



Promoting sensible and stable attitudes  
toward regulation is part of risk management.

# Lessons from the Financial 'Accident'

BY MALCOLM K. SPARROW

Many of us learn by analogy. This journal was not the first to ask me what useful lessons for risk-control professionals might be extracted from the global financial wreck.

Some aspects of the financial meltdown are peculiarly *financial*, and probably not of much interest to other fields, like the failure to recognize that the risks associated with credit default swaps (insurance policies against defaults on commercial loans) would turn out to be highly correlated in strained economic conditions — a factor which undermines the general presumption of insurance market integrity and famously brought AIG to the brink of disaster.

But several aspects of the meltdown appear to have analogues in the aviation safety business. Let me propose four here.

## Catastrophic Novelty

In mature regulatory environments, all catastrophic failures are novel. “Didn’t we learn *anything*,” people ask, “from the savings and loan crisis?” Yes, we did. We learned how to prevent another *savings and loan* crisis! The forensic debriefing of that particular disaster — just like the investigation that follows any major airplane crash — taught us everything necessary to prevent that particular catastrophe from happening again. Such disasters are studied assiduously,

lessons learned and disseminated, controls enhanced. But just how *different* does the next disaster need to be, for the lessons learned last time to appear too narrow, too particular and not sufficiently generalized?

As regulatory regimes mature, they reach the limits of forensic debriefing and control feedback loops. All “major causes” of accidents have been identified and eliminated. Residual risks are novel, hard to imagine and often the result of complex interactions among multiple systems. At this point, any further advances in risk reduction rest on analysis and navigation of the early stages in the unfolding — among the precursor events, and precursors to the precursor events, at greater and greater distances from the eventual confluence of factors that would constitute the next disaster.

This is conceptually and intellectually demanding work, and requires systematic and extensive exercise of the imagination. The development of safety management systems seems to be

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civil aviation's vehicle for grappling with precisely this challenge. But this type of work is much easier to name than it is to organize, or to measure, or to master.

### The Fickle Public

The public is fickle about regulatory protections, displaying a split personality. If there *was* a disaster yesterday (e.g., a meltdown, an epidemic or a crash), the fault must obviously be the result of "regulatory failure." Or, if there *hasn't* been a disaster within recent memory, "regulation is suffocating the nation." The result? An oscillating, binary, all-or-nothing support for essential regulatory protections. Public fickleness echoes at the political level, and oversight bodies — which should be better anchored in reality — end up slapping regulators around, first one way (for being overbearing and intrusive) and then the other (for being ineffective in controlling risks).

My point is not to blame the public, but to identify an important job for safety professionals and regulators. Particularly with respect to these once-in-a-blue-moon but high-consequence events (like plane crashes or financial market collapses), the experts need to prevent public opinion from lurching from one ridiculous extreme to the other — from *no tolerance* for controls one day, to screaming "regulatory failure" the next.

Society needs a more rational, stable and sustainable middle-ground commitment to regulatory protections. The challenge for government and industry leaders is to figure out how, on a continuous basis and in the absence of catastrophe, they can stimulate the public imagination about what *could* go wrong, and extend their memories about what *has* gone wrong before. We need appropriate levels of vigilance, with sustained public and political

support, more durable in the face of the twists and turns of fate.

### Too Big to Fail?

It is an ugly dilemma for government when major institutions teeter on the brink of collapse. Either you let them fail, with potentially disastrous consequences for the markets; or you bail them out, committing billions of taxpayer dollars. How much better to consider the question *earlier*, long before failure becomes a looming prospect.

As financial regulators around the world set about designing their new regimes, perhaps they'd consider some deliberate steps backward, restoring a degree of industry segmentation, and reconnecting with the notion *small is beautiful*. No bank should be too big to fail, if errors of judgment lead it that way. Financial institutions should not be in so many different financial businesses that trouble in one area ripples through the whole system. We design ships with flood doors and flood compartments, so we can lose a few, if necessary, without sinking the whole ship. Over the last 15 years, the global financial system seems to have lost all its flood compartments.

New regulatory regimes might usefully embrace the principle that companies should never be allowed to grow so large or so dominant in the market that they are deemed too big to fail. Nor should they become so powerful that officials can no longer call them to account in the public interest, or take effective enforcement action against them, or put them out of business if necessary. Maybe *small is beautiful*, and we need to ensure a reasonable degree of segmentation in our vital industries.

### Beware of 'Low Salience'

Political scientists tell us that the policy-making process is different for

issues of high or low *salience*. "High salience" issues are commonplace, visible, frequently in the public and media spotlight. Obvious examples include abortion policy, education quality, local crime control. For these, the debates are public and frequent, and the policy process highly political.

Issues of "low salience" are not so much in the public mind. These concern risks that seldom materialize, and which are often complex and technical. Before the financial crisis unfolded, the public never debated or discussed the liquidity of the credit markets, or the risks associated with credit default swaps or complex derivatives.

The real danger with issues of low salience is that the regulators themselves may not understand them, consider them sufficiently or discuss them much. The more highly technical the issue, the more regulators depend on experts to assess risks. But the experts on emerging technologies generally work for the private sector, and are closely associated with those new technologies. As corporate employees, their primary obligations involve fiduciary responsibility to the shareholders, not broad protections for the public. And as champions of the new technologies and systems, these experts naturally emphasize their upside potential.

So, who should we trust to imagine the worst and to warn us about possibly disastrous effects or interactions? That has to be the regulators, because this task aligns poorly with industry's natural incentives. Hence the lesson: Regulators beware! When the issue is complex and technical, and out of the public view, it is exceedingly dangerous for regulators to rely on the advice and assurances they get from industry experts. The financial crisis has just shown us where that approach leads. ➔