Eyes on the Wrong Prize: Leadership Lapses That Fueled Wall Street's Fall

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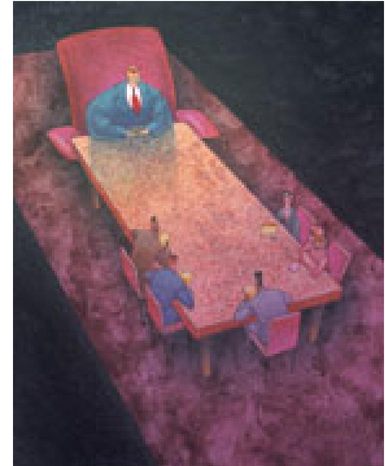

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AIG, Bear Stearns, Fannie Mae and Freddie Mac needed government bailouts or takeovers to survive. Lehman Brothers is in bankruptcy. Merrill Lynch has been sold. The shocking succession of corporate meltdowns signals a massive leadership failure across the financial services landscape, according to Wharton faculty. Executives at these troubled firms may have ignored or failed to see the level of risk their companies were taking on in a crusade to enhance results and their own compensation. When markets turned against them, their firms -- big as they were -- crumbled.

Wharton management professor Peter Cappelli says this type of lapse in leadership dates to the 1980s when companies began to focus on aligning executive incentives with shareholder interests. He believes an excessive focus on individual financial goals, at the expense of managing in the best interests of the company overall, is at the root of the leadership debacle that has rocked the financial services sector.

"We ought to start thinking about whether this idea is really working," says Cappelli. "It seems to work for the people in charge, but is it really working for the company? It's certainly not working in the broader society. The shareholders and the executives who have shares in the company are in trouble, but this is spilling over into the economy in a way that I haven't seen before."

Harsh Managers, Narrow Focus

Cappelli says too many managers simply choose not to lead. He says managers believe that if they hire smart people and provide huge financial incentives for individual results, management of the firm will take care of itself.

Surveys of incoming MBA students who had worked in finance, and particularly in investment banking, according to Cappelli, indicate that managers in these fields are particularly harsh and ineffective. These managers provide little feedback, expect long hours in the office even if they are not productive and destroy an employee's work-life balance. The long hours make up for management's lack of discipline and planning. "All the problems were smoothed over by bonus money, lots and lots of it, based on individual performance," Cappelli writes in a column published this week by *HR Executive*. "Taking risks to achieve one's individual targets, even if it puts others or the organization as a whole in danger, seems acceptable. Covering up failures becomes the norm."

Thomas Donaldson, Wharton professor of legal studies and business ethics, says top level managers too often focus narrowly on issues that concern their organizations and do not pay enough attention to what is going on across their industry. "These problems are so tightly connected to broader problems in the overall financial services and banking industries. Everybody in those industries needs to be better attuned to slowly percolating [crises] and ethical issues," he says.

From the outside, it was perhaps easy to see that home prices were inflated even though complex

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securitization made it difficult to determine the true value of assets. "Alarm bells should have gone off," Donaldson notes. "But in many major industries, problems grow slowly and come to be accepted by members of the industry, only to explode later." He points to the conflict inherent in allowing brokerage houses to provide research into equities they market as an earlier example of a problem waiting to happen.

Donaldson says companies continually underestimate what they have to lose by allowing their reputations to be tarnished through "corporate Watergates." Every year, companies lose more through damaged reputations than they do from regulatory fines or legal actions, he adds -- although some firms in recent years have become more aware of the threat.

"One thing you can say with confidence is that the next big ethical disaster to befall Corporation X is going to be one that will blindside most of the people on the board of directors and the top management, too," he predicts. "That's all the more reason for being more vigilant and for setting up processes, especially at the top levels of leadership, to allow people to talk about some of these things that are hard to talk about."

Change: A Leadership Challenge

In today's business climate, it often takes the board of directors to make a course correction when a company is on an illegal or irresponsible heading, according to Cappelli. But that happens rarely, he notes, and typically only if some of the board members are veterans of the period before executive compensation was tied to stock price. They are more likely to recognize and point out "that what's going on now is peculiar." But he's hopeful about the new generation of business leaders who entered the workforce over the past 10 years and are more oriented toward working in groups. They are not likely to let extreme individualistic behavior push entire markets into taking ever bigger risks just because their competitors are doing so. Cappelli attributes this mind-set to changes in the educational system initiated at the request of business, which needed more people who were able to attack complex problems in a team structure. "It's not so weird [now] to talk about a team-based, effort-and-reward system in which a group takes responsibility rather than just an individual."

Donaldson says regulatory efforts in the United Kingdom are now focusing on industry-wide cooperation that may prevent a rogue individual or company from doing something that could be ruinous for competitive markets, such as mortgage securitization. "The UK has a track record of having key people in industries create blueprints for themselves and then let the government participate. In [the U.S.], we have more of a tendency to want the government off our back and to resist any reform." He notes that the head of British Petroleum took the unprecedented step of joining with other leaders in the oil and gas industry to encourage government to take uniform steps to reduce climate change. "It keeps the playing field even so you don't have the virtuous paying more," Donaldson adds.

Following the demise of Enron and other scandals, the accounting industry began to take some initiative at reining in ethical problems. Many firms created an anonymous hotline for employees to report such matters. However, Donaldson notes, the problems that really trip up companies are so obvious they don't lend themselves to a tip line. For example, the entire accounting industry was at one time participating in ways to shelter income from taxes that either broke the law, or came close to it -- until regulators finally cracked down. "These are the kinds of things that people sitting around at a top management meeting have a queasy feeling in their stomach about, yet don't really want to talk about it," he says. "Usually a lot of money is being made."

Donaldson has helped companies develop a system in which a trusted senior executive is designated as a sounding board for employees who don't want to put their careers at risk with a public campaign, but are concerned about broad-based unethical behavior. Many firms have ombudsmen, but they are usually lower down in the corporate hierarchy. He suggests that companies should designate a senior manager to be open to these types of conversations in order to assess and protect against potentially damaging reputational risk.

U.S. businesses need to be aware of what a tribe in New Guinea called "mokita," or the truth that everybody knows but agrees not to speak about, Donaldson advises. "When it came to subprime and many of the other problems that have tripped up Fannie and Freddie and so many others, there was

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mokita."

Moral Hazard

Eric Orts, a Wharton professor of legal studies and business ethics, worries about the so-called "moral hazard" created when financial services companies get a government bailout to stave off widespread economic disaster. Such rescues may contribute to weak leadership, because "markets for efficient organizations work only when they are allowed to correct and punish mistakes and mismanagement. ... Some of the current examples of very large government bailouts are setting bad precedents for the future." He concedes some bailouts may be necessary to prevent a broad collapse of the financial system, but the need to take such extreme measures is a clear indication that a regulatory overhaul is necessary to reduce the long-term economic risk to taxpayers.

Donaldson suggests better regulation is only one solution. "Unfortunately, regulation typically lags behind awareness in an industry," he says, predicting that the unregulated hedge fund industry may pose the next big challenge to the economic system. "We're maybe one or two big hedge fund failures away from Congress stepping in with regulations." However, the Sarbanes-Oxley legislation passed in the wake of massive accounting scandals has not solved those problems entirely and has introduced new challenges. "The solutions lie with the hedge fund industry policing its own house." How would that happen? "It means asking the questions people in polite conversation don't want to ask," says Donaldson.

The combined public and private missions of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corp. may have contributed to special leadership problems at those companies. "A quasi-public private organization, such as Fannie Mae or Freddie Mac, has difficulties in terms of playing a dual role [of] enhancing the ability of private individuals to gain mortgage financing to purchase their own homes ... and maximizing shareholder value in a highly competitive environment," says Orts.

Meanwhile, pressure within the mortgage industry intensified the disconnect between the dual roles within both Fannie and Freddie. "Mortgage securitization seems to have been allowed to spiral out of control with insufficient regulatory oversight. Pressure to increase profits at Fannie Mae and Freddie Mac led to excessive financial risk-taking rather than prudent banking." In retrospect, he adds, regulatory efforts to encourage competition between Fannie Mae and Freddie Mac were misguided because they intensified the pressure on entities that were not completely free-market vehicles. Leaders either did not understand or were unable to balance the goals of a "public-private hybrid" Orts notes. "It might be more sensible to have a clear division between 'public' and 'private' organizations in order for them to focus on a clear mission."

Donaldson points out that Fannie Mae and Freddie Mac spent more than $150 million on lobbyists over the past decade, illustrating another leadership problem stemming from the organizations' structures. "That's wholly inappropriate for a government agency and yet, given the way the business model was set up, lobbying had to be an attractive option for the leaders -- though perhaps not to that extent," he says.

Gary Gordon, who follows Fannie Mae for Portales Partners, an independent equity research firm in New York, says the leadership failures at Fannie and Freddie were aggravated by the recent housing price bubble that has led to problems across the financial services sector. While asset bubbles are common, from tulips to Internet stocks, the housing bubble was even more difficult to prick because the price inflation benefited so many Americans across the income spectrum. "I'm not sure you can come up with a system that could fix it," he says. "You would have to create a system where some human being would blow the whistle as everyone else is benefiting."

Moshe Orenbuch, a Credit Suisse analyst who follows the mortgage industry, says Fannie and Freddie came under the same pressures that led private mortgage firms and companies in other industries to restate income related to derivatives. Fannie and Freddie continued to write loans after the credit markets seized up in 2007 in order to fulfill their public mission, leaving them with a greater share of the market and more problem loans. "If you take market share without tightening criteria, you effectively loosen," notes Orenbuch.

In recent years, regulators did raise questions about management at the government-sponsored housing

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lenders. In 2006, the Office of Federal Housing Enterprise Oversight (OFHEO), which monitors the financial health of Fannie Mae and Freddie Mac, released a report describing an arrogant and unethical culture at Fannie Mae where employees manipulated earnings to generate higher bonuses for executives between 1998 and 2004. "Our examination found an environment where the ends justified the means. Senior management manipulated accounting; reaped maximum, undeserved bonuses; and prevented the rest of the world from knowing. They co-opted their internal auditors. They stonewalled OFHEO," said James Lockhart, the director of OFHEO when the report was released.

Companies can get into dire straits when they ignore early signals of problems like those at Fannie Mae and Freddie Mac, says Robert Mittelstaedt, a former Wharton dean who now leads the W. P. Carey School of Business at Arizona State University. "These warnings kept popping up. At some point in time there had to be somebody somewhere in these organizations that said, 'This just doesn't feel right.' It's a common mistake."

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