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News release

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The dog and the frisbee – paper by Andrew Haldane

In a paper given at the Federal Reserve Bank of Kansas City's 36th economic policy symposium in Jackson Hole, Wyoming, Andrew Haldane – Executive Director for Financial Stability and member of the Financial Policy Committee – explores why the type of complex financial regulation developed over recent decades may be sub-optimal for crisis control. In doing so, he draws out a number of public policy lessons. The paper is co-written with a Bank colleague, Vasileios Madouros.

Andrew Haldane presents evidence from a range of real-world settings to demonstrate that decision-making in a complex environment can benefit from the use of simple decision rules of thumb. He argues that complex rules often: have punitively high costs of information collection and processing; rely on "over-fitted" models that yield unreliable predictions; and can induce defensive behaviour by causing people to manage to the rules.

He argues that regulatory responses to financial crises, past and present, have been to increase complexity with: "...a combination of more risk management, more regulation and more regulators". As the Basel Accords have evolved over time, he notes, so has opacity and complexity associated with increasingly granular, model-based risk-weighting. Meanwhile, detailed rule-writing in the form of legislation has increased dramatically, as has the scale and scope of resources dedicated to regulation.

Andrew Haldane uses a set of empirical experiments to measure the performance of regulatory rules, simple and complex. He finds that simple rules such as the leverage ratio and market-based measures of capital outperform more complex risk-weighted models and multiple-indicator measures in their crisis-predictive performance. He says that: "The message from these experiments is clear and consistent. Complexity of models or portfolios generates robustness problems when understanding a complex financial system over plausible sample sizes. More than that, simplicity rather than complexity may be better capable of solving these robustness problems."

Andrew Haldane considers five policy lessons that financial regulation can draw from these findings. First, he suggests that the Basel framework could take: "...a more sceptical view of the role and robustness of internal risk models in the regulatory framework...simplified, standardised approaches to measuring credit and market risk, on a broad asset class basis, could be used."

Second, he says the leverage ratio could be placed on an equal footing with capital ratios, an approach taken by the Bank of England's Financial Policy Committee, and market-based indicators of capital adequacy added to regulators' and investors' indicator set.

Third, Andrew Haldane calls for a fresh approach to financial supervision, one which is less rules-focussed and more judgment-based. He notes that this approach: "...will underpin the Bank of England's new supervisory model when it assumes prudential regulatory responsibilities next year." To be effective, he says that will require more experienced regulators working to a smaller, less detailed rulebook. He adds that greater simplicity and consistency in disclosure practices could also strengthen market discipline.

Fourth, he considers the case for tackling complexity directly and at source. He says that recent events have re-demonstrated the problems that arise in risk-managing large, complex banks: "At present, no explicit regulatory charge is levied on those complexity externalities. Doing so would help protect the system against failure, while providing explicit incentives to simplify balance sheets."

Finally, Andrew Haldane notes that, while quantity-based restrictions such as the Independent Commission on Banking proposals in the UK and the Volcker rule in the US are robust to complexity and uncertainty, they risk being mired in detail in their implementation. He argues that cleaner solutions could be considered, or that the market could lead by encouraging banks to sell-off assets and reduce complexity.

Andrew Haldane says that: "Modern finance is complex, perhaps too complex...As you do not fight fire with fire, you do not fight complexity with complexity. Because complexity generates uncertainty, not risk, it requires a regulatory response grounded in simplicity, not complexity." That would require "...an about-turn from the regulatory community from the path followed for the better part of the past 50 years." But when it comes to financial regulation, concludes Andrew Haldane, "...less may be more".

Key Resources

http://www.bankofengland.co.uk/publications/Documents/speeches/2012/speech596.pdf
Full speech by Andrew Haldane