Massive Strategic Failures in the Financial Services Industry

Joseph Gilbert
University of Nevada Las Vegas

Strategic management theory concentrates mostly on business success. However, much can be learned from studying business failure as well. During the Great Recession, an unusually large number of major financial institutions failed. Many books and government reports document the details of these failures and present various causal analyses. Much remains to be learned, and academic studies using the tools of strategy and other business disciplines should lead to increased understanding of these failures. If we could attain a better understanding of the failures, steps might be taken by executives and regulators to reduce the risk of their repetition.

Most strategic management textbooks contain a chapter on missions, goals and values. These chapters typically do not include avoidance of bankruptcy or sudden unplanned sale of the company as corporate goals. A strategy that results in such an event is clearly a failed strategy. Strategic management textbooks usually make it clear that success in strategy requires both selection of a strategy and execution of the strategy once selected (David 2013; Hill & Jones 2013; Hitt, Ireland & Hoskisson 2013). If bankruptcy or sudden unplanned sale of a company represents the ultimate strategic failure, then it makes sense to study cases of such failure in order to learn as much as possible about its causes and conditions.

During the financial crisis that began in 2007 a number of very large companies in the financial services industries suffered such strategic failure. A non-comprehensive sampling includes Countrywide Financial, Ameriquest Mortgage, New Century Mortgage, Bear Stearns, Lehman Brothers, Merrill Lynch, Wachovia Bank, Washington Mutual Bank, Fannie Mae (Federal National Mortgage Association) and Freddie Mac (Federal Home Loan Mortgage Corporation). All of these companies operated in what can broadly be called the financial services industry. The occurrence of such a large number of failures of major competitors in one industry in a brief period of time is highly unusual. Because these failures are both recent and well-documented, and because they resulted in such widespread financial harm to customers, investors, employees and the economy as a whole, it is important to learn as much as we can from them.

In the writings on these companies and this period, there has been no shortage of explanations. Some have blamed the devil (at least metaphorically) in books with titles like *The Devil's Derivatives* (Dunbar 2011); *A Demon of our Own Design* (Bookstaber 2007); and *All the Devils Are Here* (McLean & Nocera 2010). Others have blamed greed, including books titled *The Age of Greed* (Madrick 2011) and *Fool's Gold* (Tett 2009), or the size of companies as in *Too Big to Fail* (Sorkin 2009) and *Crash of the Titans* (Farrell 2010). Still others have blamed basic failures in judgment, with titles such as *A Colossal Failure of Common Sense* (McDonald 2009); *Reckless Endangerment* (Morgensen & Rosner 2012); and *In Fed We Trust* (Wessel 2009). All of these and more are books published during or soon after the Great Recession. In addition to a significant number of books covering events of the period, there have been several well-researched and well documented government investigations resulting in extensive reports available to the public. The most widely known of these is the *Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* (Financial Crisis Inquiry Commission 2011).

These books and reports describe failures of strategic choice and of strategic execution. Selection of a strategy is typically covered under two rubrics: one is the selection of a business strategy and the other the selection of a corporate strategy. According to models first developed by Michael Porter over thirty years ago and still widely taught in current textbooks, there are three distinct strategies for competing in a single business or industry. Cost leadership involves concentrating on keeping costs low in order to compete on price and still maintain profits. Differentiation involves creating a perceived difference in a company's product or service that generates a premium price from customers. Focus involves concentrating on one segment of a larger market, and competing on the basis of expertise in that segment. Corporate strategy deals with the question of what businesses a company should be in and, by implication, what businesses it should avoid.

Execution of a strategy, once it has been selected, constitutes a second major topic in the theory of strategic management. This topic includes such issues as corporate structure (lines of reporting and decision-making authority), control and reward systems within the organization, and resource allocation decisions. Some of the theories in this area originate in the academic discipline of organizational theory, but they have direct relevance to the area of strategy execution. Functional strategy involves the role of each major business function (marketing, finance, human resources, etc.) in executing the business and corporate levels of strategy.

Companies that originated mortgages such as Ameriquest and Countrywide chose a business level strategy of cost leadership. They chose to operate in only one rather narrow segment of the home mortgage business. They advertised to their prospective customers based on price, by featuring adjustable rate mortgages with low initial rates. They also kept their costs down by skimping on underwriting individual mortgages, often allowing low or no documentation of borrower information. They became very adept at marketing individual mortgages and at processing applications quickly and funding loans (Muolo and Padilla 2008). Unlike commercial banks, these non-bank mortgage lenders did not take deposits from customers. Their source of funds was large loans from banks, known as warehouse loans. It is interesting to note that two of the largest providers of warehouse loans to Ameriquest in the early 2000s were Bear Stearns and Lehman Brothers, both of which ceased to exist as independent companies in 2008 (Muolo and Padilla 2008). Companies in this group originated home mortgage loans, funded them with proceeds borrowed from other banks, then promptly sold off the loans to other banks.

Ameriquest, Countrywide Financial, and other non-bank mortgage lenders received their revenue by selling the loans they originated to securitizers—companies that packaged individual loans into securities and sold these securities to investors. Thus the originators of the loans were paid in full shortly after the loan was funded, and did not appear to have any financial interest in how well the loan subsequently performed. This strategy or business model involved two kinds or marketing: the first to potential borrowers who wanted to take out mortgages, and the second to securitizers who purchased the completed loans. As the market for mortgage-based securities grew rapidly, marketing them became easy. The challenge for companies following this strategy was to find enough borrowers. In their efforts to do so, they reduced the standards required for loans to individuals in ways that made it likely that many of the borrowers would be unable to continue long term repayment of their loans. As later events proved, this was a very poor long-range strategy. An executive choosing such a strategy could have reasonably foreseen what actually happened.

Commercial banks such as Washington Mutual and Wachovia took deposits from literally millions of individuals and businesses in the form of checking and savings accounts, and invested some of these funds by making mortgage loans to individuals. While these banks had other lines of business besides making individual home mortgage loans, they chose to grow this one line of business to such an extent that its failure endangered the entire bank. Washington Mutual and Wachovia are examples of companies following this strategic choice. When large losses occurred in their home mortgage lending business, the entire bank was put at risk of failure (Grind 2012). In the case of Washington Mutual and Wachovia, these very large commercial banks were sold to healthier banks under crisis conditions and ceased to exist as independent companies. While these banks with their multiple product lines were following an accepted strategy of related diversification, their execution of this strategy led to corporate failure.

Other commercial banks, such as Wells Fargo and U.S. Bank chose to compete in multiple market segments and maintained a balance among their various lines of business in such a way that they were able to survive and even thrive in spite of losses in their individual home mortgage business. These banks also pursued a strategy of related diversification but did so successfully. One obvious question for research is to identify variables between banks that pursued the related diversification strategy successfully and those that did not.

Banks that originated individual mortgage loans, whether non-bank mortgage lenders or full-scale commercial banks, sold most of the loans they originated to securitizers. These were institutions that purchased individual mortgages from the originating banks, bundled them into securities, then sold the securities. Fannie Mae and Freddie Mac had been pursuing this strategy for more than twenty years before it became widely popular among investment banks and some commercial banks in the early 2000s. These securitizers offered a new type of financial product to a wide variety of individual and institutional investors. Some banks, such as JP Morgan Chase and Lehman Brothers, performed both functions, originating the loans which then were processed or bundled into mortgage backed securities.

One additional step in the process involved the buying and selling of credit default swaps. These instruments are financial derivatives which function in the same basic way as insurance. If a company has an outstanding loan, or owns bonds backed by loans such as individual home mortgages, there is an inherent risk that the borrower will default on the loan. A credit default swap is a contract that guarantees, in exchange for a non-refundable payment or premium, that the contracting party will make good the loss in case of default. Thus, the risk of nonpayment is swapped from the lender to the guarantor.

A number of financial service companies bought and sold these contracts. AIG, the giant insurance company, did the highest volume of business in this product. They sold (but did not buy) protection against credit default on a massive basis, but did not set aside reserves in case payment was required. This business was viewed as a minor sideline business by corporate management until widespread defaults nearly caused the bankruptcy of the entire company (Boyd 2011). AIG was saved from bankruptcy by the infusion of more than $150 billion by the U.S. government. This was by far the largest government bailout of any private company.

There were two proximate causes of strategic failure by companies pursuing one or more of the lines of business described in the preceding section. One was a failure to keep the volume of business related to home mortgages in balance with the other businesses conducted by a company as a whole; the other was a failure to conduct one or more of the lines of business related to mortgages on a sound basis (Blinder 2013, Cohen 2009, McGee 2010, Morgenson and Rosner 2012, Zandi 2009). Standard strategic theory teaches that the choice of businesses in which to operate, and the balance among these businesses, is a central concern of strategy formulation. The other major element of strategy is execution, namely, conducting the business(es) in which a company operates in such a way that they will yield sufficient profit and avoid significant losses.

While the choice of strategy (formulation) is generally considered to be the task of top managers, its implementation involves the work of a wider group of managers and employees. Nonetheless, responsibility for successful implementation ultimately rests with top management. In a financial service firm such as a bank, maintaining sufficient liquidity to survive unusual demands for withdrawal of funds is normally considered a technical matter, executed by the treasury department under the general direction of the Chief Financial Officer. Regulations prescribe minimum capital reserves against loans and under normal circumstances top management, with the exception of the Chief Financial Officer, does not concern itself with such a basic issue as liquidity. Choosing a strategy that involves large investments in risky instruments has implications for liquidity. Even the execution of a strategy once chosen might proceed with little attention paid to issues of liquidity (Paulson 2010, Wessel 2009).

From the accounts of the last days at Bear Stearns, Lehman Brothers, Washington Mutual and other institutions that failed it is clear that liquidity was the proximate cause of failure (Kelly, 2009, McDonald, 2009, Grind 2012). These large investment and commercial banks, even though they had billions of dollars of cash on their balance sheets, were unable to meet the demands for withdrawals that were presented when the bank's creditworthiness came into question. Similarly, AIG came within one day of bankruptcy because of a liquidity crisis (Boyd 2011). In each of these cases and others, top managers made intensive and widespread efforts to raise capital and save their firms but in the final days it was as if the levers they were pushing and pulling were not connected to anything (Gilbert 2010). The strategies that they had chosen proved incapable of execution and they ultimately led to failure of the firm.

Other comparable firms in the same industry at the same time performed well enough to survive and, in some cases to prosper. Bear Stearns and Lehman Brothers failed, but Goldman Sachs and Morgan Stanley did not. Washington Mutual and Wachovia failed, but Wells Fargo and Bank of America did not. AIG required a massive government bailout that made the U.S. government its major stockholder. Travelers did not. In each of these cases and others like them, comparative studies using available data might well shed light on management choices that led to strategic failure. Many of the books describing the conduct of individual companies during the critical period of the Great Recession suggest causes for failure. The Financial Crisis Inquiry Report surveys the companies and causes involved and identifies causes of failure and suggested remedies (Financial Crisis Inquiry Commission). While this report was not unanimous, and some members of the Commission filed dissenting views suggesting alternate causes for failure, this report is the most comprehensive single review of the economic crisis and events leading up to it.

Academic studies using available data from the period and the insights of the many authors who wrote books describing one or more companies involved in the crisis would add weight to the conclusions reached by the National Commission and the various authors who detailed the events of the period. Such studies might well provide results that would add to or change some parts of strategic theory as it is currently taught to business students at both the undergraduate and graduate levels. Such a contribution to understanding of past failures and the workings of strategy in the real world would be of great value.

Some companies chose to operate in only one segment of the financial services industry, namely mortgage origination, and to do so in ways that could not be self-sustaining. Some companies chose to make the creation and selling of mortgage derivatives a new and significant line of business to complement other lines of business in which they had long competed. The mortgage derivative business then brought down the entire company. Some companies chose a reasonable strategy for competing in this industry, but then lost control of their execution and failed.

What is needed now is scholarly analysis of the wealth of information provided. From strategic management to organizational theory and behavior to finance, experts can and should work with the rich trove of reported facts. Hypotheses need to be formed, based on what has already been established in the various disciplines, and tested for validity. Quantitative data is available in many of the books and government reports that have been published. It may be difficult to operationalize the theory that the devil caused the recession, but issues of firm size, different adopted strategies, and senior management attention to such functions as risk management are testable based on the works cited in this paper and others like them.

Studies of capital and leverage ratios are within the scope of finance, as are studies of the benefits and risks of various kinds of instruments such as collateralized mortgage obligations, collateralized debt obligations, and credit default swaps. The role of risk management in the overall management of financial service companies could be studied using the tools of organizational theory as well as those of finance. The extensive reliance on risk models developed by quants (individuals with PhDs in engineering or physics but little or no knowledge of business) could be studied by organizational theorists as well as finance specialists. The relative importance given to marketing as opposed to other functions within financial services firms, particularly in the area of compensation, could be studied by human resource specialists as well as experts in organizational behavior. Strengths and weaknesses are regular grist for the strategy mill, but such topics as financial stress tests are almost wholly absent from this field.

Regulators and top executives would benefit from the insights of business faculty on such topics as appropriate capital and leverage ratios, as well as the balance between expense reduction and careful underwriting of mortgages. Many types of mortgages were offered during the years immediately preceding the great recession. Studies of the success and failure rates of such instruments would be beneficial to both senior managers and financial regulators. Derivatives have been praised and damned in the wake of the Great Recession. Experts in finance have much to offer if careful studies were conducted of various types of derivatives, their risks and returns, and the level of transparency that might be desirable in trading such derivatives. All of these studies and more could contribute to our understanding of corporate strategy.

Most of the study of strategic management is aimed at helping companies to compete more successfully. Perhaps we have not devoted enough attention to helping companies to avoid bankruptcy or sudden unplanned sale. This appears to be a rather minimalist goal, but if the companies that failed during the Great Recession had competed more successfully, much of the economic and personal devastation that occurred might have been avoided. If, by studying the recent strategic failures using the techniques of the business disciplines and the wealth of material readily available, we could help to prevent similar failures, this would be no small thing.

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