Financial innovation: A solution for the current economic climate

In this extract from a Keynote Speech given by **Professor Robert C Merton**, a **Nobel Prize Laureate** for Economics, at The Geneva Association's 2016 General Assembly in Rome, he stresses the need for the industry to rebuild trust and to tap into financial innovation to do this.

In order to have growth and economic development, a well-functioning financial system is needed and the real economy and financial economy are inexorably connected.

Crisis can induce innovation that can promote permanent improvements. In the US in the 1970s, a series of shocks and risks hit the system to create a crisis – the fall of Bretton Woods, the first oil crisis, double-digit inflation not seen since the 19th century Civil War.

There were double-digit interest rates and the US stock market dropped 50% in 16 months. There was no mortgage money at all, no matter what your credit rating. There was 9% unemployment and stagflation. These things were all hitting the system at one time.

Innovation steps in

So what was the reaction in the financial system? Innovation. Some examples are the creation of the first options exchange, of financial futures, new ways of hedging, NASDAQ high-yield and floating-rate bonds, and index funds.

This wave of innovation opened the door to the institutionalisation of the investment process. TIAA CREF was the first institution to create diversified investment theory. That led to securitisation and the creation of the modern mortgage market. Since then, there has always been a mortgage market in the US. The Research and Innovation Support and Advancement (Risa) was created – the foundation for global diversification – as well as the Q Group. A wave of financial innovation followed the crisis. These markets, created in the US, spread to almost all areas of the world.

Unintended consequences

So what will happen in the aftermath of this crisis? There were some regulatory reactions, and reactions may still do a lot of damage even if they are for the greater good as in the case of fire: water used to douse the fire may cause quite some damage, but it is necessary and stops wider harm. It is also similar to the unfortunate side-effect of a drug. Regulatory reactions can cause damage, but we can use innovation to cope with this damage.

The unconventional monetary policy will be discussed by the panel, but for pension funds, the cost has been enormously destructive in value and has taken some into insolvency. US municipal public pension plans have liabilities that have been as much as US$4 trillion under water during the financial crisis. Now the shortfall is at about $3.5 trillion (not taking account of Federal government liabilities for military and public-sector pensions, etc).

Rebuilding trust

So what are the challenges for the insurance industry? First, insurers have to prepare themselves for the fact that low interest rates are not the result of QE. When QE ended in the US, there was no interest rate spike. So once QE is reversed, there is no guarantee the rates will go back to where they used to be.

A second challenge is competition to the insurance industry in the form of disruption. Wherever there is processing, clearing and settling, for example, there is likely to be disruption. And this is really where we get to the importance of trust.

The financial services industry needs to rebuild its trust if it is to stay ahead of innovative disruption. Today, transparency is being used as a substitute for trust. We have noticed that since 2008/2009, there has been a shift away from active investment management and a massive increase in the use of tracker funds – the ultimately transparent instrument. Look at the success of trackers.

People do not trust financial institutions as much as they did before the crisis. Insurers need to think about trust.

Now to move on to the opportunities...

Some activity is inherently opaque. For example, for a knee surgery, you could know every tool that will be used, all the timings, all of the medicine and anaesthetics required, but still the success of the surgery is dependent on something that is not transparent – the skill and experience of the surgeon.

When trying to think about solutions to crises, with banks – much of what they do is opaque – if banks are going to be restored to their former prominence, they need to be trusted again.

Netflix is a prime example of the importance of good content as well as process. The process at Netflix gets you a film when you want it, how you want it, where you want it. The process is incredibly effective, but the issue is that the content is not necessarily what you want, the selection of films is only OK at best and so, quite quickly, you no longer use it.

This is a good and extremely important parallel for financial services, because the quality of content on investment products only becomes apparent over a much longer period of time.

The process from a Silicon Valley disruptor may be excellent but the advice may be poor (given that financial services require all sorts of human skills that are opaque, as in the case of surgery). If the advice a financial adviser gives me (which is inherently opaque) is poor, that becomes clear only much later on.

So at heart, are you really going to trust a company that was set up in Silicon Valley recently with no track record in financial services that's offering you process-based financial advice without the ability to know for a while whether that advice was good? Probably not.

Trust and FinTech

The issue of trust is a hugely important area and a fundamental message of what I am saying today – how can insurers create trust and increase it. If you can answer that question, you will find that what Silicon Valley does will not compete with your business but it actually leverages you.

You use the technology of FinTech to reach many more people with the same quality. If your business model is truly advice, then look at this process-based model not as a competitor, but also as an enhancement of your business. It will displace parts of your business – the mechanics – but your great opportunity lies in the high value of trust and competence.

Demographics

It is no longer the case in the US that people are really going to retire at age 65. There is a huge growth opportunity for insurers to serve that population in a richer way. The role of annuities and the reverse mortgage needs a lot of work and design, but they are going to be one of the cornerstones of how we finance retirement. These people's assets are a bank account and a house – usually nothing else. Leveraging that asset will become increasingly important to pay for the longer lives we are seeing.

There's also empirical evidence that our cognitive skill-set eventually deteriorates between ages 75 and 80. As this happens, so our ability to make financial decisions reduces, making trust even more important. Being a trusted adviser that supports people in retirement will be a significant but valuable responsibility.

Highlights

- Regulatory reactions can cause damage, but we can use innovation to cope with this damage
- The insurance industry needs to focus on building trust if it is to stay ahead of, and exploit, innovative disruption

How can insurers create trust and increase it? If you can answer that question, you will find that what Silicon Valley does will not compete with your business but it actually leverages you.

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