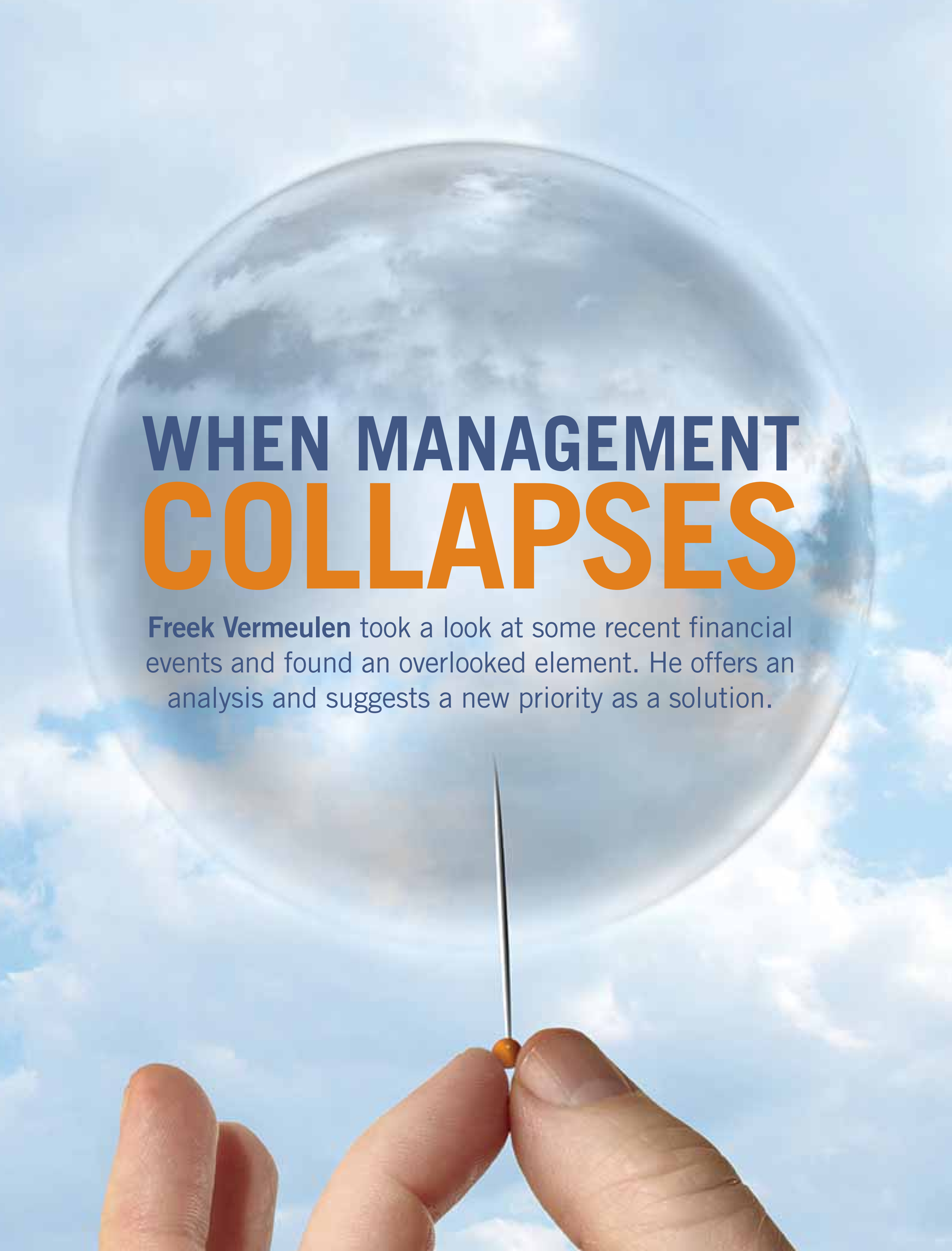
WHEN MANAGEMENT COLLAPSES

Freek Vermeulen took a look at some recent financial events and found an overlooked element. He offers an analysis and suggests a new priority as a solution.



When you compare the 2008 banking crisis with the Enron debacle, with Ahold's demise or even with the Union Carbide disaster in Bhopal in 1984, some surprisingly clear parallels emerge. Various explanations have been offered for each of these crises, ranging from top management greed and failing watchdogs to insufficient government regulation and inappropriate accounting and governance structures. Yet, there is one common cause underlying all these symptoms and triggers, and that is the structural failure of management. How did it happen? There were several key factors:

Specialization within and across organizations
One central element in each of these disasters, including the banking crisis, is the degree of division of labour and specialization within and across organizations. In the case of investment banks, financial engineers drew up increasingly complex financial instruments that, among other factors, incorporated assets based on the American housing market. Yet, the financial engineers didn't quite understand the situation in the housing market; the people in divisions and banks participating in the instruments didn't quite understand the financial constructions or the American housing market; and all the way to the level of departments, groups, divisions and whole corporations, top managers had no clue what they were exposed to and to what degree.

Similarly, Enron managers did not quite understand what its energy traders were up to; Ahold's executives had long lost track of the dealings of its various subsidiaries scattered all over the world; and the managers at Union Carbide's head office had little knowledge of the chemical plant in faraway Bhopal. In all these cases, the organization, both within and across participating corporations, had outgrown any individual's comprehension and surpassed the capacity of the traditional control systems in place.

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The myopia of success Another crucial role was played by the myopia of success. Initially, the approach by the companies involved was limited and careful, while there often were countervailing voices that expressed doubts and hesitation; there certainly is evidence of all of this in the case of Enron, Ahold and Union Carbide. Yet, when financial returns began to be realized, as in the case of the banks, the usage of the complex instruments increased, sometimes dramatically, and they became bolder and more far-reaching. Iconoclasts' countervailing voices ceased to be raised or were dismissed. For example, in Ahold and Enron, the financial success of the firms' approaches suppressed all hesitation towards their business strategies.

Social pressure This happens when "do the wrong thing" becomes the way of the day. It actually became improper *not* to follow the approach that brought so much success to many. In other words, to be good became bad. In the case of investment banks, other banks and financial institutions that did not participate to the same extent received criticism for being too conservative and old-fashioned. Investors, analysts and other stakeholders joined in the criticism, and watchdogs and other regulatory institutions came under increasing pressure to get out of the way and not hamper innovation and progress.

Similarly, in the 1990s, Enron was hailed as the modern way of doing business, while analysts (whose investment banks were greatly profiting from Enron's success) recommended the company stock as a "buy" till days before its fall. Similarly, Ahold's CEO, Cees van der Hoeven, continued to receive awards while the company had already started its freefall. All of these organizations' courses of action had turned into an irreversible trend supported by the various parties and stakeholders in its business environment.

The greed factor All of the organizations and individuals involved in the current banking crisis seemed to have let short-term financial gain prevail over common sense and good stewardship. But in all these cases, greed was not restricted to the few top managers who ended up in jail or covered in tar and feathers. Ahold's shareholders initially profited as much as its executives. Investors, politicians and customers shared in equal measure from the early-day benefits of Enron; likewise in the investment bank situation. Even the Church of England made big bucks on the financial practices they so heavily criticized in the days following the collapse of the system. →

→ The greed factor, however, does not stand apart; it is built into the structure of the whole corporate system. Traders are incentivized to concentrate on making money, top managers are supposed to cater to the financial needs of shareholders, customers are expected to choose the best deal in town without having to worry where and how the gains were created. However, none of these parties actually see what lies behind the financial benefits or where they come from. The traders just see the numbers, the investors only see their dividends and earnings per share and the Church of England simply chooses the best deal – little did the archbishops know it amounted to selling short. The high degree of specialization and division of labour both within and between the financial institutions may have revealed the result of the process but showed no sign of how these profits were actually produced.

What to do

In combination, all these elements create a system that escalates risky short-term strategies until they culminate in an irreversible course of action and it becomes illegitimate to do anything else. As in a pyramid investment scheme, everybody is interlocked and benefits till the whole structure collapses, sometimes with deadly consequences. The 2008 banking crisis is only unique in the sense that it did not concern one organization but a whole global sector of interlocked firms, due to the high degree of similarity between the various corporations, their business strategies and the unprecedented extent of the financial linkages between them.

All these things point to one underlying cause: the structural failure of management. The management systems used to govern these organizations were unable to control the inevitable progress towards destruction. Whether analysing Enron, Ahold, Union Carbide or banks in 2008, the striking commonality is the sheer inevitability of failure. More rules and regulations and more quantitative and financial controls are unlikely to solve the problem or prevent similar things from happening in the future. All organizations and people involved in these cases, ranging from top managers to traders and customers, were governed and incentivized by means of quantitative and financial controls. However, today's businesses are too complex to be controlled by rules and financial systems alone.

Instead, organizations will need to tap into the fundamental human inclination to belong to a community (such as an organization) and the desire to do things for the benefit of that community rather than focus on one's individual, narrow interests. These are alien concepts in the City today, where incentives are geared towards optimizing individual short-term performance. At the same time, company loyalty and a sense of community are all but destroyed by those financial incentives and culture. Yet, when such human desires to contribute to a community are artificially suppressed through narrow financial incentive schemes, weird things can happen.

And the 2008 banking crisis certainly was one weird thing. Looking back – even from this near a term – shows that deep down the calamities were predominantly caused by the systematic failure of corporate management. ■

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