

# Role of Financial Innovation in Achieving Economic Sustainability: A Review Study

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## Abstract

*Financial innovation accelerates the economic sustainability of firms by enhancing financial markets' productivity, accelerating capital development, improving financial services, and creating more effective financial intermediation. This article, therefore, highlights the possible economic performance associated with applying different methods of financial innovation. Employing a desk study methodology, this paper discusses the effectiveness of financial innovation techniques in enhancing firms' economic sustainability performance theoretically. In doing so, this review paper provides policymakers and practitioners with several insights into the efficiency of such strategies for businesses' sustainable economic growth.*

## Keywords

*Economic Sustainability, Exchanged-traded funds, Financial innovation, Hedge funds, private equity, weather derivative.*

## INTRODUCTION

Economic sustainability is tremendously motivated by rapid financial innovations internationally [5]. Financial innovation can thus play a significant role in achieving economic sustainability for firms by mainly (i) easing the financial activities in global trade and (ii) enhancing financial proficiency. Financial innovation is deemed as an instrument for appreciating the financial progress [19], high-tech advancements [21], qualified financial intermediation [13] and hence it is expected to lead to enhancing firms' economic sustainability performance [5].

Recently, a few studies examined the possible impact of financial innovation on economic growth; see, for example, [18]; [15], [4]. However, there is a scarcity in investigating the possible effects of financial innovation on the broader concept of economic sustainability. Hence, this review paper seeks to extend the relevant literature in a number of ways. First, in this article, different financial innovations like hedge funds, weather derivatives, private equity, and retail-structured products are discussed briefly. Second, the role of financial innovations in promoting businesses' economic sustainability is further discussed, pointing to its advantages and disadvantages. Finally, this study explores how financial innovations can be beneficial for organizations' economic sustainability performance.

This article is structured as follows. Section 2 discusses the role of financial innovation. The advantages and disadvantages of financial innovation are reviewed in section 3, while the research method is explained in Section 4. Sections 5 and 6 discuss the potential impact of various financial innovation techniques on the economic sustainability performance of firms, while Section 6 is the conclusion.

## ROLE OF FINANCIAL INNOVATIONS

Risk transfer, equity, credit generation are important and vital parts of financial innovation [24]. The role of financial innovation in sustainable economic growth is unquestionable. Crucially, the sustainable development of contemporary corporations is not possible without the appropriate innovation management, knowledge, reputation, and confidence management [6]; [9]. On the other hand, Arthur (2017) said that the whole process creates and implements new ideas under which the valuable circulation of goods and services revolves. The prerequisite design of financial innovation expects creativity to blend multiple ideas in a unique way.

Financial innovations engage remittances, mobile banking, equity capital, and others. Not only business organizations but also individual persons can benefit from financial innovations. Financial instruments have the critical function to store wealth and payment means. Savings and earnings, allocating risks, providing financial services, and financial innovations accelerate the growth of the financial industry [7]. The great role of financial innovation is to process the capital throughout the market and keep it active throughout the entire time. Financial definition and role are bounded by the credit-debit form of money beyond the encrypted token.

## ADVANTAGES AND DISADVANTAGES OF FINANCIAL INNOVATION

Financial innovation is the act of creating and popularising financial instruments. It has implied advances in payment methods of borrowing and lending over time. It is helpful for the payment mechanism of the economic system. Financial services offer vital services, and it screens, evaluates, and allocates capital. After allocating the capital, it also monitors the use and facilitates transactions in order to observe risk

management. If the financial system offers a well-maintained service, the capital reaches the most deserving and promising firms. The entire system promotes sustainable economic growth. Financial innovations are created from new securities, organizations, and markets, which are now presenting improvement in the financial service sector, and accelerating sustainable economic growth [11]. These advances engage innovation in technology, credit, equity generation, and risk transfer. A number of innovations have been included among them over time.

Financial innovations are represented to improve the material well-being of the big economic players. Positive innovations like hedge funds and private equity have helped business organizations and individuals attain targeted economic goals. It has enlarged the possibilities and places for the mutually advantageous exchange of money and goods. It has also created intermediation, increasing product variety for the business; on the other hand, at an individual level, it has provided security, assisting in widening productive use of finances (Isaeva and Leshchenko, 2019). Financial innovations have also helped moderate business cycle fluctuation and motivated technological advancement as well. While it is compared with the disadvantages, the rate of threats in financial innovations is comparatively less than its benefits that can emerge for the high-speed trading overseeing the output and complexities in applications [14].

## RESEARCH METHOD

Financial innovation is not only recognized as a simple financial tool but also the entire payment structure is relied upon. The major role of financial innovation is applicable in the borrowing and lending of funds. Following [2], this study uses a desk study method to understand the potential influence of financial innovation on corporate economic sustainability. The study has adopted a review approach that discusses the empirical findings of previously published literature and documents of the same field. This review paper has emerged useful to highlight the multiple issues of financial innovation. The study has become necessary with the diverse analysis on this day.

## RESULT AND DISCUSSIONS

### Hedge Funds

Besides the risk properties and unique costs, hedge funds include financial innovation by adapting novel investment strategies that minimize the market risk, namely 'beta', which may improve the return attributable to the manager's skills, 'alpha'. The historical performance of hedge funds indicates that the ultimate result of this financial innovation focuses on helping the capital investors by reducing the financial losses in times of downturn [16].

### Private equity

Private equity is the substitute form of investment, consisting of capital that is not enlisted in the public exchange. It is composed of investors and funds which are

directly invested in private organizations. Retail investors and institutional investors supply the capital to tackle private equity where the capital can be engaged to make an acquisition and private equity. Private equity solidifies the working capital and the balance sheet. Usually, the private equity fund consists of limited partners; these partners hold almost 99% of the shares. With the limited partners, the liability is also limited where it is also responsible for operating the investment and executing the fund [24].

### Weather derivatives

Individuals or organizations use weather derivatives to hedge against losses and weather-related risks. Weather Derivative deals over-the-counter (OTC) via exchange or through brokers [17]. It agrees to carry the circumstances of disaster for a premium. Before the expiry of the premium, if any disaster does not happen, the seller gains the profit; on the other side, the buyer can claim the contracted amount if the adversity created by the watch can be proven. It almost acts as insurance paying out the amount according to the contract incurred the effects of weather. Tourism, travel, energy sectors, and agricultural sectors are a few of them that can benefit from this financial innovation to mitigate the challenges of weather, achieving sustainable economic growth [10].

### Retail-structured products

Financial innovation has totally changed the rise of investors in the retail sector. In this innovative approach, structured products remain pre-packaged, which basically includes the assets that are linked to interest single or more derivatives. It grabs the conventional securities like investment-grade bonds and alters the known payment feature with non-conventional payoff [20]. Structured products may be a principal guarantee that issues the returns based on the maturity date of the premium. The risks and challenges associated with it are fairly complex and likely to lack liquidity [22].

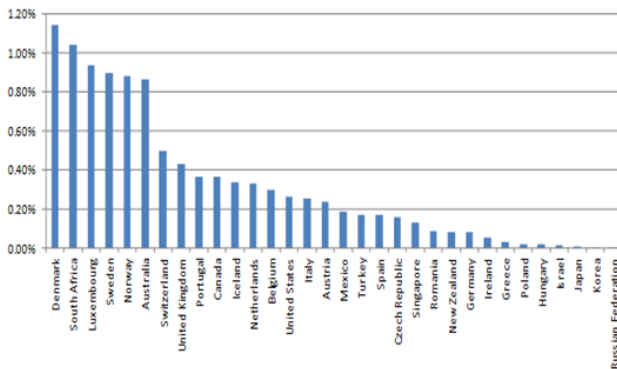
### Exchange-traded funds

Exchanged-traded funds (ETF) are the set of multiple security variables like shares, bonds or the money-market components. In simple terms, it can be said that an ETF is the collection of various investment avenues which offer attributes of financial assets- stocks or mutual funds. It very often focuses on the underlying assets. In some places, it is similar to mutual funds regarding the basic structure, management style, and regulations [22].

### Financial innovation and economic sustainability performance

The importance of financial innovation on sustainable economic development has long been placed. Irrespective of supply function or demand, it is necessarily believed in the sustainable economic growth performance. Consequently, it accelerates the growth in developing as well as in developed countries [8]. Economic development through financial

innovation allows people to access huge institutional credit as an investment [17]. Progression is considered as the channel of effective mobilization of sustainable economic funds. According to [20] and [23], credit in financial innovation has a huge influence to promote sustainable economic growth.



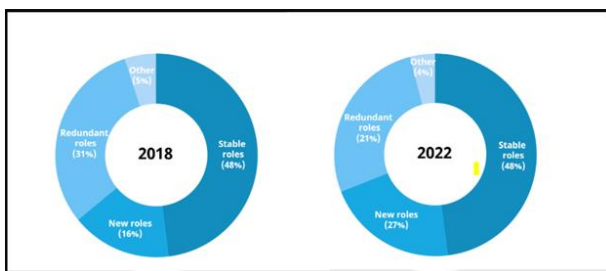
**Figure 1:** Financial innovation throughout the countries (Source: Inspired by Yang and He, 2019)

Figure 1 presents the picture of financial innovation across many countries. It relates cross-country indicators to the financial sector and real outcomes to obtain the final outcomes. This shows that Denmark, South Africa, and Luxembourg stock markets react to financial innovation more efficiently and effectively than other countries, such as Japan, Korea, and the Russian Federation. The high and low rates can be seen in the graph.

### TYPES OF FINANCIAL INNOVATION AND ITS IMPORTANCE TO ORGANIZATIONS' ECONOMIC SUSTAINABILITY

#### Financial growth through innovation

Countries, where financial organizations spend more on innovation can access sustainable economic growth opportunities and translate them into GDP. Industries that depend on external finance and R&D activity are also experiencing volatile economic growth, making the expenditure on financial innovation. Given Yang and He (2019), those countries where the banks spend more on financial innovation are fragile. This relationship is strong between those banks and the tiny market shares. Those countries where the banks invested more in innovation before the crisis may confront a huge reduction in profit.



**Figure 2:** Impact of innovation in business (Source: Yang and He, 2019)

#### Potential risks and profit of financial innovation

Financial institutions and the markets perform like the plethora in economic profit and loss. Innovation can only benefit the way it is established, and sometimes the profit is huge; on the other hand, it may be temporary, [16]. One of the most common aspects of financial innovation lies in the *Payment* function. It is also functional in *savings and earning* at an individual level or in the industrial pace offering proper access in saving assuring the potential circumstances. While it talks about the primary sector, the developing countries that are majorly dependable on the primary sector can benefit greatly. Agricultural places in Asian countries or coastal areas are hugely affected by the vulgar nature of weather. Financial innovations like weather derivatives are helpful to attain profit mitigating the challenges. It is also beneficial for the small and medium industries to deal with the risks and challenges [23]

Financial innovation may also be fragile and tend to shock. As a sign of robustness, it may also be vital. It has been seen; before the potential applications, it may face profit reduction when the organization invests more in financial investment. Besides the challenges and risks of financial innovations, the output has dynamic potentiality on the business and individual levels.

#### Solution plan

The Profit of the financial innovation appliance is comparatively higher than the loss. In order to reduce the fall, companies should observe whether it is applicable, and they should invest in financial innovation. This can help to control the array of profit and loss that emerged from financial innovation fragility. The observance holds for large arrays or other organizational features measuring the financial depth, credit to GDP. These variables altogether may provide evidence both for the financial innovation fragility and the sustainable economic growth.

#### CONCLUSION

From the observance of financial innovation in this study, it can be concluded that the relationship between financial innovation and sustainable economic growth or economic sustainability performance is not only significant but also complex. Financial innovation is highly associated with economic sustainability controlling the aggregate indicators. The application of this innovation and the outcomes vary across countries. Apart from the risks and challenges that appear due to financial innovation, the benefits can be observed in the payment, risk assessment, and savings and earnings at both the organizational and individual levels.

This review paper is beneficial to policymakers, the corporate sector and practitioners. Specifically, it gives a better understanding of the topic as this review is directly related to the recent innovation boom compared to traditional investment methods. It is argued that financial innovation has dramatically influenced the economic benefits, and the potential risk factors can be reduced if managed carefully.

Although this study is limited in terms of nature to a review approach, it offers avenues for future studies to empirically explore the potential impact of financial innovation on the economic sustainability of firms internationally.

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