In the words of Thomas Alva Edison, arguably the greatest innovator, “invention is one percent inspiration and innovation is ninety nine percent perspiration”. The world is dynamic and ‘change’ is the only constant parameter. Since the invention of wheel, man has been on a path of continuous innovation to make life comfortable. The man, as he gained more and more knowledge, began unravelling the mysteries of nature resulting in an exponential increase in the number of innovations. The rapid technological innovations made in the last century have made knowledge ubiquitous and easily accessible, causing a rippling effect, leading to innovations in other fields. Some innovations have wiped away dominant products from the face of the planet like i-pod for walkman, computer for typewriter. Innovations, generally, have been effective though the extent of their effectiveness may be a debatable question. However, there lies a set of innovations whose genuinity can’t be tested in the short run and these have a potential of causing a catastrophe in the financial markets. These are termed as “financial innovations”.

As defined by the financial times lexicon “Financial innovation is the act of creating and then popularising new financial instruments as well as new financial technologies, institutions and markets”. During the Silicon Valley boom huge investments were made and enormous profits were realized. The companies functioned on the principle of “innovate or die”. The financial markets too started growing rapidly during this period. Scientists, mathematicians and statisticians were lured by the extreme compensations and pay packages. The greed for obnoxious bonuses attracted the brightest minds to the financial sector. They designed complex financial products to assist their firm to remain competitive and to generate gigantic revenues from the products. In retrospective, the commissions they received out of revenues were the main culprit behind the frivolous innovations. Not all financial innovations are bad. Some of them have been revolutionary such as introduction of ATMs and online banking model. Examples of recent financial innovations are hedge funds, private equity, collateralised debt obligations, Islamic bonds to name a few. Financial innovation is a necessary evil but the question remains, where should we draw the line?

Several theories about financial innovation have evolved since its inception. The most prominent among those being Modigliani-Miller theorem which proposed that in efficient markets and in the absence of all external factors, the different types of securities issued by firms ultimately add up to the same value. As a result, no innovation would be superior and all
would be ultimately be equal. But in reality, the markets are not efficient. There tends to be belief disagreements between the prices of same assets between different sets of people. This provides scope for betting and speculating. The recent financial crises was a generally a result of this mismatch of belief disagreements on the success of the CDOs. But the phenomenal growth of financial markets is attributed to increased transactions and diversified risks which resulted from financial innovations. It tends to expedite transactions and foster economic activity. Innovations have brought different financial markets together where products from different markets can be linked to that of other markets thus resulting in integration of various markets.

One of the major breakthroughs in financial innovation is microfinance. The social innovation and financial innovation themes were clubbed to provide credit to poor and the financially excluded people. It became a huge success and the model is now replicated in different countries around the world. Financial innovations such as these, which target the bottom of the pyramid, have far reaching consequences in the improvement of overall economy. Earlier the innovations were generally targeted towards the wealthy investors barring the majority of population which could not take advantages of these innovations. Another significant breakthrough has been pooling of risks as in the system of keiretsu of Japan. Various investors come together and pool in their wealth so the risks are distributed amongst them and in case of any unlikely event the shocks would be absorbed equally. Syndicate loans were introduced on this concept. Hedging is probably the most relevant financial innovation in the contemporary world in times of excess volatility and fears of recession. Exporters can hedge their risks against currency, the farmers can hedge their risks against fluctuation of prices and so on. The idea basically is to transfer the risk from someone who cannot bear it to someone who has an appetite for risk. Pension funds and mutual funds are among the most successful models of financial innovation. The mutual funds have brought in a large number of people to invest in capital markets who were generally averse to investments in risk bearing securities due to their lack of knowledge in financial markets.

The returns on investments on high risk financial products are tempting. As long as the financial products perform well, it is a win-win situation for both the parties involved. But the bubbles created due to miscalculated financial innovations result in a huge loss to the economy when they burst. They can stall the economic activity of the entire world. The growth level becomes stagnant triggering a wave of unemployment, reduced consumption levels and eventually the macroeconomic parameters create a negative sentiment in the business environment. The irony of the fact is that a very few people are able to anticipate the obvious beforehand. Ben Bernanke praised the financial innovations and CDOs months before the world went into recession. This is not the first time the financial innovation has failed, this happens on regular intervals. Some of the examples being the internet bubble or the oil prices bubble or the Asian crises. Unlike innovations in other fields where a failure is seldom witnessed, success rate in financial innovation is on the lower side. The question arises, “why do they not learn from their mistakes?”
The role played by the regulatory bodies becomes crucial in this scenario. The whole concept of financial institutions being too big to fail and then granting huge stimulus from the treasury puts unnecessary burden on the citizens who were exploited in the name of financial innovation by designing complex derivative products. There should be a check on extreme freedom granted to these institutions and the feasibility of the innovation should be examined. The traditional banking system has evolved leaps and bounds. The aim of the bank was basically borrowing and lending i.e. to provide credit to needy from someone who has excess of it. Financial innovations should keep the development of society as a whole rather than focusing on the select few. Only then the innovation would have an impact which would be productive in the long run.

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This article has been authored by Paraag Sabhlok from IIM Ranchi