By Tim Becker

# Anatomy of a Bust

## Universal lessons from the financial meltdown

Economists declared an end to the recession last year. Unfortunately, most people are not yet feeling the effects of economic recovery. Unemployment is stubbornly high, businesses are not investing, and consumers are not buying. Nevertheless, we seem to have averted a crisis.

The midterm election is behind us, providing a clearer sense of the political and regulatory landscape for the next two years. Business leaders are starting to look further into the future and think more strategically. However, they should keep one eye on the rearview mirror and invest time to learn the lessons of the recent financial crisis. These lessons apply to more than just bankers, economists, and regulators; rather, they have broad applicability to all businesses.

**Reduce or mitigate business complexity.** A key driver of the financial meltdown was complexity. Wall Street was awash in complicated derivatives and risk management tools based on mathematical models developed by whiz kids with Ph.D.s. Ironically, such tools do not take into account the risks associated with the complexity arising from their own use. At many companies, these tools were "black boxes"—objects whose inner workings managers and executives did not understand.

The Capitol Hill testimony of some executives from major financial institutions highlighted this ignorance of critical elements of their businesses. The reality is that you cannot manage what you do not understand. Overcomplexity not only results in mismanagement, it also can encourage—and provide excellent cover for—malfeasance, as the financial crisis abundantly revealed. The broad lesson: Reduce unnecessary complexity, or ensure that you understand, evaluate, and mitigate the risks of complexity.

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**Avoid excessive specialization and disintermediation.** Another driver of the financial meltdown was diffusion of responsibility, which was clearly demonstrated in the mortgage origination and servicing industries. Traditional vertical integration gave way to value chain disaggregation. Functions once concentrated in lending institutions were farmed out to other entities. New players, or links, in the value chain emerged—some acting as intermediaries or middlemen. Investment banks bought, sliced, diced, and repackaged mortgages into bonds that were sold to investors.

This fragmentation of functions among so many players fostered miscommunication and created a system opaque to all parties, including regulators. Such specialization also meant no single party had enough at stake. The result was a poorly functioning process that easily and quickly disintegrated as mortgage holders defaulted on loans. The lesson for business is to reevaluate processes and look for opportunities to reengineer. Ask yourself: Have your processes become fragmented? Are there too many handoffs? Are handoffs clean? Are there bottlenecks? Are communications effective?

**Evaluate and refine incentives.** The financial meltdown demonstrated the impact of incentives in business. In the case of the mortgage industry, the structure of bonus incentives fostered gross market distortions and sometimes out-and-out fraud, contributing to the financial crisis.

Examples abound. Appraisers were paid off by the banks, which quickly flipped mortgages to other buyers. Higher appraisals meant bigger mortgages and higher revenues for banks—but also inflated home values, creating a housing bubble. Another example is found in the overly generous bond ratings published by rating agencies. These agencies once were paid by the buyers of bonds. However, over time, their customers became the sellers instead of the buyers. The results were predictable: inflated bond grades. The lesson for businesspeople is to take a close look at the incentives you have created—sometimes implicitly—for suppliers, employees, customers, and other stakeholders. Will these incen-

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tives create the behavior and results you are seeking?

**Promote transparency.** A close reading of the financial crisis points to a lack of transparency exacerbating the situation. At many firms, a veil of secrecy was lowered around the profit-making machinery, and few people were privy to its inner workings. Sometimes even senior executives were left in the dark. At some firms, the finance powers largely were left unchecked and ran amok, often reckless in their assumption of risk and sometimes engaging in outright malfeasance. Less isolation and more transparency in these firms might have unmasked the mismanagement and misconduct before they reached critical proportions. The lesson for business is to avoid paranoia in protecting company information and to provide more internal transparency.

**Believe your indicators.** A common theme of market bubbles, as in the real estate or dot-com bubbles, is a wide belief in paradigm shift. A common refrain is that this time, things are different—the old rules no longer apply. However, the reality is that paradigm shifts are rare and usually occur over long periods. Business fundamentals eventually exert a strong, gravity-like pull on irrationally rising prices. Often, the age-old indicators of an overly unstable market are clear. In the case of the mortgage market, in many locales, the indicators were widely divergent from trend lines.

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For example, in San Francisco in 2007, less than 25 percent of the city's population earned enough to qualify for buying the market's median-priced home. In today's post-correction market, that figure has risen to 50 percent. In some markets, the cost to buy was 250 percent of the cost to rent. (Compare this to the historical average of 85 percent.) Such prices are self-evidently unsustainable. These are just two of many widely published indices that should have alerted the market to an imminent bust. However, industry professionals suspended belief in long-trusted indicators, rationalizing that market fundamentals had changed. Businesspeople must understand and monitor the key performance indicators in their markets and in businesses. Look for deviations from the normal range of values, and act accordingly.

**Invest in people.** As in many industries, financial services has heavily relied on technology to automate and improve its functions. However, technology is just a tool; it cannot replace the good judgment needed to guide businesses. People cannot be removed from the equation completely; in fact, the people who remain after automation are more important than ever. They must be highly trained and adept at managing a business model made more sophisticated by technology.

However, many financial services professionals did not internalize this lesson. Instead, they relied on technology (and supercharged bonus compensation) to drive their businesses. This resulted in serious managerial missteps and, in the worst cases, the collapse of several prominent firms. The takeaway here is to keep focused on the development of human resources while continuing to make smart investments in technology. There is no substitute for competence and good judgment.

**Build trust-based relationships.** A deficit of trust was perhaps the single greatest factor in the financial meltdown. Much has been written about business trust in the last few decades. Oddly, it seems that the more trust is discussed, the scarcer it becomes. Stark examples of breaches of trust abound across the mortgage industry's value chain, including inflated appraisals, predatory lending, "liar loans," and overly generous bond ratings. Remember that an untrustworthy business partner can cause serious harm. Business leaders need to screen business partners carefully and invest in relationships abundant with trust while expeditiously divesting trust-deficient partners.

Crises in the business world, as in the wider world, come with regular frequency. While the industry affected and the nature of the crisis tend to vary, the underlying causes and associated lessons learned often are quite similar.

In April 2010, another major crisis—the BP oil spill—struck the business world and eerily echoed many of the same themes of the financial meltdown: overcomplexity, diffusion of responsibility, failure to believe indicators, and lack of trust. The Gulf disaster was yet another reminder to business leaders that the fundamental tenets of business must be understood—and followed.

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