

IS SIMPLE GOOD?

Commentators on the present banking crisis put much of the blame on the complexity of credit instruments such as securitizations and credit-linked synthetic structures. Some have gone so far as to question whether such innovations have any value.

According to this argument, the instruments and legal structures used to package up credit risk and sell it to investors were too difficult for investors to understand and value. In fact, the main purpose behind them was to make it easier to sell investors a 'pig in a poke'.

Let's return to the 'glory years', the argument runs, when financial life was simple: loans and deposits. Banks can go back to extending credit only where they intend to hold the asset to maturity in the fortress balance sheet. Investors can stick to investing in simple instruments where there is a clear, liquid market price.

It's a soothing argument at a time of market stress. We all know that 'complex' doesn't always equate to 'better'. But with rule makers of various kinds looking for easy targets, it's time to point out the flaws:

- Simple may not have saved us. Economists and statisticians worry about something called 'survivorship bias' - the danger that they are looking only at the parts of the population that survive into a given sample, or that are included in the period under observation, rather than looking at the population as a whole. As commentators on the 2007 credit crunch, we suffer from an extreme case of survivorship bias. We can easily see the problems caused by poor risk transparency in the originate-to-distribute model. But we can't know how much worse the situation might be in a world without these newer risk transfer mechanisms, improved market

infrastructure and instruments, and more sophisticated risk models, data and methods.

- There's no line to draw. After a shock, it's always tempting to draw a clear line marking out good behavior from bad. But if we define that line in terms of instrument complexity, where do we draw it? The simplest way to buy a house, after all, is to save up your whole life while living in a tent, then buy the house for cash when you are 70 years old. Turning to the financial markets, should we have banned derivatives after the first market spasm - including the 'plain vanilla' variety now so beloved by today's more homespun professional investor?

There is one simple, novel rule that works: professional investors should not invest in instruments they don't understand.

- We've been here before. In the early-to mid 1990s the financial markets experienced an earlier series of derivative 'disasters' (eg, the Orange County, Gibson Greetings and Procter & Gamble cases) that led to similar calls to clamp down on fancy derivative structures. Again, the crisis trigger was investors searching for yield without taking full account of embedded risk, and again the villains of the day were derivative traders, who were accused of taking advantage of unsuspecting corporate and institutional investors. Thankfully, instead of massive new regulation and federal oversight of the nascent market, the market itself began to define best practice, investor and dealer responsibilities and required risk management systems and processes. Rather than crush what has since become a critical market, innovation was allowed to continue and the

lessons learned from the 'disasters' caused major improvements in risk control, risk transfer and risk management.

There is one simple, novel rule that works: professional investors should not invest in instruments they don't understand. This will lead some investors to abandon complex credit instruments - and this is as it should be. No investor should place their capital into investments for yield only, and forget the first law of finance: there is no such thing as a free lunch. It will lead many other investors to increase their understanding of credit instruments and demand the kind of fundamental risk information that allows them to differentiate between the good and the bad. When they do this, needless instrument complexity will be seen as spurious and inefficient. Financial meltdowns often lead to a 'burn and learn' event, setting the scene for revolutionary advances in risk management practice.

The originate-to-distribute model is not going to disappear and we cannot go backwards in how we monitor and control risk. The lessons from the present crisis will help mend flaws in risk management implementation, and the present intense scrutiny will improve risk practice. In the long run, we can look forward to new generations of instruments, greater flows of information, greater risk management and modeling sophistication across a wider (not narrower) investor population, improved risk transfer, and and greater wealth in the world economy.

In the short run, however, we all need to remember that, while informed choice is always good, simple is good only sometimes.