Introductory Remarks by Thomas C. Melzer
For Session II: New Instruments - New Risks

Innovation & Structural Change in Financial Markets
A Conference Sponsored by the Federal Reserve Bank of New York
May 4-6, 1986

The subject of our second session is "New Instruments - New Risks." What we will be exploring in this session is whether new financial instruments, which have the effect of redistributing certain risks to those better able to take them, might at the same time exacerbate other risks or perhaps create additional risks. Among our speakers, we have represented the corporate issuer of securities, the institutional investor and the financial intermediary, with each speaker wearing at least two of these hats. Accordingly, we will be approaching this question from various perspectives.

In thinking about risk, it is helpful to consider the various categories referred to in the BIS study: credit risk, market risk, settlement risk and liquidity risk. My own suspicion is that, in general, financial innovation has resulted in an effective redistribution of market risk--that those unwilling to take market risk have a number of options available to lay it off to those who are both willing and better qualified to take it. In the process, the capacity of the system to take risk might in fact be increasing.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

However, at the same time many non-bank financial intermediaries end up holding positions in medium to long-term instruments or contracts having limited or no marketability. While the market risk can be hedged, increasing amounts of credit risk are being incurred by entities historically unaccustomed to taking such risks. Therefore, while new credit risk is not being created, perhaps the entities taking it are, at least until they develop greater expertise, more vulnerable than traditional lenders.

This raises a question as to whether new instruments are being properly priced to account for the credit as well as the market risk, particularly against the backdrop of intense competition. There is also a question as to whether financial reporting is adequate for third parties who might incur exposure to non-bank and bank intermediaries to properly assess their credit, as so many of these new instruments are "off balance sheet."

Perhaps the area in which one might argue that new risks are being created is in settlements. The new instruments, by facilitating the hedging of market risks, create a more complicated web of contractual

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

interrelationships as well as increased trading volume in underlying markets as participants pursue arbitrage as well as hedging strategies. By definition, settlement risk goes up as volume goes up; but perhaps the greatest vulnerability in this area revolves around the concentration of settlement risks in a relatively few large entities. This vulnerability would be further complicated by greater market volatility which some observers associate with the new instruments, although as pointed out in the BIS study, research would generally not support this conclusion.

There are certainly a lot of interesting questions to explore, so with that brief introduction, let us begin.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis