Research shows that the human brain is biased in favour of making safe choices. This is part of the drive behind " securitisation ", where the financial sector turns risky debt into "safe" debt by pooling assets together or carving out the safe bits.

But this debt may not be as safe as we think. And as individual traders load up on "safe" debt, they are putting us collectively at risk of another financial crisis.

This exact scenario has led to previous financial crises. It contributed to the panic of 1857. It also led to the 2008 global financial crisis.

Safe debt

Imagine a bank lends someone A$1 million to buy a house, but should the person default the bank can only recover A$500,000 by foreclosing and selling the home. The bank does not want this loan on its books so it sells the loan to a financial institution that specialises in creating "safe debt".

The loan is then split into two pieces of A$500,000, one labelled a "senior tranche" that gets paid first, the other is called the "junior tranche". Because A$500,000 can be recovered by foreclosing and selling the home, the senior tranche is sure to get all its money back.

Voila, A$500,000 of safe debt has just been carved-out of a risky A$1 million loan.

But the junior tranche can also be made safer by pooling several different loans together. This process can and does take place with many different kinds of debt - mortgages, corporate bonds, credit cards, car loans, and student loans among them.

This is how trillions of dollars of risky assets were transformed into supposedly "safe" assets before the global financial crisis.

An obsession with safety

Studies have found that different regions of the brain are involved in evaluating safe and risky choices. Because of this, humans are hardwired to treat safe and risky choices differently.

A collection of experimental studies have more directly tested the notion that certain and uncertain choices are evaluated differently.
They found
that people display a disproportionate preference for safety.

This means that financial institutions have an incentive to carve-out as much safe debt as they possibly can, because we are willing-to-pay disproportionately more for safe debt.

This is fine as long as the assets really are safe. But if they aren't, it's potentially a big problem.

Going back to the example from earlier, how sure can we be that in a real crisis the house wouldn't actually be sold for less than A$500,000? Perhaps A$400,000 or even A$300,000?

If A$500,000 of the debt was carved-out and considered safe, but only A$300,000 is recovered, then the "safe" debt is really not that safe. It is, in fact, a risky asset.

And if our brains lead us to pay disproportionately more for safe debt, then the same preference, in reverse, could cause a sudden and sharp decline in the value of its risky incarnation.

How it could go wrong

The fact that we have a disproportionate preference for safety means financial institutions have an incentive to create as much safe debt as possible. In the past this has led to excess creation of safe debt, where even risky debt is traded as safe debt.

In this context, a financial crisis is a sudden realisation that what was previously thought to be safe, is actually risky.

The onset of the global financial crisis has been linked to exactly this phenomena . Before the crisis, the hunger for safe debt had led to the creation of huge numbers of supposedly safe debt. By July 2007, mortgage defaults revealed how risky this debt actually was, and a crisis ensued.

To prevent another financial crisis we need to be proactive. There needs to be regulations in place with the aim of preventing the excess creation of safe debt.

It's not an easy problem to solve, as the human desire for safety will continue, and no one will ever know exactly what is safe, especially in a crisis. However, more regulatory caution should be built into the system.

Hammad Siddiqi does not work for, consult, own shares in or receive funding from any company or organisation that would benefit from this article, and has disclosed no relevant affiliations beyond the academic appointment above.

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