

NEW FINANCIAL INSTRUMENTS

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THE GILBART LECTURES

— an historical summary

The 1987 Gilbert Lectures are the 106th in a series that began in 1875 (there were none in the period of 1940-46) as a result of an endowment to the University of London by James William Gilbert. They commemorate a man who even in his time appeared almost a caricature of the upright Victorian banker. Unmarried, and aware that his aloofness had left him without deeply affectionate friends to mourn him, Gilbert made provisions in his will for perpetuating his own memory. His executors were directed to erect a suitable monument to him (now in Norwood Cemetery), and to use the residue of his estate after the distribution of the major part to his nieces for:

Establishing at some one or more of our Collegiate or Public Institutions permanently or temporarily as his said Trustees might in their discretion determine, a Lecture or Lectures to be called 'The Gilbert Lecture on Banking' and that each Lecturer at the commencement of each lecture should read from one or another of the Testator's published works a page or more bearing as near as might be upon the subject of the Lecture.

This last provision is now observed only in abbreviated form and with ever increasing difficulty.

NEW FINANCIAL INSTRUMENTS: Introduction to the Lecture Series

by Dr Ian Cooper

The subject of the Gilbert Lectures this year is New Financial Instruments. The importance of this topic has been excellently summarised by the Bank for International Settlements:¹

'A sharp acceleration in the pace of innovation, deregulation and structural change in recent years has transformed the international financial system in important ways. Major new financial instruments . . . have either been created or have dramatically increased their role in the financial structure; international credit flows have shifted away from loans through large international banks into direct credit markets; the volume of daily transactions has multiplied; financial markets have become far more closely integrated worldwide; capital has become much more mobile.'

The three themes of the revolution are thus: new instruments, securitisation, and globalisation.

The role of the new instruments is, in fact, even more important than this categorisation would suggest. The instruments are the vehicles whereby securitisation and globalisation are achieved. Securitisation results from the substitution of notes, commercial paper, certificates of deposit and traded bonds for direct lending. Globalisation results from the increased use of the Euromarkets and swap transactions which arbitrage international anomalies in interest rates.

To analyse these new instruments fully is an impossible task. We are in the midst of the revolution and any statement about its causes, costs, benefits or ultimate impact is necessarily speculative.

1. Bank for International Settlements (1986), page 1.

This year we, therefore, depart from tradition in having a Gilbert Lecture Series with four speakers. Each of the speakers will present a view of the new instruments from a particular perspective. From these different perceptions we hope that a coherent overall picture will emerge.

The three views that will be given in the later lectures are those of the banks, represented by Andrew Bain of Midland; the corporate customers, represented by Archie Donaldson, formally of ICI, and the regulators, represented by Lionel Price of the Bank of England. In the first lecture I will give an overview of what the new instruments are, why they have emerged, and where they will ultimately lead. Since the title 'overview' might suggest neutrality I should disclose the point of view that I represent. One unambiguous result of the new instruments is that they have increased competition in the supply of banking services. I subscribe to the view that competition is the principal objective to be pursued in any market, and this will be the perspective from which I view the new instruments.

It is a tradition to begin the lecture series with a quotation from the works of their founder, J.W. Gilbert. As you will appreciate, finding an appropriate extract for this year's series was a difficult task. I searched the indices in vain for mentions of securitised loans, options, financial futures and swaps. So instead, I thought I would use a quotation which reflects Gilbert's view on how one should evaluate banking innovations.

The major banking innovation with which Gilbert was intimately involved was the formation of the London joint-stock banks. Here is his reaction to the question:²

'What effects have been produced by the establishment of joint-stock banks in London?

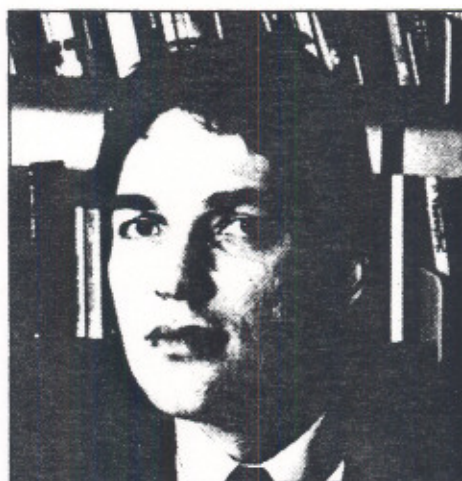
'One obvious effect has been the introduction of new principles into banking practice. Such are the allowing of interest on deposits, and by some banks on a certain portion of the balance of a current account – the opening of

2. Gilbert W. (1859) 'The Logic of Banking', Longmans.
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commission accounts – and the establishment of branches of the same bank in different parts of London. And the extent to which these new principles have been adopted shows that they are suitable to the wants and desires of a large portion of the community.’

Gilbart thus suggests a simple method of testing whether financial innovations fulfil the needs of the consumers of financial services. The test is the extent to which new techniques are adopted. The new instruments pass this test with flying colours. The pace and scope of their penetration of financial transactions has been electrifying.

This makes life difficult for regulators and those whose traditional markets are challenged by the innovation. One possible response is to hope that the whole thing proves ephemeral. Should you be tempted to this view, an inspection of the list of innovations referred to by Gilbart in the above passage should convince you that practices which seem new at first rapidly become part of standard banking procedures. There is no doubt that many of the new instruments fulfil such basic requirements of customers of the financial sector that they are here to stay, and the current scale of their use is only a beginning. The challenge is, then, to separate the useful from the transient and to respond to the opportunities to provide enhanced services using the new instruments.



Dr I. Cooper

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His areas of research, teaching and consulting interests are bond, options, and swap markets and financial innovations. Recent publications include 'Financial Innovations: New Market Instruments' (Oxford Review of Economic Policy, 1986), 'Costs to Crossborder Investment, and International Equity Market Equilibrium' (Recent Developments in Corporate Finance, 1986), and 'The Measurement of Treasury Performance' (Midland Bank Corporate Finance Journal, 1987).

He has been extensively involved in the development of the currency options market.