Innovation Caused the 2008 Financial Crisis

Economists still debate the causes of the 1929 stock market crash. Dozens of books have dissected the 2008 subprime mortgage crisis that pushed the banking sector to the brink of collapse and triggered the Great Recession. A federal inquiry concluded that the 2008 crisis was avoidable, but no one agrees on the actual causes.

Anjan Thakor eschews many of the traditional theories on the causes of financial crises. Instead, he proposes an examination of the structure of the banking industry that, he argues, can create conditions for crises.

Thakor finds the seeds for financial crises in the combination of a competitive financial market with limited patent protection for new financial products. The competitive nature of the financial market means that it is hard for financial firms to make high-risk-adjusted profits on well-established products. Thus, they seek financial innovations that are inherently more risky but less susceptible to imitation by their competitors. The market for these products is (at least initially) not very competitive and allows the innovator to earn high-risk-adjusted profits.

In other words:

- A competitive financial system with no patent protection means profits of financial institutions, or banks, are driven to relatively low levels on products offered by other banks.
- Incentives are, therefore, created for banks to create innovative products that are less susceptible to poaching by competitors.

The catch is that banks must create products with limited risk data (i.e. credit default swaps; bundles of subprime mortgages) to ensure disagreement among potential competitors about profitability of these products. Competitor disagreement limits market entry and boosts profits for the innovator bank.

This means that banks must invent products that are unfamiliar to all. But the downside of this is that these products are also unfamiliar to investors, so there is a risk that investors may decide to withdraw funding at some point if they lose confidence in these products. The likelihood of this happening is higher the more unfamiliar the product.

“Progress and crisis are intimately related; the elements that make innovation possible necessarily open the door to market instability.”

How innovation can lead to crisis

Within the confines of a competitive financial market where none of the players can patent a new product to attract investors, no one has a monopoly on innovation. Information on the amount of risk versus the potential for return on an investment product is the key differentiator in the creation of new banking products. In general, the more innovative a product is, the greater the risk.

After providing initial funding, bank financiers may receive signals that cause them to question the soundness or desirability of continued investment in a new, innovative product. When this occurs, they might refuse to provide new funding to the bank, causing premature liquidation of the loan.

The risk grows if investors aren’t sure which banks are making standard loans and which are using the new lending vehicles. This sort of “partially opaque” view can cause investors to withdraw funding not just from the banks with the innovative products but from all banks. Such withdrawals could quickly snowball into a full-out financial crisis.

This was the scenario in the subprime mortgage crisis and provides additional evidence for Thakor’s theory that innovative financial systems are more prone to financial crises. In fact, a crisis is more likely to arise after complex financial products are introduced, he finds.

While it increases risk for investors, Thakor suggests some opaqueness in banks’ balance sheets may be necessary for financial innovation. But if regulators force banks to increase the transparency of their balance sheets for investors, banks’ incentives to innovate will diminish.

To lessen the likelihood of a crisis, regulators could require banks to have relatively high amounts of capital on hand for new products, according to Thakor. But, he cautions, more regulation could curtail innovation and its potential benefits.

Thakor rejects traditional crisis theories, which fall broadly into three groups:

- Crises arise from panics unrelated to underlying economic fundamentals. (PANIC GROUP)
- Crises arise from shocks to economic fundamentals and are an intrinsic part of the business cycle. (BUSINESS CYCLE GROUP)
- Crises arise as a result of the interconnectedness of banks and complexity. (COMPLEXITY GROUP)