THE ROLE OF THE MANAGEMENT OF FINANCIAL INSTITUTIONS IN REDUCING THE EFFECTS OF THE ECONOMIC CRISIS

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ABSTRACT: *The financial crisis profoundly affected the USA economy, highlighting many problems related to the five management systems of financial institutions. But the most important aspect that influenced the dramatic evolution of these institutions in the last few years was the inadequate management manifested in the lack of coordination and equilibrium between the five systems. Most of the problems highlighted in the financial crisis can be pursued at the deficiencies related to the five leadership systems inside each major public or private actor from the financial markets: incentive measures, control and information technology, book-keeping, human capital, culture.*

KEY WORDS: *leadership systems; economic crisis; subprime crisis.*

JEL CLASSIFICATION: *G01.*

1. INTRODUCTION

The present-day model of the unitive governance in the United States of America and abroad is abusively damaged and all takes place since many years. The financial crisis revealed the extent to which these problems came. Neither managers, nor the board of directors foresaw or hindered the massive destruction of value which affected companies such as AIG, Bear Steams, Fannie Mae, General Motors or General Electric. Nor external private monitors like the media, stocks and shares analysts, credit analysts and rating agencies warned enough against the danger that would appear for the companies. Of course, public agencies like the Federal Reserve, FDIC or Securities & Exchange Commission did too little to preclude the financial conflagration.

To approach the fact that systemic failures of the unitive governance caused the economic crisis is a very controversial statement. Some assert that the lack of

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adequate regulations combined with an excessive corporate avidity was enough to determine these problems. In the case in which regulations had been more severe, or managers less covetous, the crisis would have been avoided.

So, what went wrong? What should have managers done to protect their companies and the whole society? What should have directors done? What would have resulted from using compulsory regulations? What should have investors done?

Every aspect of the system must be changed, from the book-keeping governance system to the roles and structures of the company members. The most important and difficult changes are the ones requested to the company managers, because they abide a disproportionate part of the responsibility for what happened and what is unrolling. What is recently going on happened before, but not at the same scale.

Managers made wrong and very dangerous decisions, investors and consumers involved in risky businesses and the settlement authorities were inefficient. Greed played a tremendous role, but a bigger problem was incompetence.

2. THE ECONOMIC CRISIS

The whole society is in the middle of a difficult period of meditation and adjustment. The greatest attention seems to be paid to settlement structural changes and the norms that affect unitive governance and to financial markets. Changes that will result will do too little to reduce the probability or the proportion of the next panic bubble - panic cycles. Roots of these cycles are very deep and it is little probable for them to be approached through the public order or other external means.

Most of the problems highlighted in the financial crisis can be pursued at the deficiencies related to the five leadership systems inside each major public or private actor from the financial markets (Sahlman, 2009):

- *Incentive measures* - the manner in which risk and reward are shared, how people respond to this crisis if they rely on their own interest from the money prospect.
- *Control and information technology* - how behavioural limits are distributed, how information is perceived and shared, the way in which risk and reward are measured and the manner in which these estimations affect tactics and strategy.
- *Book-keeping* - the manner in which managers choose book-keeping politics, the way in which managers measure economic damages and profits.
- *Human capital* - the process through which persons with certain specific features (skill level, experience, character and attitude) are drawn and administrated or encouraged to leave the organization.
- *Culture* - values that guide group or individual decisions.

Patient, successful companies have remarkable proficiency and high integrity employees, sensitive book-keeping politics that reflect the economic reality, data of great interest over the measurement of the risk level and of the management system, and sensitive incentives that balance risk and reward between staff and leadership members. These companies have a culture in doing the right thing to help protect all electoral circumscriptions even if these do not transform in reward. Companies prone to risk have a combination between all the ones mentioned before, but in the opposite sense.

In the last twenty years, there were remarkable examples of problems caused in the firms whose managers did not succeed in administrating their merchants efficiently. Examples include Société Générale and Jérôme Kerviel (the loss of $7.2 billion), Baring Securities and Nick Lesson ($ 1.3 billion) and Sumitomo and Yasuo Hamanaka ($ 2.6 billion).

In the study of the financial crisis, this clearly shows that many organizations suffered from a lethal power mix, sometimes wrongly manifested, inadequate control of risk administration systems, deceivable book-keepings and a low human capital quality concerning integrity and/or competence, all covered in a culture that did not succeed in offering a quality management behaviour guide. This estimation refers to the financial service firms such as Countywide, AIG and Bear Steams, but it also applies to other fields like regulatory agencies, politicians, rating agencies and, why not, individual consumers.

Taking as an example, Investment Bank UBS, specialized in administration of the wealthy people's estates, reported a shocking loss of $18.7 million related to *subprime* mortgages in 2007. This was followed by a $19 billion loss in the first quarter. In April, 2008, the company put forward a special report to the shareholders, who diagnosed the causes of these damages. Actually, this report revealed fundamental failures proceeded from incentives, control systems, book-keeping decisions and decisions made by employees.

In the incentives area, UBS discovered a few major effects, like (Sahlman, 2009):

- employees received high incentives in order to engage in the so-called currency transactions with interest rate differential in which they used the capital of UBS to invest in mortgage debentures .UBS paid a very low cost of capital and did not change the rate based on the risk level assets bought;
- the structure of duties at UBS stipulated special incentives to buy more risky securities. For example, merchants received a three to four times higher tax when they bought CDOs (collateralized debt obligations) than when they bought safer ones;
- UBS supplied "insufficient incentives to protect the UBS Franchise for a long period". They offered a lot of cash compensations to individuals who engaged in trading operations, but who endangered the company an increased risk. Also, they rewarded bonuses which "were measured against gross returns after personnel expenses without taking into consideration the quality or the viability of these incomes".

Generally, these problems related to incentives are classic: the supply of "strong" incentives to engage in risky fields; lack of incentives to protect the company and measurement of insignificant events in an adequate period. These mistakes probably wouldn't have been so expensive if UBS had had in exchange risk countermeasures or a general manager with dominant responsibility and authority.

UBS centred on the “mea culpa” adage, and management details diminished in these segments.

UBS presented a report in which it highlighted 75 different areas that suffered and moreover, brought damages at the company level concerning making certain decisions and doing wrong processes.

At the leadership level, administration management worked out a growth strategy centred more on market share incomes and profit growth than on reducing the risk level. In every own business there were errors in the risk measurement, weak or absent compulsions regarding position dimensions, inadequate and prone to loss book-keeping. Persons responsible for making decisions either had not the competence to understand and change the risk rate, or had not the necessary incentives or authority to expel them.

Besides, financial leadership’s decisions were not in the same consonance with the risk of assets decisions, and in some cases these even exacerbated the general risk level of UBS. For example, the company owned mortgage secured assets that supplied liquidities in case of assets diminution - these values eventually diminished very much and cash assets disappeared.

A common problem, that can illustrate the ones mentioned above , was that all market players relied abusively on the rating put forward by firms like Moody’s and Standard & Poor’s. Afterwards, there was presented a report of UBS in which market risk control unity was described.

MRC relied on the AAA type rating of several *subprime* positions although CDO were built from RMBS small rated tranches that meant a residential mortgage guaranteed titles. This thing seems to have been common for the whole industry. There was no clue that MRC tried to revise the quality of extant portfolios like questions raised in connection with the *subprime* sector. A comprehensive analysis of portfolios would have shown that positions would not have been necessarily made in accordance with their rating. From the forecast retrospective ratings assigned by external rating agencies to real mortgage estates were wrong. These agencies were for a long time in the corporate bonds issuer representation risk assessment activity (Sahlman, 2009).

Many technical aspects referring to the way in which risks were estimated and ratings assigned existed, but the main causes were implicit assumptions through which prices for dwelling places would have been rather probable to decay and the coefficient of correlation between prices of dwelling places from different regions to lower. For example, if prices lowered for Miami property acquisition, this would not mean that these would lower in Phoenix too (afterwards, both regions being seriously affected by the financial crisis).

A problem of the rating agencies was that they adopted structure incentives that led to the creation of possible conflicts. Specifically, these agencies were paid by issuers of real estates and not by buyers or regulatory authorities. For a variety of reasons, there were only two main rating agencies that intensely competed for the same clients. This is a system from which the most precise estimations do not result, but for a change ratings meant to disadvantage clients in order to increase the market and profit share.

The safety assessment assets business was extraordinarily profitable. Between 1997 and 2006, to illustrate, Moody's incomes from this source increased nine times, representing the biggest income source for the company. Price of stocks grew from $15 in 2001 to more than $70 in 2006.

All the employees who worked for S&P and Moody's had no doubt that they were not meeting the requirements demanded by the company's managers in order to perform the job. Companies had internal politics meant to ensure that ratings were not influenced by the desire to receive a business or market share. Moreover, no one realized that they were doing dangerous conjunctures about the possible prices of dwellings. Profits, stock and compensation prices were all exorbitant and none of them foresaw the end of the financial boom.

Many of the problems concerning the estate industry financial crisis are assigned to the political and economic system in the global economy. All type politicians are willing to promote ownership and increase of prices. Industry is full of fundamental challenges regarding the connection between incentives, control systems, book-keeping and human capital.

Taking into consideration the two main financial institutions in the USA market - Fannie Mae and Freddie Mac, both private companies but sponsored and granted by government, they were privileged by the congress with a mission to "supply cash, stability and accessibility for estate and mortgage markets from USA". They fulfilled this objective through the acquisition or guarantee of mortgage property values from the secondary markets. Their capital costs are low because they have a guarantee on the behalf of the government.

These are organizations that from the economic viewpoint are very big and that had, at the end of 2006, a fortune or guarantee right of over $500 billion. These rights were in the form of mortgage credits representing almost half of the USA market. A possible obvious problem is that both companies have a clear objective to maximize the estate of the shareholders. General Managers are paid alike private market salaries and own a substantial quotation of the shares. In case in which great damages appear, the American Government is responsible, but if these companies present a high profitability level, managers will be awarded in the same measure.

A second problem appeared for Fannie Mae and Freddie Mac refers to the objective declared in order to sustain the ownership in disadvantaged groups and/or in regions subdued to economic turnovers. Every year, both organizations are obliged to report to the Government progresses of these dimensions.

Politicians, having an important role in the decision power, reproved many times the leadership of the two main companies for being much more aggressive in sustaining the social objective to increase the power of property over buildings, even if these do not have purchasing power. Congressman Barney Frank encountered both companies to roll the dice in the name of dwellings acceptable for their price (Wall Street Journal, 2008).

One of the supplementary concerns, valid for many governmental agencies, is that Government does not levy an insurance premium for the implicit guarantee of the GSE - uttered debts that vary once with the risk of vested interests decisions.

Moreover, the levied rate is not a market rate after all, but it is a political negotiation between settlement agencies and companies.

Putting these three systems together, a volatile mix creates. Government guarantees a set of activities but does not levy costs for the right to insurance and allows companies to be extremely plunged into debts. Politicians centre on risky credits, ironically increasing the economic cost of the guarantee. Private managers come to bet on possible personal payments and on governmental guarantees. It was not surprising the fact that these companies got in a doubtful situation when real estates started to decline, because they were set up effectively to thrive on these markets and not to go on the wane.

Similar evolutions always existed on the markets on which governments bear a part or all of the risks of certain private activities. Some would say that these savings and credit crises of the 80's reflected a toxic mix in increasing governmental deposit guarantees, in industry deregulation, in companies' ownership and in the dynamic increase of the risk of vested interests decisions, without a proportional growth of insurance premiums requested by government.

Although it looks like the S&L crisis, assessed by government to almost $500 billion, appeared in a relatively short period of time, the reality was that this had a good precedent several years before, when inadequate incentives were put into practice. USA's real budgetary deficit before the crisis period was bigger than the deficit that followed in the crisis period, because of adopting inadequate costs for the insurance of deposits.

A final aspect in the characterization of the financial crisis is held by the level of competitiveness in which companies operate. To illustrate this thing, when managers have the possibility to increase incomes and to gain market share in competitive sectors, they become more aggressive in order to establish prices and innovation.

In any company, the only way to get a market share or to remain at odds regarding the company's profit is to offer a product based on the preferences of consumers or employees. Unfortunately, in mortgage businesses, the only way to maintain market strength was to reduce the standards for granting a loan and/or to introduce new price-pay systems such as reduced fees for advance. In a business that is situated in a very competitive industry, the marginal price is often established by the lowest common denominator - the company with a more reduced quality, the most honest and aggressive consumers, the weakest control system and the most aggressive book-keeping system.

One of the American financial companies through which this system was exposed is Countrywide Financial. It is one of the greatest mortgage companies from USA, and their management strategy was a special one. Named "the matching strategy" or "the supermarket strategy", through which it compelled the company to be engaged "in offer of no product and/or underwriting manager available from at least one "competitor".

This politics lead to dramatic, and ultimately fatal, rise of *subprime* loans, including ARM payment loans. The latter, representing over 20% of the company's loans was particularly risky, because debtors many times had small tax credits, high loan - value ratio and high profitability of non-payment. Eventually, Countrywide encountered severe financial difficulties and was bought by America's Bank. Therefore, America's Bank was intoxicated too, after it bought Countrywide, by its problems.

In autumn 2008, the possible decline of AIG triggered a wide range of governmental responses that changed forever the Global Financial landscape. At mid 2007 AIG had a market capitalization worth of $200 billion and until October 2008, the total worth fell under $10 billion, and government invested almost $100 billion in saving the company.

A clear problem at AIG was the fact that a small group of employees, fewer than 400, of the Financial Products Group (FPG) wrote a large amount of insurances, over $500 billion, for corporate bonds and real estates, including the ones for mortgage securities. Because AIG offered impeccable credits and because few people thought that there was a risk in any of these titles, FPG was capable to issue insurances without any guarantee requested in advance. Thus, any profit represented a high, even infinite, capital yield.

3. CONCLUSION

Management enables the appropriate coordination of all elements or systems of the components that ensure proper functioning of an organization or institution. This is why adequate management of incentives, information technology, book-keeping, human capital and culture would have created a balance between all these and would have offered the opportunity to prevent financial institutions from collapse and, implicitly, to avoid, or at least, to diminish the financial crisis and its effects felt until today in economy, at its global level.

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