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Ben W. Heineman Jr. - Ben Heineman Jr. has held top positions in government, law and business. He is the author of *High Performance with High Integrity* (Harvard Business Press, 2008).

FCIC: The Private Sector Failed

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By Ben W. Heineman Jr.

After the Congressionally appointed Financial Crisis Inquiry Commission issued its report last week, there was a virtually unanimous, critical reaction.

The report said little new. Its analysis was undermined by sharp partisan division because the six Democratic members differed with the four Republicans about the role of regulation. And its impact would be limited because it appeared after Congress enacted major financial services reform (Dodd-Frank).

But these assessments ignored a fundamental agreement among nine of the 10 members -- a source of the report's continuing importance. The bipartisan commissioners emphatically concluded that one of the primary causes of the meltdown was massive failure of private sector decision-making, especially in major financial institutions.

This consensus highlights an enduring question even in a new era of increased regulation. Given the nearly catastrophic mistakes of many major financial institutions, how can they govern themselves in the future to achieve necessary safety and soundness, to balance properly economic innovation and risk management -- to avoid the next self-induced disaster? But the Report is not very acute or cogent or comprehensive on this question of the organizational, motivational, accountability,

ethical and cultural failures of the major institutions. Such a sophisticated understanding of internal corporate failures is necessary to devising effective corporate change in the future.

The Commission's Democratic majority describes in narrative detail the serial failure of homeowners, mortgage originators, mortgage brokers, speculators -- then, ultimately and most consequentially, the failure of major financial institutions which created toxic mortgage backed securities and unsecured credit default insurance. These majors failed to see warning signs of a housing market bubble and ignored risk by creating too many unsound assets and assuming too much leverage with too little liquidity. They, not the government, drove us to edge of another Great Depression. The conclusion about massive private sector failure is summed up in a quote from JP Morgan's CEO Jamie Dimon who, when reflecting on the causes of the crisis, told the Commission: "I blame the management teams 100% and no one else."

This conclusion about the signal failure of many of our nation's major financial institutions is also highlighted by three Republican members in their separate statement (Bill Thomas, former chairman of the House Ways and Means Committee; Douglas Holtz-Eakin, former head of the Congressional Budget Office and Keith Hennessey, former economic advisor to President George W. Bush). In assessing the "essential causes" of the crisis, they note a number of private sector failures along the chain from origination to securitization, including the following:

> *An essential cause of the financial and economic crisis was appallingly bad risk management by the leaders of some of the largest financial institutions in the United States and Europe. Each firm that the Commission examined failed in part because its leaders poorly managed risk.*

And they, too, cite the toxic combination in major institutions of overly concentrated assets in one industry (housing); too much leverage; too little liquidity; and poor risk management systems.

The bipartisan consensus of nine of 10 Commission members -- after using its subpoena power, reviewing testimony of 700 witness, holding 19 days of public hearing and reviewing millions of documents -- puts an important exclamation point on this critical cause. This is so because of the welter of prior views -- you will get a list 27 titles (!) if you search Google for "Books on the Financial Crisis."

Whatever one's views on the failures of Federal Reserve, the ineffectiveness of other regulators, the poor performance of the credit rating agencies, the mindless cheerleading of business media and certain short-term shareholders or the promotion of

affordable housing as national policy, no one made the boards and business leaders of the major private institutions -- Merrill Lynch, Citigroup, Bear Stearns, Lehman Brothers, AIG, Goldman Sachs, Morgan Stanley, Bank of America, Washington Mutual, Countrywide et al -- take a self-destructive course on the most fundamental decision businesses make: how to allocate capital and under what conditions. Why didn't leaders ask, critically and skeptically, basic -- not esoteric -- questions about exposure to one sector, degree of downside risk, amount of leverage and adequacy of liquidity?

Whatever one's views on the effectiveness of the major provisions of Dodd-Frank, among other things, to assess systemic risk in the financial system, increase capital and liquidity requirements, protect taxpayers from major institutional failure, require more transparency on complex products and give shareholders an advisory voice on executive pay -- especially after the numerous and voluminous regulations to implement these provisions are written---a basic reality remains.

The fundamental capital allocation, risk management and integrity promoting decisions which will dictate whether a firm succumbs to a financial crisis are taken by its board of directors and its business leaders. Unfortunately, the Financial Crisis Inquiry Commission did not go beyond its broad agreement on major institutional failure to analyze cogently and coherently why these major corporations failed, in part because of its narrative style (all 400 plus pages of it).

- It did not explain how the various levels of checks and balances inside corporations failed to work: operational leadership, the risk function, the finance function, the audits function, the legal function and top leadership and the board of directors. Understanding the dynamics of private firms is essential to understanding the ultimate private sector failure.

- It did not provide a coherent assessment of whether the problems, at various levels, were due to mistake, negligence, recklessness or intentional acts.

- It did not seek to untangle the dominant characteristics of key decision-makers and corporate culture which require future attention: hubris, competitiveness, greed, lack of understanding and training, short-termism or misperception of corporate purpose. Greed is an important part of the story, but hardly the whole story in highly complex organizations.

- It did not, therefore, accomplish its stated goal of explaining the causes of this financial sector failure -- for all its extraordinary detail on the development and failure of financial instruments -- so that private sector lessons can be learned.

To be sure, there were have been calls for a wide variety of private sector changes

since the 2008: elevating the stature and pay of the risk function, better education and training of business leaders on risk management, greater internal transparency on total firm exposure to certain risks, improved risk processes at CEO and board level, restructured executive compensation. (For my own attempt, see the policy brief, Restoring Trust in Corporate Governance: Six Essential Tasks for Boards of Directors and Business Leaders.) And, many financial institutions have made changes in systems and processes, including executive compensation, although not enough has been written about whether these are paper changes or real changes in culture.

But, because of its potential stature, because, in fact, there was agreement among nine of 10 members and because the issue remains critical even after Dodd-Frank, the Commission could have had a greater future impact on this vital subject had its analysis been deeper and more acute.

And this issue of balanced and disciplined private sector decision-making remains significant because, despite the swinging of the regulatory pendulum, it will always be difficult for regulators to keep up with the creativity and dynamism of the private sector due to lack of knowledge and to the difficulty of securing public sector experts at a fraction of private sector compensation. (As Lord Turner, head of the UK's Financial Services Authority said, the "poachers are better paid then the game keepers.")

The initial reaction to the Financial Crisis Commission did not, in my view, stress enough its solid consensus on massive private sector failures as a central (in my view the "primary") cause of the financial and economic melt-down. But the report itself did not, unfortunately, delve deeply enough into why this happened -- from operating leaders to risk, finance, audit and legal functions to CEOs and boards -- in some of the largest and most important corporations in America.

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