaries (brokers, distributors). Faced with a declining client base and high maintenance costs, the financial service provider

may have no option but to discontinue the product. Existing customers might stay invested in the product, but it is not sold to new investors. For example, recurring deposits are being eased out of the product suite, because there are many new products fulfilling the same objectives, which promise higher return.

Conclusion

Several factors positively or negatively influence a financial product during every stage of its lifecycle. As in the case of other product lifecycles, the stages of a financial product lifecycle too do not occur in silos, but rather, overlap to a certain extent. Financial service providers must closely monitor changing investor need and economic trends, as well as the lifecycle of their products in order to take timely decisions to develop a new product, promote a fledgling one, or nurse an established product through maturity. They should also know which products are on the verge of death and be ready to replace those with new innovations.

¹ India Mart

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