"Complexity cloaks Catastrophe"

William Leiss (17 January 2012)

> Good risk management is inherently simple; adding too many complexities increases the likelihood of overlooking the obvious.
> Leiss, "A Short Sermon on Risk Management"
> (http://leiss.ca/?page_id=467)

The quoted phrase that forms the title for this paper comes from the opening pages of Richard Bookstaber's indispensable 2007 book, *A Demon of our own Design: Markets, hedge funds, and the perils of financial innovations* (New York: Wiley). This book inspired much of my own subsequent work in this area, as published in *The Doom Loop in the Financial Sector, and other black holes of risk* (University of Ottawa Press, 2010: e-book available at: http://www.press.uottawa.ca/book/the-doom-loop-in-the-financial-sector); see the section on "Complexity" at pages 80-83). Bookstaber's key point is that *complexity in financial innovations is itself an important risk factor for systemic failure in the financial sector*.

Now the *New York Times* columnist Joe Nocera has written in his January 17 column, "Keep it Simple" (http://www.nytimes.com/2012/01/17/opinion/bankings-got-a-new-critic.html?hp), about an important new source for this topic. This is a November 2011 paper prepared by staff at a firm called Federal Financial Analytics, Inc.: "A new framework for systemic financial regulation: Simple, transparent, enforceable, and accountable rules to reform financial markets," available as a PDF file at: http://www.fedfin.com/images/stories/client_reports/complexityriskpaper.pdf.

In effect, both the paper and Nocera's commentary argue – with reference to the U. S. Dodd-Frank Act – that responding to complexities in financial innovations with complex regulatory regimes is a mug's game. It does not solve the problem of "complexity risk" and in fact may exacerbate that risk. It also does a poor job of anticipating the next challenge, as the recent collapse of MF Global shows.

The Obama administration has put its faith in "smart regulation," which ignores the fact that it is the industries being regulated which can hire the smartest people and task them with finding a way to circumvent any set of rules, however complex. (Meanwhile, his Republican opponents work feverishly to gut his regulatory agencies of competent staff and leaders.) Similarly, the authors of the paper, "A new framework for systemic financial regulation," propose solutions involving new corporate-governance regimes, but the private-sector risk governance regimes failed utterly the last time around, so why on earth would the rest of us want to retry this experiment?

In the end we have to turn to the most reliable guide, Simon Johnson, whose advice is simple: Break up the big banks. (Follow his blogs at: http://baselinescenario.com/; the

latest is, "Refusing to take yes for an answer on bank reform.") Banks to big to fail should be regarded as too big to exist. And yet the leading financial institutions in the United States are bigger than ever. No "systemically-important financial institution" will ever be allowed to fail. The bankers who run them know this. They also know that they cannot be outsmarted by the regulators.