



QUICK QUIZ: Match the financial innovations (column A) in the chart below to the dates of their appearance (column B). (Answers below.)

The point of this exercise is not to test your history-of-economics acumen, but

to show that financial innovations not only have been around for centuries, but also have long been valuable, creative tools that have helped grow our economy and have contributed greatly to our standard of living.

But in the market meltdown of 2008-9, the process got a black eye. Many economists, government officials and policymakers blamed the crisis on innovative financial products ranging from collateralized debt obligations to credit default swaps to securitized mortgages.

While there is no question that the misuse of financial tools was a cause of the crisis, we at the Milken Institute believe that their proper use can be part of the cure.

As with any powerful tool, things can go awry if not used properly – a chainsaw is great for cutting trees, but you wouldn't use one to trim your nails. Take credit default swaps. As originally intended, they allow buyers of securities to cover their losses in the event of a default – like buying fire insurance for your home – thereby making it possible to manage investors' risk and, in the process, en-

courage more capital to flow into the market. But in many cases, these swaps were originated, bought and sold by people who had no direct interest in the underlying transaction. This created a vast, unfathomably complex web of liabilities (many times the value of the underlying payments being guaranteed), while adding little to the process of efficient capital allocation.

That's not the instruments' fault; it's the fault of those who used them in ways that put the whole financial system at risk.

Much of the Institute's work is focused on financial innovation because we believe new

financial tools, when used properly, can help to meet some of the biggest challenges facing contemporary society. Our financial innovation labs, for instance, have examined new ways to facilitate the pres-

ervation of vital ecosystems; to get food aid to those who need it more quickly and efficiently; to lessen our dependence on oil; to reinvigorate low- and middle-income housing markets; and to expand insurance coverage in disaster-prone areas.

As you'll see in this issue of the *Review*, there is no consensus among the experts on how to "fix" our financial system. I would urge reformers to think twice before making changes that would stifle the sorts of financial innovation that entrepreneurs can use to aid in our economic recovery.

Michael Klowden, President and CEO

Answers: 1c, 2d, 3b, 4a

COLUMN A	COLUMN B
1. Contracts promising future delivery	a. 1498
2. Notes secured by mortgages	b. 1829
3. Deposit insurance	c. 1200 BC
4. Capital and foreign exchange markets	d. 1723