Financial regulation, not innovation, the real culprit

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IESE Prof. Xavier Vives lays most of the blame for the financial crisis on ill-conceived regulation, rather than on innovation itself.

The liberalization and globalization of the financial sector began in earnest in the 1970s, thanks mainly to the revolutionary changes taking place in information technology. However, very little new regulation has been added since then, leaving the system prone to ever greater instability.

The consequences are all too familiar: financial innovation in derivatives and securitizations, fueled by a lax currency policy, created a bubble in both the credit supply and the housing market, with the latter eventually crashing under the weight of subprime mortgages.

So, should limits be placed on innovation? How can crises be prevented in the future? What role should be played by regulation? These are some of the questions posed by IESE Prof. Xavier Vives in a recent paper on the role of innovation in the recent financial crisis.

A brief history

The recent history of the financial sector can be divided into two periods. The first runs from the 1940s to the ?70s and is characterized by strict regulation, interventionism and stability. That was followed by a period, beginning in the early ?80s, of liberalization and greater instability that, the crisis aside, has contributed to general financial development and economic growth.

One of the major drivers of this deregulation was financial innovation, which has enabled

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consumers to choose from a much broader variety of means of payment (credit and debit cards), transaction processes (cash machines, electronic banking), savings plans (investment funds, structured products) and risk-hedging techniques (derivative instruments and securitization).

All of these constitute advancements that have helped to boost the industry?s productivity, achieve better risk diversification, build economies of scale in internal activities and develop stronger ties between the intermediaries and the financial markets.

Cracks in the system

The banking sector has beefed up its financing in the market, but this has made it more volatile and increased the probability of speculative bubbles forming.

Unfortunately, the greater depth of the financial markets has gone hand in hand with a substantially raised level of risk for the system as a whole, since globalization has increased the chances of contagion between institutions.

At the epicenter of the crisis were the complex derivative products based on subprime mortgages. These enabled the banks to slough off the credit risk by securitizing mortgage loans in a chain of increasingly complex structured products.

Moreover, the opacity of the model encouraged ever greater risk taking. What followed is now common knowledge: prevailing uncertainty and the magnitude of the crisis led to full paralysis of the interbank markets and illiquidity, with the cost of money skyrocketing.

However, as Vives points out, the catastrophe was actually set off by a chain of improperly aligned incentives.

The federal agencies of the U.S. promoted the granting of subprime mortgages to families with little hope of repaying the loan; the credit rating agencies competed to grant the most favorable ratings to the higher-risk products; and a system of short-term compensation emboldened finance managers to take excessive risks.

In actual fact, securitization, by allowing for broader development of the financial markets and substantial credit expansion, has contributed to economic growth.

That is not to say, however, that it is entirely blameless. Among other things, it fostered the incentives for an excessive credit expansion at the expense of quality, while also giving rise

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to a new generation of complex structured products.

As a result, it became increasingly difficult for investors to evaluate the risks they were exposed to, bringing about a substantial and hidden increase in the levels of systematic risk.

Time to enact reforms

Numerous economists and public leaders have expressed skepticism over the benefits of financial innovations. By doing so, they ignore the fact that many of these innovations have led to greater economic growth and the development of both new technology and innovative companies in different sectors.

Vives argues that the way innovation is used depends far more on the types of incentives offered to economic actors, which are governed by the regulatory framework in place.

Indeed, it is the limited liability of financial institutions that makes them take heightened risks. By allowing compensation deals for their executives that include incentives for risk taking, remuneration is not sensitive to losses but highly sensitive to gains.

The crux of the matter is not so much the financial innovations themselves as the regulation thereof. According to Vives, the success of the measures being taken in this area will depend on their ability to adapt to a series of principles, including:

- The existence of a regulator of systematic risk.
- Homogeneous regulation for all institutions that perform the functions of banks.
- Risk premiums and limitations on operations according to the characteristics of the intermediaries.
- Requirements for capital and rates that factor in systematic risk.
- A global approach that aligns the incentives of the system?s various actors, both nationally and internationally.

Current attempts to reset capital requirements and liquidity (e.g., Basel III) and the legislative reforms in the E.U. and U.S. are steps in the right direction, albeit with potential limitations. In any event, given their undefined nature, it is still too early to say whether they will succeed.

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