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Finance By and For the People in The New Rambler

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Finance By and For the People

By PETER CONTI-BROWN

Review of **Smart Money: How High-Stakes Financial Innovation is Reshaping Our World—For the Better,**
by Andrew Palmer

Basic Books, 2015

Anyone who has ever used Facebook, Twitter, Instagram, or the vast majority of smartphone apps has often wondered: what's the point? The extraordinary redirection of human capital toward Web 2.0 has already occurred, but is encouraging 140-word fights about the latest political outrage worth the effort? In a country with dwindling infrastructure, flagging public education, and a stagnant economy, the

longing in many corners is for U.S. human capital to build something, something real, something that lasts.

To those with such impulses, Andrew Palmer, the former finance editor for *The Economist*, has a provocative response. If we want to use human ingenuity to save the world, we should root for an unlikely cast of heroes: bankers and financiers. “Bright young people should be going into all sorts of different careers,” he writes. “[F]inance should be one of them. For all of its flaws, there is no more powerful problem-solving machine.” He puts the same point slightly differently in the conclusion: “When the figures come out on the proportion of graduates going into the financial services industry, the usual reaction is to assume that other industries simply must be more productive outlets for our brightest young people. But are other sectors really more useful?”

Palmer anticipates the reflexive skepticism that a paean to finance will produce. Didn't financial entrepreneurs destroy the global financial system and send us all on the worst post-crisis recovery in recorded history? Maybe. But Palmer takes aim at the naysayers, the “consensus . . . in which finance is demonized, in which bankers are generally bad, in which there is a

‘socially useful’ bit of industry that doles out loans to individuals and businesses, [while] the rest . . . is dangerous, unnecessary gambling.”

To those critics, *Smart Money* is an effort to set the record straight by redirecting attention to the sunny side of financial innovation. Palmer writes: “The words that finance immediately conjures up— bonuses, recklessness, greed, bastards, greedy bastards— are absolutely part of the industry’s narrative. But this is also an industry that is home to creative minds grappling with gigantic problems.” *Smart Money* is a celebration of those “visionary entrepreneurs” who want to make the world a better place using finance and financial innovation as their primary tools.

I’ll return to *Smart Money*’s curious (and lamentable) central argument in a moment. First, it’s important to see what makes this book worthwhile for a generalist audience.

After presenting a (highly) stylized account of financial history, *Smart Money* proceeds, chapter by chapter, to present ways that financial entrepreneurs are able to challenge the status quo and solve problems that traditional financiers have failed to do. At the core of

Palmer's excellent reporting and lucid exposition we see four concepts. The first is the existing financial system. It has developed in fits and starts over time to address problems of the past. But at its core is the intermediation of capital between savers and spenders, lenders and borrowers. Those who have money want more of it, and they give it to those with big ideas but shallow pockets. The financial system is the place where these complementary parties efficiently find each other.

Second, some perennial problems. Social programs designed to help ex-convicts reenter society do more harm than good. Important, life-saving drugs aren't getting funded. People haven't saved nearly enough for their longer-than-expected retirements. Consumer borrowers—homeowners and students, mainly—aren't getting loan terms that accurately reflect their risk profiles.

Third, there's a flaw in the system. Unlike some of the economic models of the financial system, not every worthy project gets funded, not all information is symmetrical, not all markets are efficient. Savers want to invest, and spenders want to build, but they aren't

finding each other using the financial rules of the road as currently written.

Fourth, the financial entrepreneur (or banker, or economist) recognizes the systemic flaws in the third concept, wants to solve the problems in the second, and sees how to use the tools from the first to accomplish these goals. The book is a monument to examples of these entrepreneurs in action. We learn about “social impact bonds” and their ability to finance public programs that succeed at resolving some of the most intractable social problems we face, such as how to make life for ex-convicts sufficiently hopeful such that they see hope in living inside the law. We learn about securitized structures that are employed not to blow up the subprime housing market but to spread risk for funding highly experimental drug treatments that are more likely to fail than to succeed. Behavioral finance and big data make repeated appearances, for example, to help resolve the problem of too many people retiring too early with too little saved to survive. And we see students getting loans from alternative lenders who don’t slip into the same irrational habits (embraced by big banks and the U.S. government alike) that assume Wharton graduates are

as likely to default on their student loans as those who received a communications degree from an unaccredited online university.

The breadth of the examples gives *Smart Money* its charm. And while it's not the most original account of, say, innovations in the mortgage industry, the book is a welcome invitation to ponder some of the holes in our current financial system and how the little guys are the ones most likely to "disrupt" existing juggernauts with broader benefits redounding to society. (Although Palmer does not acknowledge the debt, *Smart Money* probably would not exist without Clayton Christensen's *Innovator's Dilemma*.)

In a sense, the book represents a vision of finance by and for the people. There are problems that plague our system, but they aren't born by the most powerful of constituencies. And as a consequence, only the scrappy, resilient little-guy entrepreneur can come to the rescue. The big bankers are mostly not interested. Finance is "an industry that is home to creative minds grappling with gigantic problems," Palmer writes. "There are big banks, but there are also visionary entrepreneurs: finance is a playground for both. There are institutions skimming fat fees by sitting in the

middle of transactions, and there are upstarts trying to connect buyers and sellers directly using the power of technology and big data.”

Given the book’s many interesting examples, the most startling and disappointing aspect is the intentionally provocative argument Palmer imposes on his evidence. *Smart Money*, like so many books written after 2008, is framed as a pre-crisis, post-crisis narrative. On Palmer’s account, before the crisis we had a good vibe going. A lot of bright people went into finance. Then the crisis happened, and there has been backlash, with the critics demanding that no one bring any new ideas to finance. Some of that backlash is deserved. But now it’s gone too far. Finance is really a thing of the future, and we should do all we can to use it as a tool to solve the problems that we all agree have not gone away.

Smart Money’s central flaw is in this overgeneralized schematic. First, I’m not sure “finance” has ever had a particularly rosy reputation. A tour of financial history more detailed than Palmer offers consists of debtors and creditors jockeying for political power, each vying for supremacy. While bankers and financiers have had more than their share of political triumphs, they have rarely inspired popular affection.

Second, Palmer's post-crisis diagnosis is more seriously wrong. Critics have not called for a "freezing in place, no bright ideas allowed" for finance, as Palmer accuses them of doing. Indeed, some of the most compelling critiques have seemed downright radical in their proposals to change the financial system (see [Mian & Sufi's "shared-responsibility mortgage"](#) or [Admati & Hellwig's proposal to increase bank equity by an order of magnitude](#)).

Who, then, is Palmer arguing against? There are certainly people who espouse any number of ideas about the financial system. But Palmer's quarry is not the fringe simpletons who want to prohibit "fresh thinking," a phrase he returns to again and again. He wants to stake a claim in defense of his reified hero: "finance." Those who oppose "finance" and especially "financial innovation" are the villains in this story.

The book's argument is unfortunate and distracting from the entertaining and informative examples it offers. The argument makes the rest of the book something of a non-sequitur. In Palmer's many examples, he isn't providing a defense of "finance" against those who oppose it. He is simply arguing—correctly if unoriginally—that the financial system we

have is not, as yet, the financial system we need. Had *Smart Money's* arguments matched its evidence, the book would be an even better addition to the popular literature on finance and banking.

The core problem with this argument is that it's not clear his conception of "finance" does the work he wants it to do. The book ends with these sentences: "My belief is that tremendous good will come out of the financial industry in the coming years, thanks to the sorts of entrepreneurs and innovators we have met in the preceding pages. The next time someone says that finance is good for nothing but enriching bankers, think of them."

But is "finance" the umbrella category he needs? I don't think it is, largely because "financial innovation" is deployed in very different contexts whether one is a trader at a large investment bank or working inside a nonprofit trying to get funding to save the world. To see the point, consider two examples: "regulatory arbitrage," or the practice of using financial innovation to evade or avoid government regulations (a concept Palmer mostly ignores), and the "social impact bonds" that Palmer profiles in chapter 4.

First, regulatory arbitrage. There is a significant amount of money to be made in the financial system by designing products and services that conform to the letter of the law while skirting its spirit. Indeed, much of the field of structured finance involves building financial structures that satisfy the demands of lawyers, accountants, and regulators but that still allow firms to engage in practices that would otherwise violate the law. One of the most sensible critiques of otherwise well-intentioned policy proposals is precisely that talented, entrepreneurial, even visionary financiers will simply figure out a way to ignore the rules and make the financial system more opaque and complex in the process. To quote one colorful and profane banker Palmer interviewed (in one of the only references to this subject), “Whatever rule those fucking idiots come up with on Monday, I’ll have found a thousand ways around it by Friday.”

Palmer doesn’t want us to think about financial innovation in those terms. He wants us to see what the little guy is doing on the edges of the financial system to make the world a better place. But even there, it’s not clear we’re really talking about “finance.” Consider one of Palmer’s examples, the “social impact bond.”

These “bonds” bring a partnership between governments, nonprofits, management consultants, and private investors. The government identifies the problem that needs addressing—say, criminal recidivism or early childhood education—and seeks collaboration from nonprofits to address them. Private investors—the bankers and financiers in the equation—provide the capital required to fund the programs, but delegate the administration of those funds to the nonprofits. The “bonds” are structured in such a way that the governments will pay out to the investors only on the condition that the social programs themselves meet certain benchmarks. The benchmarks are designed, in theory, to not only address the specific social problem at hand, but do so in a way that is cost-effective for the government. Repayment, then, of the “bonds” both accomplishes the public goal and contributes, on net, to saving public resources. (I keep putting “bonds” in quotes because they aren’t really bonds at all so much as a kind of bespoke derivative.)

But are social impact bonds really an innovation of finance? Maybe a little. It’s true they are using the financial system to encourage private investment in the spending nonprofits—there’s a form of

intermediation happening here. But social impact bonds are more about the further climb (or slide, depending on one's point of view) toward outsourcing more and more core social services to the private sector so that contractors rather than elected officials can run the public fisc. This isn't finance as much as it is management consulting.

Reading another book recently—Ashlee Vance's interesting biography of [Elon Musk](#)—I was struck by a similar lament. Musk's statement that “there are probably too many smart people pursuing Internet stuff, finance, and law. That is part of the reason why we haven't seen as much innovation.” I'm not sure Palmer's *cri de coeur* in favor of finance would convince Musk. If Palmer put it differently, though, and argued instead that there are failures of intermediation everywhere we look that land disproportionately outside the financial mainstream, this interesting book would be even better.

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