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 markets
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Financial innovations

- 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

- We will look at the conditions under which financial innovations are introduced to the market
- Financial innovations might be introduced in phases or shared with other banks
- We will see which strategies banks are using once they introduce financial innovations

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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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Delegation of investment decisions

- Investment banks provide advice to clients through financial analysts, but many clients have not the knowledge or time to 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

Discussion of the model results

- Investment banks invest into assets that have higher risks than the clients seeks 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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