Ezra Klein

Economic and Domestic Policy, and Lots of It

How financial innovation causes financial crises

In a new paper called "Financial Innovation and Financial Fragility" (pdf), Nicola Gennaioli, Andrei Shleifer, and Robert Vishny offer an uncommonly clear explanation of how "financial innovation" leads to financial crises. While reading this, keep in mind that the subprime securities that crashed the economy were given the AAA seal of approval by the ratings agencies, which is to say, the system treated them as virtually free of risk, like money stuck under your mattress.

> 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.
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> 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.

To put this slightly more simply, the game runs like this: Investors want to make more money with less risk. Someone invents a financial product that appears to make investors more money with less risk -- in this case, subprime securities. Demand for this new product explodes. But few understand this new product, and even the people who do understand the new product don't know how it performs under stress (it's a new product, after all). At the beginning, this actually helps the product: because its risks aren't known, they're ignored, and so it looks like a better deal than it is and sells more of itself than it should.

Then something bad happens. The new product shows its flaws. And

THINK TANK

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precisely because no one really understands it, the market cracks. Investors all run away at once, as they don't really have the tools to assess the situation. Where lack of knowledge about the product originally drove demand, now it accelerates flight.

This isn't just an interesting theoretical insight: It goes to heart of financial regulation. Most financial reform proposals accept financial innovation as a good thing and just try to protect against meltdowns, generally by controlling leverage and making it easier to dismantle failed bans. The model in this paper presents a different view: The boom-and-bust cycle of financial innovation is a risk to the economy, and thus "it is not just the leverage, but the scale of financial innovation and of creation of new claims itself, that might require regulatory attention."

By Ezra Klein | April 12, 2010; 7:03 AM ET
Categories: Financial Crisis , Financial Regulation

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And wasn't one of the principal reasons the securities got the AAA stamp the fact they they had insurance from an entity with a AAA rating of its own (cough cough AIG cough)?

I realize that it takes a while for an academic paper to shuffle through the academic process, but frankly, this is news?

Posted by: bdballard | April 12, 2010 7:57 AM | Report abuse

Well. New news aren't. But something that the current financial system wants to forget sure it is. Will the financial reform addresd it in any way?

Posted by: Vercinget333 | April 12, 2010 9:11 AM | Report abuse

Klein, can you ever stop with the "in this case, subprime securities" lie? It was mortgage backed securities, and the insurance that was bought on them, not just subprime. This is not just a subprime crisis. Why do you want to take all of the blame away from the housing gamblers who bought into the bubble?

Of course, when the big guys thought there might be a bubble, insurance products to protect against default were created. Those insurance contracts were not priced to cover counterparty risk. That is the fundamental learning in the financial sector from this event. Insurance is worthless if the insurer is bankrupt.

The problem here starts and ends with the irresponsible government and investors. Houses cost too much, so, in the infinite stupidity of the government can solve every problem crowd, we make it easier for people to borrow the money needed to buy them, by having the GSEs and FHA back or subsidize the mortgages and force the Fed to keep the rates down- which only makes the prices go up faster. The same people that were probably paying $100 for a Beanie Baby 5 years earlier started paying $500k for a condo, with 30-1 leverage. I can't get that kind of margin in my brokerage account, but the Federal Government is *still* backing, encouraging, and subsidizing with our tax dollars, loans with 3% down. Of course, with housing there, there is a nice asset there to repossess, but the price volatility *must* be greater than 3%.

Look at how well it's working for higher education to just force the government to loan money to people for something that is overpriced. The prices just keep going up faster than inflation.

Look at how well it's working for health care for government to just keep paying for something that is overpriced. The prices just keep going up faster than inflation.

How about leverage limits on individuals? China may have a property bubble, but downpayments there average closer to 40-50%. Let's admit that real estate is a risky investment and not subsidize highly levered loans.

Posted by: staticvars | April 12, 2010 10:40 AM | Report abuse

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Financial innovations like these become vitally necessary when you have income inequality like we've had for the past decade.

For the past 30 years, the growth of inequality and other structural factors have sent an ever increasing percentage of our GDP to Wall Street. That's not just top earners--it's also pension funds, it's also 401k funds, it's IRAs, it's profits that are distributed to shareholders and automatically rolled into buying more of the index or whatever fund they're already in. It's also policy decisions like running the government on a deficit to support tax cuts, and minimal growth of investment in public goods beyond healthcare (and to a much lesser extent, war and social security pensions).

The problem for Wall Street is that good business investments aren't growing as fast as the availability of money to invest in them. Other problems include the fact that not all investments with privatizable returns are investments they're interested in--they need a very specialized investment that not only has privatizable returns, but that also generates these returns on a quarterly basis.

More and more money is chasing basically the same number of investments. It's pretty clear what comes next.

The good new investments get arbitraged to ridiculously low rates of return. IPOs open spectacularly high. Stock prices themselves become wholly unnhinged from their returns, and p/e ratios go haywire. Finally, somebody comes around with a financial innovation that makes a bad investment into a good investment. And there's tons of money that desperately needs this to be true, so people believe it's true.

The whole thing goes up and up and up until there's some kind of shock, and then people freak out and pull out a significant portion of money. Collapse.

We need less money going to Wall Street's "quarterly returns" universe. We need more going to taxes, to venture capital, to basic research in things like energy, etc. We need to look very seriously at the 401k and see about creating some other kind of vehicle for retirement savings that doesn't direct funds to the insane world of Wall Street's "quarterly returns" scene. We need a LOT less money going to top earners and a lot more going to median wage workers.

We desperately need our capital to be allocated more sensibly.

Posted by: theorajones1 | April 12, 2010 11:23 AM | Report abuse

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Um, the link is down.

Posted by: finale | April 12, 2010 5:08 PM | Report abuse

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re: "This isn't just an interesting theoretical insight: It goes to heart of financial regulation. Most financial reform proposals accept financial innovation as a good thing and just try to protect against meltdowns, generally by controlling leverage and making it easier to dismantle failed bans. The model in this paper presents a different view: The boom-and-bust cycle of financial innovation is a risk to the economy, and thus "it is not just the leverage, but the scale of financial innovation and of creation of new claims itself, that might require regulatory attention.""

Wouldn't an analogy to dealing with new pharmaceutical compounds be apt here? (which begs the "how will you test them?" question -- perhaps gin up some hypothetical markets in the new securities in Second Life?)

Posted by: bdballard | April 12, 2010 5:22 PM | Report abuse

It is a good article, if not exactly light reading for the general audience. You (and practially everyone else) have a duff link. It may have been on the Stern site at some point (although no obvious reason why), but not now. The easiest place is Andrei Schleifer's site at Harvard. Look at the bottom of http://www.economics.harvard.edu/faculty/shleifer/paper for the link to it.

Posted by: wdoneil | April 12, 2010 9:51 PM | Report abuse

Thank you for the link, this is even better than what I was looking for- a whole new list of articles to consider.

Posted by: finale | April 13, 2010 12:39 AM | Report abuse

Isn't this whole banking mess basically Enron, Part II? Nobody understood what the heck those guys were doing, either -- "Smartest Guys in the Room" and all that.

It turned out nobody understood what they were doing because what they were doing didn't make any sense. But they wrapped it up in cool-kid mathematics and layers of B-school jargon, so none of the other B-school kids would admit they didn't understand it.

Enron, meet Citi.

Posted by: barnninny | April 13, 2010 12:50 AM | Report abuse

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