

The Limits of Limiting Financial Innovation

Innovation typically brings to mind advances in technology and medicine, such as the personal computer or the development of vaccines. Such innovations are a key driver of economic growth, as discussed in the cover story of this issue of *Region Focus*. But there is another kind of innovation that plays a crucial role in our economy, one that has received a great deal of attention in recent years: financial innovation.

Modern financial innovations range from ATMs and online banking to complex derivatives and currency swaps. Many have had a positive effect on economic growth and macroeconomic performance. Beginning in the 1980s, for example, new credit products reduced borrowing costs for both consumers and businesses, enabling them to better smooth their consumption and investment in the face of shocks, and potentially moderating the negative effects of reduced spending and lending on the economy as a whole. Other innovations, such as asset-backed securities or credit default swaps, help to allocate capital and allow companies and investors to protect themselves against risk.

Of course, many of these same products were at the heart of the financial crisis of 2007-2008. Should that change the way we think about the benefits of financial innovation?

I believe that it should not. At issue is not whether financial innovation is inherently good or bad, but rather the incentives market participants have to innovate, and the regulatory environment in which they do so. In particular, the size and ambiguity of the government financial safety net gives institutions an incentive to use financial innovations to take on excessive risk, believing they are insulated from losses by an implicit government guarantee. According to estimates by Richmond Fed researchers Nadezhda Malysheva and John Walter, the safety net covered \$25 trillion in liabilities at the end of 2009, or 59 percent of the entire financial sector. Nearly two-thirds of that support is implicit and ambiguous.

Outside the financial sector, the interests of innovators tend to be aligned with the interests of society as a whole; a new product or service generally will only be profitable if it improves the well-being of households or businesses. Within the financial sector, however, innovations often are a means of “regulatory bypass,” an attempt to work around the constraints imposed by regulators. For example, money market mutual funds arose as a means of circumventing regulatory constraints on deposit interest rates. Such innovations may offer legitimate benefits to end users, but problems can arise when there is a mismatch between the scope of prudential regulation and the size of the government safety net: Institutions that are not subject to prudential regulation, but believe that they are part of the safety net, often engage in increasingly risky behavior.

Prior to the financial crisis, officials often followed a policy of “constructive ambiguity” about the likelihood of intervening. Policymakers downplayed their willingness to provide support, hoping firms would limit their risk, but still left room for intervention when necessary. In practice, however, policymakers tended to intervene more frequently, increasing the market’s expectations about the likelihood of rescues.

The repurchase, or “repo,” market is an illustrative example. A repo is a short-term collateralized loan that provides borrowers with a low-cost way to finance a broad range of assets and offers lenders an attractive rate of return on a highly liquid investment. Repo financing becomes risky, however, when lenders refuse to roll over their positions and the borrower has trouble finding other ways of financing its assets, as happened to Bear Stearns in March 2008. Bear Stearns’ sale to JPMorgan Chase did benefit from government support — and the expectation of that support may have led to a reliance on such fragile financial arrangements in the first place.

Policymakers can reduce this tension by clarifying the boundaries of the financial safety net and making sure that those within the safety net are subject to rigorous prudential regulation. The response to the financial crisis has largely focused on the latter. New regulations may succeed in limiting risk insofar as they apply, but I believe the greater concern is that we have not taken adequate steps to reduce and clearly define the size of the safety net. Designing a regulatory regime before we have determined the extent of the safety net is “putting the cart before the horse.” Financial firms and market participants will continue to have an incentive to find innovations that benefit from the safety net but bypass prudential regulation.

Enhancing prudential regulation is a valuable step forward. But to start with, we must address the incentives that lead to potentially harmful innovations in the first place — and be careful not to limit those innovations that do contribute to economic growth and well-being. **RF**



A handwritten signature in black ink, appearing to read 'J M Lacker', written in a cursive style.

JEFFREY M. LACKER
PRESIDENT
FEDERAL RESERVE BANK OF RICHMOND