


Andreas Krause



Financial innovations and asset management

Investment bank business beyond advice

- Investment banks are active in many areas beyond providing advice to companies issuing securities and investors
- Companies or investors might approach them with specific concerns whose solution might be the development of new securities
- Examples of such securities were futures on interest rates and exchange rates in the 1970s, before they were available for commodities mainly
- Other innovations include stock index futures in the 1980s and credit derivatives in the 1990s
- Investment banks also take their advice one step further by offering to manage the wealth of their clients

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- ↳ Reacting to demands for new types of securities by their clients can impose significant costs
- ↳ New securities require the desired properties to be designed and legal documentation to ensure the contracts are enforceable
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Motivations when introducing financial innovations

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- ▶ Financial innovations might be introduced in phases or started with other banks
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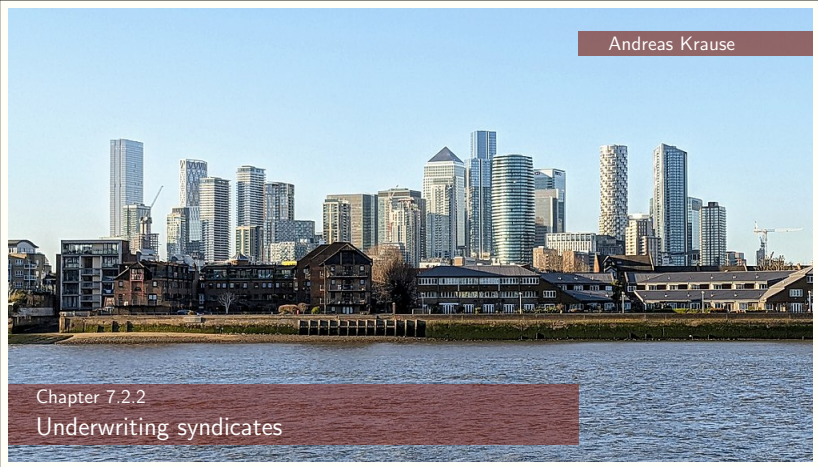
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Chapter 11.2
Introduction of innovations

Discussion of the model results

- ▶ Investment banks can use financial innovation as a tool to gain reputation and market share
- ▶ This is a strategy that is particularly attractive to small investment banks, while mid-sized investment banks seek cooperations to reach a larger market
 - Will investment banks always seek to develop controversial financial innovations to gain market share?
 - Investment banks will balance the gains from such innovations against the potential costs from tighter regulatory oversight, reputation with less aggressive clients, and general reputation with investors

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- ▶ Investment banks can use financial innovation as a tool to gain **reputation** and market share
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Delegation of investment decisions

- ▶ Investment banks provide advice to clients through financial analysts. Some wealthy clients have no other knowledge or they do not make use of this information.
- ▶ For such clients, investment banks offer to manage their wealth without clients having to make specific investment decisions.
- ▶ Investment banks make the detailed decisions within the framework of investment agreed.
- ▶ Such delegation of decision-making will allow the investment bank to make investment decisions that suit their objectives.

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Chapter 12
Asset management

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- Investment banks invest into assets that have higher risks than the clients seek
but the informational advantage might still improve clients utility
- By taking more risky investments, investment banks are more exposed to wrong information and invest more into the skills of asset managers
 - Clients would be able to establish *ex-post* that investment banks have taken higher risks than they wanted, why do they not require banks to reduce risks?
 - The risks have to be evaluate relative to the information precision of the investment bank and clients have no knowledge of this

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Summary of key results

- Investment banks will seek to exploit any informational advantage they have, especially if the information they hold cannot be verified.
- When developing new securities, they will seek to exploit their temporary monopoly optimally by extracting surplus from clients and cooperating with other banks if beneficial.
- General concerns about their long-term reputation will limit the degree with which they can exploit their advantages.

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