


Andreas Krause

A panoramic view of a city skyline, likely New York City, featuring a mix of modern glass skyscrapers and older brick buildings along a waterfront. The water is in the foreground, and the sky is clear and blue. The text 'Financial innovations and asset management' is overlaid on a dark red banner at the bottom.

Financial innovations and asset management

# Investment bank business beyond advice

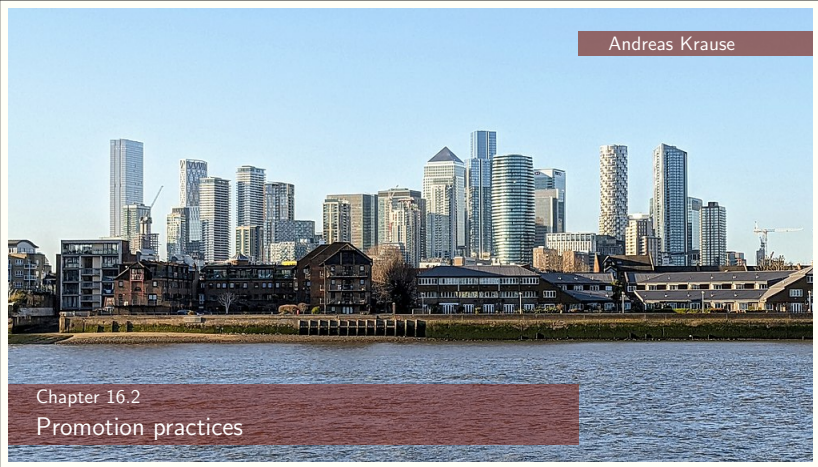
- ▶ Investment banks are active in many areas beyond providing advice to companies issuing securities and investors
- ▶ Companies or investors might approach them with specific concerns whose solution might be the development of new securities
- ▶ Examples of such securities were futures on interest 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

# 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
- ▶ Investment banks will also have to develop models to price these securities
- ▶ Investment banks will often act as counterparties due to a lack of market and expose themselves to risks

# 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



Andreas Krause


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

# 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



Andreas Krause

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

## 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



Copyright © by Andreas Krause

Picture credits:

Cover: The wub, CC BY-SA 4.0 <https://creativecommons.org/licenses/by-sa/4.0>, via Wikimedia Commons, [https://commons.wikimedia.org/wiki/File:Canary\\_Wharf\\_from\\_Greenwich\\_riverside\\_2022-03-18.jpg](https://commons.wikimedia.org/wiki/File:Canary_Wharf_from_Greenwich_riverside_2022-03-18.jpg)

Back: Seb Tyler, CC BY 3.0 <https://creativecommons.org/licenses/by/3.0>, via Wikimedia Commons, [https://commons.wikimedia.org/wiki/File:Canary\\_Wharf\\_Panorama\\_Night.jpg](https://commons.wikimedia.org/wiki/File:Canary_Wharf_Panorama_Night.jpg)

Andreas Krause  
Department of Economics  
University of Bath  
Claverton Down  
Bath BA2 7AY  
United Kingdom

E-mail: [mnsak@bath.ac.uk](mailto:mnsak@bath.ac.uk)