# SELECTED TOPICS

## Experts Warn That Innovations Pose Hazards For Financial System, Developing Countries

The wave of innovation that has swept over financial markets in recent years has increased risks and problems for the world monetary system and threatens to impede the flow of capital to developing countries, financial executives were told at a June 26–27 conference in New York.

An audience of some 200 commercial bankers, investment bankers, and corporate financial officials—attending a conference on Innovation in the Capital Markets sponsored by *Institutional Investor* magazine—heard warnings that the advent of new financial products, innovative trading strategies, and the global integration of financial markets not only has made the financial system riskier but has created new difficulties in data measurement, regulation, and the conduct of monetary policy. And in the wake of these developments, according to conference speakers, syndicated bank lending to low-income countries is drying up.

**The Impetus to Innovate.** John G. Heimann, Vice Chairman of Merrill Lynch Capital Markets, told the opening session of the conference that "fundamental forces are reshaping the world's financial markets and banking systems." Mr. Heimann, a former U.S. Comptroller of the Currency and New York State Banking Superintendent, identified these forces as (1) the increasing domination of stock and bond markets by such institutions as pension funds and insurance companies, (2) the impact of technology, (3) the global spread of deregulation and competition, and (4) attempts to cope with high inflation and volatile interest rates and exchange rates.

On the first point, Mr. Heimann noted that institutional funds managers increasingly want to deal with banks and brokerages as principals—buying and selling large blocks of stocks and bonds. "Intermediaries have thus become counterparties, using their capital to trade on their own account," he said. "This means they incur market risks which were previously borne by their customers, so they need far greater amounts of capital than before to support a given volume of transactions." But even with bigger capital bases, he observed, they still must employ "complex hedging techniques" to reduce the risks they face as principals.

Second, Mr. Heimann said, technological advances in electronic data processing have fostered a proliferation of new financial products and the "securitization" of assets—the packaging of traditional bank loans into marketable securities and the making of markets in those securities. "Perhaps most important," he added, "technology breaks down the barriers between national markets, a change comparable in its importance to such inventions as the telegraph wire or the telephone."

Third, according to Mr. Heimann, deregulation has encouraged governments to open their financial markets to foreign competition and has led to a dismantling of controls on interest rates, exchange rates, bank credit, and brokerage commissions. Finally, he said, attempts to deal with volatile inflation, interest rates, and exchange rates have prompted the development of such "derivative" instruments as futures and options, designed to transfer risk to others.

Another speaker, Eugene H. Rotberg, Vice President and Treasurer of the World Bank, listed additional forces that have fostered financial innovation in recent years: the uncertain access of borrowers to resources, a change in the pattern and volume of world savings as Japan and the Organization of Petroleum Exporting Countries have become more prominent participants, the "massive increases in government borrowings that compete for scarce funds," capital flight, the increasing competition among intermediaries for interest-sensitive assets, the debt crisis in developing countries, and "enormous balance of payments shifts."

John G. Heimann: *banks "incur market risks . . . previously borne by their customers"*

Eugene H. Rotberg: *no free lunch at the fancy financing cafeteria*

Mr. Rotberg expressed skepticism over the value of hedging strategies to issuers or investors. "We've never done an option or a future yet, on either the asset or liability side," he said, citing a paper by a World Bank colleague with the suggestive title, "There Is No Free Lunch at the Fancy Financing Cafeteria." The new instruments may save appearances through "unreal" accounting effects, he said, but the cost of such insurance is high. "They are for the most part badly priced [and] . . . like much of finance . . . of doubtful economic benefit and value. It is a sharing of unknown risks for unknown benefits at a price which is simply, at the time, market clearing."

**Problems and Risks.** Financial innovation raises several regulatory concerns, Mr. Rotberg said. Measuring the money supply and conducting monetary policy become difficult "when you have enormous amounts of investments available, particularly in short-term or floating-rate instruments, where the holders are not banks and where the credit risk is not in the hands of banks." The risk to banks from off-balance-sheet activity is also a matter of regulatory concern, he said. "Do not assume . . . that innovative instruments and financial engineering avoid risk automatically . . . or even hedge it."

Mr. Heimann of Merrill Lynch expressed concern over the undercutting of "the intermediaries' traditional role of supplying expertise on where to borrow and where to lend," along with the demands on their capital bases from the provision of liquidity to make secondary markets in the new instruments they are supplying. Such instruments as futures and options, designed to transfer risk to others, "cannot lessen the riskiness of the