New Financial Instruments

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THE recent trend towards globalisation and securitisation in the world economy has sufficiently changed the requirement and mode of the financial market. The focus of the financial market has been more on risk management, competition and deregulation.

The word goes that necessity is the mother of invention. The financial market has followed the step. Newer instruments are sweeping the market by its feet. An Indian company issues European pound debt, in American market and swaps it for floating rate dollar debt, has become a matter of common place. The trend of this is surely towards a global market. Banks are taking up intermediation in trade markets through sale of debted securities, such as commercial paper, Eurobonds, Euronotes and collateralised mortgages, thereby changing the feature of the institution-based intermediation to market-based intermediation. The volatility of the interest rate, exchange rate, bond prices and equity prices are brought down or hedged by instruments such as options and futures. The peripheries of competition and regulation are being blurred by the new instruments as they tend to decrease the distinction between different segments of the market.

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New Financial Instruments (NFI)

Many of the new instruments are not that new. As Miller (1987) puts it: "Many of the financial innovations... already existed in one form or the other for many years before they sprang into prominence".

Cooper (1987) observes that such instruments have merely changed names. Parallel loan and back to back loan, preciders of the instruments now known as swaps were used thoughtout the 1970s as a way around UK exchange control. The novelty lies in the volume of the use. The reach of this has been extended to almost all securities. For example, options are now traded on all securities like equity, bond and even in interest rates, currencies and commodities. Cooper is right when he observes that "the weekly innovation has almost revolutionised the scope and dimension of the global financial market". The outlines of some of the new instruments are given below.

Forward Contract

The foreign exchange forward contract can be thought of simply as an agreement to make an exchange of currencies at a pre-specified price at some future date. If this contract is held to maturity, the holder will make or lose money at maturity date. The amount of gain or loss depends upon the spot exchange on the particular date. The key financial character of the forward contract is that its pay-off is simply proportionate to the difference between the forward rate in the contract and the market price at the maturity date. A significant innovation along the line has been the forward rate agreement,

EXECUTIVE SUMMARY

The advent of new financial instruments in the wake of globalisation has become a phenomenon in the financial market. Banks feel greatly threatened as their monopoly status is questioned. These instruments are basically risk-hedging devices meant for providing liquidity and greater yield to the users. Because of being information-oriented, banks may find themselves in a better position to do business in these instruments.

whereby the financial contract is on an interest rate. For instance, a six monthly Forward Rate Agreement (FRA) on six months from now, the difference between three months of LIBOR and the FRA date.[1]

Swaps

Swaps are forward contracts for stream of cash flow rather than single payments. A standard currency swap consists of an agreement to exchange payments of the fixed interest in one currency for the fixed interest in another currency with an exchange of the principal at the maturity of swaps.

Sirs

Standard Interest Rate Swaps (SIRS) consist of an agreement to exchange floating rates payments for fixed interest payments in the same currency.

Financial Futures

Financial futures are forward contracts which are traded, collateralised with margins and resettled daily. The trick is that the future contract is settled day by day. As long as the holder of the future contract has enough margin in his account to settle the maximum daily move, there is absolutely no risk of default. If the holder of the contract is unable to regain the position for the next day, the contract is simply closed with the resulting defaults[2].

Options

Options are generally expressed as the ways open before the holders of an instruments to take either of the many redemption payment ways. Such options may be to take redemption in two or more currency rates. Options are now used with many types of securities such as equities, bonds and debentures.

Caps

A borrower who issues a long term floating note is exposed to the possibility that rates will rise/fall. To protect against such eventuality, the borrowers may buy protection in the form of a Cap. A Cap ensures that the interest paid will never be more than a pre-specified 'Cap Rate'. To achieve this, the seller of the Cap agrees to make a payment

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Table 1
Some Common Terms in Context of NFI

Forward Contract	An aggrement to exchange of currencies at a pre-specified price at a future date.
Swaps	Forward contracts for stream of cash flows rather than single payments.
SIRS	Standard Interest Rate Swaps are aggrement to exchange floating interest rate payment for fixed interest payments, in the same country.
Futures	It is a forward contract, Collateralised with margins and resettlement day.
Options	Ways open before the holder of the instrument to take either of the many ways of redemption.
Caps	A pre-specified interest rate, that ensures the user of the instrument against the interest rate never falling below the aggregated rate, thereby saving him from windfall losses.
Collers	Essentially, a means of allowing the Cap purchaser to Pay for the Cap without charging an upfront fee.
LIBOR	London Inter Bank Offer Rate

Note: This list is illustrative and not exhaustive.

[1] For detail see I. Cooper (1987) New Instruments: An Overview.

[2] There is a problem in the swaps. It fails to envisage the default risk. The problem arises due to the possible change in currency spot rate in future. The only way to handle it is to apprehend and compensate the forward rate, through some statistical risk calculation. There is however another way of dealing with the default risk of forward contract, and this has led to the most significant new instrument as measured by volume — Cooper (1987).

equal to the difference between the floating rate and the Cap rate whenever the former is higher on a resetting date.

Coller

It is essentially, a means of allowing the Cap purchaser to pay for the Cap without charging an upfront fee. Instead of a fee the Cap seller agrees to take compensation in the form of a payment wherever the floating rate falls below a certain level (the floor rate).

Securitised Loan

This is a simple innovation. Instead of borrowing by loan agreement with financial instruments, companies and other institutions, borrow by selling securities. Such securitised loan may be a commercial paper, Euroissue, Eurobond, collateralised security or a property income certificate.

Banking and NFI

Banking is necessarily an information business. The bank with the best information and the greatest capability to convert information to the best of their advantage earns profit. The first swap option earned greater profit but as the technique became common the margin decreased. The new instruments and new markets threaten the profitability of the banks' established business because they make information, which undercut the banks (Bain, 1987). The new instruments have changed the financial market scenario. They have led to lesser risk and higher yield. Banks have already started to take up the instruments as a part of ongoing process, which include securitisation, the substitution of marketable securities for non-negotiable bank loans. Interest rate futures and swaps make it possible for the banks to improve the management of their interest rate exposure. The clearing houses are now much better placed to hedge against possibility of an unexpected fall in interest. As is well known, the rise in interest rate has a positive effect on the profitability of the bank. By engaging in suitable transaction, the banks may now hedge against the risk that interest rates may turn out to be lower than expected by the market.

Banks can take up transactions such as providing futures, swaps and options to their customers to assist them in better financial management. They can even earn a profit by charging a fee higher than the cost of hedging the contract in the present or future market or simply by retaining a part of the potential saving inherent in any swap transaction. Besides, banks can also engage in trading in the new instruments in the new-found market and deepen their liquidity position.

Conclusion

The advent of the newer instrument has become a phenomenon in the financial market. The instruments are basically risk hedging devices meant for providing liquidity and

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greater yield to the users. The banks feel greatly threatened by the advent of these instrume as they question the bank monopoly status in the financ market. The banks are trying comprehend the situation an using it to the best of the advantage. Since, the instuments are basical information-oriented they a placing the banking business a better position and not wors A prudent use of this instrume will make the bankers flouri even more in the future.

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