Economics

Free exchange

The next big thing

Apr 12th 2010, 15:57 by R.A. | WASHINGTON

A NEW paper by Nicola Gennaioli, Andrei Shleifer, and Robert Vishny explains the dynamics by which financial innovation generates crisis:

> *Many recent episodes of financial innovation share a common narrative. It begins with a strong demand from investors for a particular, often safe, pattern of cash flows. Some traditional securities available in the market offer this pattern, but investors demand more (so prices are high), or perhaps demand securities with slightly higher returns and no extra risk. In response to demand, financial intermediaries create new securities offering the sought after pattern of cash flows, usually by carving them out from existing projects or other securities that are more risky. By virtue of diversification, tranching, insurance, and other forms of financial engineering, the new securities are believed by the investors, and often by the intermediaries themselves, to offer at least as good a risk return combination as the traditional substitutes, and are consequently issued and bought in great volumes.*
>
> *At some point, news reveals that new securities are vulnerable to some unattended risks, and in particular are not good substitutes for the traditional securities. Both investors and intermediaries are surprised at the news, and investors sell these "false substitutes," moving back to the traditional securities with the cash flows they seek. As investors fly for safety, financial institutions are stuck holding the supply of the new securities (or worse yet, having to dump them as well in a fire sale because they are leveraged). The prices of traditional securities rise while those of the new ones fall sharply.*

Sound familiar? These risks seem like an intrinsic part of financial innovation, which means that the costs associated with crises are also an intrinsic part of financial innovation. So the question is, should we still embrace financial innovation? Back in February, Bob Litan assessed a number of financial products to try and determine whether, contra sceptics, financial innovation has managed to produce any socially useful products. It has, he says: credit and debit cards, investment funds, inflation-indexed securities, options and swaps. Other innovations have been less of a boon for the economy, including collateralised-debt obligations (securities built from other securities, pooled and chopped up) and structured investment vehicles (off-balance sheet investment funds used by banks). But, as he notes, socially useful financial innovations can be misused (just as socially useful technical innovations can be misused). He concludes:

> *I believe that financial innovations in general are much less like drugs and nuclear power, which deserve some kind of preemptive screening or regulation, and much more like virtually all other innovations to which U.S. policy historically has applied a "wait and see" regulatory approach. To be sure, given the various events that led up the recent financial crisis, policymakers must be better prepared in the future than they were before the financial crisis to step in – first with disclosure standards and possibly later with more prescriptive rules – when finance looks like it is taking a wrong turn.*
>
> *The one area where an exception to this general "be prepared" strategy may be appropriate and even necessary relates to long-term contracts entered into by consumers, such as mortgages (when borrowing) or annuities (for retirement). There is a strong and growing literature in behavioral finance indicating that individuals are not always rational in their investment decisions. This tendency is dangerous when even well-informed individuals are making long-term financial commitments, with heavy penalties (in the case of mortgages) or perhaps no exit strategies (in the case of annuities) for changing one's mind later. In these cases, preemptive approval of the design of the financial products themselves may be necessary to prevent many consumers from locking themselves into expensive and/or potentially dangerous financial commitments. But this exception should remain that way and not become the rule.*

As Mr Litan admits, his analysis is more qualitative than quantitative, which is too bad. It leaves us arguing more about principles than about costs and benefits. Obviously, there is some benefit to an environment conducive to innovation. But there are also some costs to the creation of new financial products. Some of these costs are minor—stemming from products that give issuing firms new market power, for instance. Others are the large, tail-risk costs associated with crisis. These are painful enough that greater pre-emptive vigilance may be warranted.

About *Free exchange*

In this blog, our correspondents consider the fluctuations in the world economy and the policies intended to produce more booms than busts.

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Though as Mr Litan also points out, financial regulations can themselves induce financial innovation, to get around bank-profit limiting rules. And because finance is global, innovation that occurs outside a highly regulated market can nevertheless disrupt that market. One can't just consider the costs of innovation; you also have to understand the extent to which action can limit those costs.

It might not make sense, then, to try and rein in innovation in the financial sector. But it is critical to remember that there is an inherent element of danger in the activities of the financial sector and in financial innovation, and private rewards and government policy should reflect the risk that related costs may well be passed on to the broader economy.

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jomiku wrote: Apr 12th 2010 4:02 GMT

It sounds familiar because it's a retelling of what we just saw. And 90% of that is a retelling of such basic bubbles as the tulip mania, complete with substitution and degradation effects.

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fundamentalist wrote: Apr 12th 2010 4:04 GMT

"Sound familiar?"

No. It doesn't. Why can't economists get the history of the latest crisis right? The crisis isn't even over yet and we're getting false histories repeatedly. This never happened: "At some point, news reveals that new securities are vulnerable to some unattended risks..." Instead, what actually happened was that the collapse in housing prices make it abundantly clear to everyone that the MBSs no longer had the same value. MBSs would never have lost value if housing hadn't collapsed first. Innovation had nothing to do with the collapse in housing prices.

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hedgefundguy wrote: Apr 12th 2010 4:11 GMT

"Sound familiar?"

Yep!

Minksy's "Stabilizing an Unstable Economy"

- I'll have hash, re-hash, re-hash, re-hash, and spam.

Regards

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fundamentalist wrote: Apr 12th 2010 4:11 GMT

"individuals are not always rational in their investment decisions."

Where's the beef?!! There is no evidence for that. There is evidence that investors can be fooled when the state intervenes in the marketplace and distorts prices. But when investors act on distorted prices as if they were real, and they don't know the prices are distorted, then that's perfectly rational.

Of course, every intervention by the state is justified by saying people are irrational. But if investors can be irrational, why cannot regulators be irrational, too? Does working for the state suddenly make one omniscient? In fact, regulators are far more likely to be irrational because 1) they don't have all of the data they need to make decisions and 2) regulations are often contradictory and too numerous for regulators to keep up with. Investors have a much simpler job: figure out where to invest my money for the highest return. Of course, when the state distorts interest rates, which distorts all other prices, investors are bound to make mistakes.

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OneAegis wrote: Apr 12th 2010 5:25 GMT

No evidence that investors are irrational? There is a whole industry built upon that very fact, and that isn't even taking into account the illegal activity (Ponzi schemes, etc.)

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fundamentalist wrote: Apr 12th 2010 5:35 GMT

Yes, there is a whole industry devoted to the "irrational" investor, but there are whole industries devoted to UFO and bigfoot citings, too. I'm saying that what people call irrationality in investors is actually investors acting rationally on distorted data. Those who favor the "irrational" investor approach also defend regulators as being omniscient and wise and belief the feds can never make a mistake. The reality is that regulators and the feds act irrationally, distort price signals and cause rational invetors to make mistakes. Those who want to defend their sacred cow (the state) claim the investor, not the state, is irrational.

Investors act rationally based on the price signals they have. But the state severely distorts price signals so that investors make mistakes. Investors don't know that those signals are distorted because they follow mainstream econ (through the mainstream media) which asserts that the state never under any circumstances makes a mistake.

The crash of the airliner that killed the President of Poland and many others may have been caused by a faulty altimeter. If the altimeter read that the plane was 500 feet above ground when it was actually 50 feet above ground, the pilot would fly the plane into the ground. But was the pilot irrational to trust his altimeter? In the same way, the feds monkey with the altimeter (prices) that investors rely on, they blame the investors for relying on that altimeter and call them irrational.

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OneAegis wrote: Apr 12th 2010 10:09 GMT

I think you present a false dichotomy - I don't believe that regulators are anymore perfectly rational than investors are. Presenting any human actor as purely rational is to set a system up for failure.

If the pilot is looking out his window and his landing gear is brushing the grass, he would not be rational to trust his altimeter; in the same way investors purchasing MBS's when it was common knowledge that the majority of underwriting standards had flown out the window.

Our government is set up as a system of checks and balances because of the recognition of human fallibility. Neither the market, investors or regulators are infallible, which is why we must endlessly debate where the right balance of power between them should be, and make adjustments.

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bampbs wrote: Apr 12th 2010 11:29 GMT

Financial innovation whose purpose is evasion of prudential regulation ought to be illegal as such. It is impossible to anticipate every dodge beforehand.

Then there are great successes, like the home equity loan. What a brilliant way to allow spendthrift Americans the chance to consume the savings built up in their homes. The only real financial benefit of homeownership is automatic saving, and we broke that piggy bank, too.

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fundamentalist wrote: Apr 13th 2010 2:33 GMT

oneaegis: "in the same way investors purchasing MBS's when it was common knowledge that the majority of underwriting standards had flown out the window."

It was common knowledge that underwriting standards had fallen for a minority of mortgages, the "subprime" mortages.

oneaegis: "Neither the market, investors or regulators are infallible..."

Regulators are the most fallible, because as I pointed out earlier, they cannot keep track of all of the conflicting regulations. One theory of the crisis is that it was the perfect storm of conflicting regulations, conflicts that regulators were completely ignorant about. The debate over regulation vs free markets was answered by Hayek in the knowledge problem. Investors don't need vast amounts of knowledge; they just need accurate prices. Regulators need to know everything that is on the mind of every market participant as well as expert and perfect knowledge of all regulations and how they interact. Regulators fail constantly because they lack the knowledge they need to do their jobs.

bampbs: "Financial innovation whose purpose is evasion of prudential regulation ought to be illegal as such."

And when did that ever happen? It didn't. The financial innovation that everyone laments was in response to banking regulations in order to become more compliant with the new Basel I and II accords. It's just nonsense to clame that bankers were trying to get around regulations. They were trying to comply with new European regulations.

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hedgefundguy wrote: Apr 14th 2010 2:56 GMT

fundy,

Two words.

"Regulatory Capture".

Greenspan admitted as much when he testified to Congress that he bascially allowed "free markets" in the financail sector run run amok, unabated.

Regards

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fundamentalist wrote: Apr 14th 2010 1:31 GMT

Greenspan must have been experiencing a senior moment when he said that because we don't have anything close to a free market in finance.

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