Study identifies upside to financial innovations

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Financial innovations can make or break an economy. While the negative impact of financial innovation has been extensively covered, a new study of financial innovations before and during the last financial crisis indicates that financial innovations are not all bad. Many provide positive returns, especially in the United States. However, those that are easy for consumers to understand provide the best returns for investors.

The study by Gerard J. Tellis, professor, director of the Center for Global Innovation and Neely Professor of American Enterprise at USC Marshall School of Business and his colleagues, Lisa Schöler and Bernd Skiera at the Goethe University Frankfurt in Germany, is titled "Stock Market Returns to Financial Innovations Before and During the Financial Crisis in the U.S. and Europe." It is published in the current issue of the *Journal of Product Innovation Management*.

Financial innovations, Tellis notes, are most likely known in the public's mind as having caused the recent financial crisis. However, they are one of the most important service innovations because they have offered substantial benefits to consumers, and fostered the growth of national economies. For example, financial innovations are responsible for home mortgages and auto loans, which empower lower and middle class consumers; credit to entrepreneurs who have built successful enterprises; and credit to emerging markets, which has helped raise millions of people out of dire poverty. Not surprisingly, such innovations account for a substantial portion of world economies and the huge market capitalization of banks.

Tellis, Schöler and Skiera studied financial innovations during the recent financial crisis. Using an event study and financial expert ratings, the authors analyzed the types of innovations and returns on 428 financial innovations by 39 major banks in North America and Western Europe between 2001 and 2010. Returns were measured as cumulative abnormal returns—the difference between the actual return and expected return—to stock market prices during the event window.

The researchers' analyses of the data offered conclusions with wide-ranging implications as to the impact financial innovations have had across the United States and Western Europe. First, financial innovations are profitable and deliver on average a return of $146 million. They are twice as high in the United States as in Western Europe. The implication, Tellis said, is that "the market considers financial innovations profitable, not harmful, despite their apparent responsibility for the financial crisis." This result should encourage banks to develop more financial innovations, he added. Tellis and his colleagues found that on average, innovations in securities have a return of $158 million, innovations in mutual funds have a return of $64 million, innovations in credit generate $100 million, innovations in account management produce $447 million and innovations in insurance have negative returns of $520 million. Moreover, radical innovations—those that are perceived as totally different from and offer consumers substantially superior benefits than existing ones (and would include home mortgages and auto loans, to entrepreneurs who have built successful enterprises; and credit to emerging markets)—bring higher cumulative abnormal returns because they allow firms to charge premium prices.

Further, assuming the innovation is simple, the researchers find that returns increase with how risky or radical the innovation is. In contrast, increasingly complex innovations have a negative impact on returns. The implication, Schöler said, is that "banks need not avoid risky financial innovations, they should avoid complex ones and strive for radical

innovations." In the recent financial crisis, some innovations were so complex that even the firms that created them did not fully understand their implications.

Given the positive returns to risk, the authors note that regulatory authorities cannot rely on self-motivation in financial markets to reduce risky innovations. However, regulators might be able to rely on the market itself to punish complex financial innovations.

Finding that recession has a positive impact on cumulative abnormal returns, "banks should act contra-cyclically and introduce simple innovations during recessions to increase their financial value," Tellis said. However, given that cumulative abnormal returns increase with radicalness during an expansion but decrease with radicalness during a recession, he added, "Banks should time their launch of radical financial innovations to coincide with periods of expansion rather than recessions."

Geography moderates the returns that risky innovations generate. Cumulative abnormal returns increase with risk in the United States, but they decrease with risk in Western Europe. Consequently, Tellis noted, "This dramatic difference in propensity to risk suggests that researchers and firms should treat investors differently in the U.S. versus Europe. Therefore, the United States is a more suitable market for launching more risky innovations."

Provided by USC Marshall School of Business

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