Our Perspectives:
Commentary on the economy & regulatory policies affecting financial companies

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The Dog and the Frisbee[*]

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I wish I could take credit for that title, but I cannot. The "Dog and the Frisbee" is the title of a paper presented by Andrew Haldane at the recent Jackson Hole conference sponsored by the Federal Reserve Bank of Kansas City.[1]

Andrew Haldane is the executive director for financial stability for the Bank of England and his paper (which is co-authored by Vasileios Madouros, an economist with the Bank of England) raises a fundamental question for financial regulators and the financial services industry — has financial regulation become too complex?

The central point of the paper is that financial regulation should be simplified. The dog and the Frisbee is a clever analogy designed to reinforce this point. In the paper, Mr. Haldane observes that catching a Frisbee involves a complex set of factors, yet dogs are able to master this task because they follow a simple rule: they "run at a speed so the angle of gaze to the Frisbee remains roughly constant." Likewise, notes Mr. Haldane, catching a financial crisis is difficult since it requires regulators to balance a complex set of factors. Yet, his analytical research indicates that simple rules, such as a single liquidity indicator, may be a better marker for catching a financial crisis than more complex models.

Mr. Haldane provides several reasons to support his argument that simple is better. He cites natural limits on our ability to process complex information (chess grandmaster can only think five moves ahead), as well as research on topics such as sport predictions and investing that indicate that

[*]The information contained in this newsletter does not constitute legal advice. This newsletter is intended for educational and informational purposes only.

[1]Andrew Haldane, ***The Dog and the Frisbee***, Bank of England (Aug 31, 2012)

simple rules can outperform complex rules (picking a winning team based upon name recognition can outperform complex team rankings derived from data-driven algorithms; passive investment strategies can outperform complex, active strategies). He also cites the potential for models to produce unreliable predictions as they become more complex, and the potential for complex rules to trigger defensive actions that are focused on details rather than the big picture (doctors fearing malpractice suits may take actions that may reduce their risks, such as admitting a patient to a hospital, and this may increase the patient's exposure to other diseases and infections).

Yet, the trend in financial regulation is not toward simple rules. It is toward more complex rules, more complex internal models, and more and more regulators. Mr. Haldane's paper includes some data on the growing complexity of financial regulation, which would not come as a surprise to anyone involved in the financial services industry. His favorite foil is the Basel risk-based capital structure, which he repeatedly refers to as the Tower of Basel.

Mr. Haldane concludes his paper with five policy recommendations, all designed to reduce the complexity in financial regulation, yet (in his view) enhance its effectiveness. These recommendations are premature. While Mr. Haldane makes a good case for simplifying financial regulation, there are strong forces aligned against such an approach. Every new crisis brings calls for additional, not less, regulation. Regulatory agencies, once in place, look for ways to expand their authority, not reduce it. Also, notwithstanding complaints over excessive regulation, the financial industry routinely advocates for the legal certainty that rules provide, and traditionally has resisted efforts to consolidate federal financial regulatory agencies. Thus, before there can be any consideration of the merits or demerits of how to simplify financial regulation, there needs to be a more fulsome discussion of the fundamental issue raised in Mr. Haldane's paper — has financial regulation become too complex?

Greg Wilson, my longtime friend and colleague on various projects, has suggested that one way to conduct this discussion is to convene an annual summit of financial regulators from various countries, much like the Jackson Hole conference is a summit of central bankers. Such a summit could serve as a forum to debate not only the merits of Mr. Haldane's paper, but other financial regulatory matters, especially those that require international coordination and cooperation.

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