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Some financial innovations are good ideas and make large contributions to economic growth and prosperity. Others are not so good and can lead to bad outcomes including excessive leverage, financial fragility and even financial crises. Economists Posner and Weyl[1] suggest that it is possible to assess the potential benefits and costs for new financial products "ex ante", that is, before they are introduced to the market. They propose establishment of the "Financial Products Agency" (FPA), a government entity that will have the authority and responsibility to evaluate and approve or deny new financial products, much like the FDA has with new drugs. The purpose of the FPA would be to prevent potentially dangerous financial products from being released on the market.

The main test proposed by Posner and Weyl is whether the proposed financial product would be primarily used for risk management or hedging, which is good, or for speculation, which in their view is bad. Financial products that already exist will be grandfathered, just as were drugs already in existence when the FDA was created. The authors speculate whether various current financial products would or should have been approved, had the FPA been in operation at the time they were introduced. For example, the authors believe that life insurance policies purchased by a breadwinner on his or her own life would have been approved. But life insurance policies purchased on a third party would not have been approved. In the former case there is an "insurable interest" and in the latter case there is not. To take another example, the authors believe that put and call options on individual stocks are primarily used for betting and would not have been approved by the FPA.

I agree that in principle assessment of the quality of a new financial product is a good idea. Poorly designed products can cause great hardship. Financial products can be very complex and difficult for users to assess. There is a great informational advantage favoring sales people over customers. The negative effects of financial products may take many years to show up, during which time they may have become disseminated widely. If we could isolate a new product and examine how it would work in various environments perhaps we could prevent negative financial innovations from moving forward.

But the FDA analogy is not compelling. Drug testing utilizes the concept of controlled experiments, where one group (the treatment group) receives the new drug and another group (control group) does not. Then the health outcomes of the treatment and control group are compared. While the process can be quite lengthy, it is based on sound statistical theory. This does not mean that no errors are made. Indeed, the FDA can make two types of errors. First, they can keep a sound drug off the market. Second, they can approve a bad drug for the market. FDA officials probably worry more about the consequences of the second type of error, and therefore lean towards making more errors of the first type.

The FPA would not have the benefit of running controlled experiments. They would have to conduct thought experiments. Posner and Weyl propose to measure the likely hedging and speculative demands for a given product. What risks can this product address? How great are these risks? Are there other methods for addressing these risks? Similarly, they propose similar questions to address the likely speculative demand. If the speculative demand exceeds the likely hedge demand, then the product would not be allowed.

One problem I see is the assumption that speculation is per se bad. On the other side of every hedge transaction you will find a speculator. Thus, even a contract that has huge hedge interest will have 50% speculator usage. There is a long history in economics that sees a positive economic role for speculation. Rather than being a drag

on the economy, speculators contribute to improved economic outcomes by providing liquidity to hedgers, increasing information flows and lowering transaction costs.

A strong advocate of the benefits of innovation in derivatives markets is Richard Sandor who as chief economist for the Chicago Board of Trade was instrumental in the design and implementation of financial futures and options contracts in the 1970s and 1980s. Professor Sandor has recently published an autobiography[2] in which he details his forty-year experience in futures market design. He takes the reader through the development process both for contracts that succeeded and others that failed. This development process is detailed and painstaking. He concludes that necessary conditions for a successful product include first a fundamental hedging need, but also contract standardization, trading on an exchange, clear ownership rights, transparency, and liquidity provided by market makers and speculators. This is the definition of a good derivative. A bad derivative would be one that does not have these characteristics.

I was particularly intrigued with Professor Sandor's story because in a former life my hedge team was one the largest users on the planet of Treasury Note and Treasury Bond futures and options contracts. I had not been aware that since 1990, Professor Sandor's efforts have been concentrated on developing markets for trading toxic emissions and other environmental products. His efforts along this line will be topics for future blogs.

[1]Eric Posner and Glen Weyl, "An FDA for Financial Instruments," University of Chicago Working Paper No. 589, February, 2012.

[2]Richard Sandor, Good Derivatives, Bad Derivatives, Wiley, 2012.