# General Discussion: The Dog and the Frisbee

*Chair: Susan M. Collins*

***Mr. Liikanen:*** Mr. Andrew Haldane's presentation reminds me of a famous phrase by Mencken, who said that for every complex problem there is an answer that is clear, simple and wrong. I still think Andy may have a point. When I look at your (Mr. Haldane's) propositions, you say for instance that you need to take flaws in internal models into consideration. You raise the issue of quantity-based regulation. Is your proposition that these should be *substitutes* for risk-weight-based regulation, or should they *complement* them? If they are complementary, it is not simple—but it can make sense.

***Ms. Malmgren:*** Urban planners are finding that if they remove street signs, drivers and pedestrians take more responsibility for their actions and there are fewer accidents. But to apply this lesson to monetary policy would require such a degree of bravery among central bankers and regulators that I can only wonder whether we can think it humanly possible. Along the same lines, there was a great article in *The New York Times* in 2008 called "Goalkeeper Science," which noted that although goalkeepers in soccer have the best chance of stopping the ball if they stay in middle of their goal, they nevertheless do not do so. They go to the left or they go to the right, because the crowd expects it. So how do we deal with the human factor: needing to be seen as taking action, in a moment of crisis?

***Mr. McAndrews:*** I just wanted ask Andy about the influence of the information technology revolution and the enormous availability of data, and data-analysis power that is available today. Does that context have implications for his 75 pieces of information, provided by banks, versus 7,500? Might the latter approach be much less costly today, than in the past, and wouldn't regulators be remiss not to keep up with the same sort of mass data and analytical capabilities that financial institutions are using?

***Mr. Honohan:*** I think I agree completely with the orientation of the paper. But to me it seems that, to some extent, it may be the formality of these complex rules that Andy is really referencing. He notes that the Bank of England will use great discretion, by which he means the bank employs an incredibly complex set of rules that remain implicit, that are never set out, and, therefore, cannot be gamed. I think to some extent it is the formality of these rules, and the complexity of managing them, that distracts supervisors from what really matters. To some extent also, depending on the legal situation, the rules' formality and complexity tend to constrain supervisors from deviating from the rules. If you have all these rules, how can you then, in addition, come in with "supervisory discretion?" To do so can be taken as an indication that you failed to cover the current conditions with the rules.

***Mr. Taylor:*** Andy, this paper makes a lot of sense. I would ask a question though about the trend toward macroprudential regulation. It tends to be *more* complicated and to involve even more contingencies. Regulatory capture does seem to have been a serious problem, though Andy did not emphasize that very much. It seems to me that the problem of regulatory capture is another very strong reason to seek simplicity and transparency, so that that regulatory capture can be prevented.

***Mr. Posen:*** I want to strongly second what John Taylor just said. To me, that was always the strongest argument. What I find weakest about Andy's otherwise excellent paper is the increasing room for the discretion of supervisors. The whole point of simple rules is to constrain supervisors. There is a theme in the remarks from both of the discussants of this idea, namely, that there is complexity. They push back at Andy's argument for simplicity. But there are plenty of other industries engaged in very complex matters—like pharmaceutical development, aircraft safety or military procurement, to name just a few examples—where we manage to have relatively simple rules, and relatively nonexpert supervisors manage to enforce them. I think this discussion is taking place without enough reference to the context of comparative regulation.

Finally, to comment further on Patrick Honohan's remarks: it was not that we saw regulatory capture due to some complex phenomenon. Regulatory capture occurred because a group of top central bankers and supervisors decided we could allow a very lax regulatory regime for 15 years. Thus, I think there is actually a quite simple explanation for what happened.

***Mr. Panetta:*** The paper argues that we should make the financial system simpler in order to make it safer. But the problem becomes: how do you do this? How do you achieve the goal of making the system simpler? My view is that the main source of complexity in the financial system is represented by the presence of large and complex banking institutions. In the past, large banks were thought to be safer than other banks for three main reasons. First, they were thought to be more efficient due to economies of scale. Second, they were thought to enjoy the benefits of asset diversification. And third, they were thought to have better risk management systems. Each of these three assumptions has proved to be wrong.

First of all, many papers now have shown that economies of scale in banking are at best illusive. Beyond a certain relatively small size, the average cost curve starts increasing, mainly due to the cost of complexity. Secondly, the performance of highly complex risk management models has proved to be rather poor. And third, the benefits of diversification are also questionable, because in a crisis all correlations go to 1—and rapidly. So in the end, what you are left with is the potentially very large cost of complexity, which increases the risk of "mega-banks," especially in a crisis situation.

If we want to simplify the financial system and make it safer, I think we should start from the real source of complexity and risk: very, very large banks.

***Ms. Collins:*** I would like to note an additional example of a place where a relatively simple rule appears to be very, very effective. That is in the world of international cooperation efforts related to nuclear deterrents, where tit-for-tat strategies appear to outperform many much more complicated strategies. This is a very powerful and surprising example.

Meanwhile, I was really struck by a point that both the discussants and a number of other commentators have made. They raised this question of whether we are discussing two things that are complementary, or are substitutes for one another. As I was listening to Andrew's presentation, it seemed to me that we do in some ways fight fires with fires. In fact, we often use fires to try to contain the existing fire that we are trying to put out, to keep it within a circumscribed area, and then use other types of mechanisms within that area. That is an example in which the approaches can be complementary.

As this very important and interesting work goes forward I hope there is more discussion of some of the issues highlighted by Eswar: the question of what the objectives really are. To the extent that the goal is to prevent catastrophes, one may weigh some types of responses somewhat differently from the scenario whether there is a broader set of objectives in mind.

***Mr. Olsen:*** I know that almost everybody here is familiar with the discussion on rules versus discretion, in monetary policy, but there is another distinction to consider: the distinction between simple decisions and complex decisions. I would like to ask for Andrew's view in this regard.

***Mr. Haldane:*** Thank you, Susan. Thank you, José and Eswar for excellent comments and for the great questions from the floor as well. The motivation for this discussion is the fact that the path we have been on has differed greatly from the one I have set out, and it will take a real effort, both analytically and in terms of public policy, to reverse the tide that has been set in motion for the last several decades. The customary case made by industry for slimming the rule book tends to be on cost grounds. I thought it was important to put on the table the possibility of a more analytically well-grounded case for slimming and simplifying. What I have not done today, because I do not know the answer, is to know quite what that simplified set of rules looks like precisely. I think José and Eswar were right to point out that I did not address that.

For me, the key point today though is for us to recognize that the knee-jerk response we have had for the better part of 50 years now might not be quite right. There are some big questions about whether that is a defensive response by legislators rather than by supervisors. I think José makes that point, and it is a very powerful point. He also made a very important point about getting the objectives straight. Indeed, that has never really been achieved. Implicit in my paper is an objective function that weights the avoidance of catastrophe very highly and weights rather less highly the ordinary, business-as-usual provision of services. That might not be right for different countries at different points in their evolutionary cycle.

The key point is that the underlying analytical methodology of seeking to price risk through the regulatory system, and to set capital and liquidity requirements based on those risk calibrations, might be flawed. It is the same flaw that, as Fabio mentioned, the banks themselves made in their own risk management systems. So far, at least, we do not appear to have learned those lessons in our recalibration of the regulatory system. What better time than now? Indeed, if not now, in the wake of the biggest crisis we've seen in 70 years, then when? What will turn the tide?