The next financial crisis could be right around the corner

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When a financial bubble bursts, there's a run on scapegoats. With hundreds of billions of dollars in wealth wiped away in short order, it's natural to look for someone to blame. So, after each economy-shaking crash, the U.S. Congress goes after the evildoers with determination and vigor. In 1929, it targeted the brokers who fueled a speculative bubble with easy loans and abundant hype. In 2000, the villains were unscrupulous dot-com CEOs, peddlers of counterfeit value that never existed. And in 2008, it was executives at big investment banks, who created inscrutable derivatives from worthless mortgages.

In each case, Congress called the culprits to account at a series of acrimonious hearings, the purpose of which was to sniff out the reasons for the crash and to prevent a recurrence. Each time, once-cocky executives, now suitably humbled, faced the censure of Congress inside committee rooms and crushes of angry reporters outside them. In the aftermath, Congress worked to change regulations to ensure that future players could not engage in the kind of dangerously risky behavior that had led to each crash.

Think back to the dot-com crash. It was the most precipitous stock market crash since 1929, some seventy years before. In its wake came the Sarbanes-Oxley Act, which mandated greater independence of boards and audit committees, and forced auditors to engage in painstakingly thorough controls assessment and certification. We also saw revamped regulations for the accounting for stock options and whole new structures of stock-based compensation (including deferred share units, designed to give executives some downside risk that was missing from traditional options).These new regulations were implemented to fix the oversight and compensation problems that had created the dot-com market bubble; the hope was that at least another seventy years would pass before another such disaster.

Sadly, it would be less than a decade. Not only that, the next stock market meltdown would be considerably worse than the 2000 version; the next crash would threaten to bring down the entire global financial system. This time, rather than a tech bubble, it was a mortgage bubble. This time, it wasn't just the erosion of a secondary market like NASDAQ; it was a meltdown in the broader index, with the S&P500 down 40 percent in the second half of 2008 alone. In the wake of such a spectacular crash, less than a decade after the last, one might have expected that observers would ask, what did we do wrong the last time? Why didn't our fixes do what they were intended to do? Is it possible that our changes addressed symptoms, rather than root causes? One might have expected that we would ask these hard questions. Yet we haven't.

We haven't looked deeper into blameworthy CEO behavior to understand what really caused it. We haven't examined the broader theories that underpin our economy and that informed all of those ineffective fixes after the last crash. Instead, we've looked for a new scapegoat, chosen to operate from the same fundamental theories, and doubled down on the same fixes. Consequently, following the 2008 crash, more new regulations and norms have been (and will be) introduced to improve oversight and manage executive compensation, all with the aim of preventing a future crash. And few of these efforts will help. It's true that the next crash won't be caused by irrational exuberance over new-economy stocks or by the securitization of subprime mortgages; we've fixed those particular triggers for now. But as long as we fail to understand the real, fundamental reasons behind those crashes, and the bubbles that preceded them, it is only a matter of time until we will have the next crisis.

The true cause of the mayhem in our capital markets is our slavish devotion to the theory of shareholder value maximization. Over the past 40 years, we have come to utterly embrace the notion that the singular objective of a company is to maximize the return it earns for its shareholders. It is not to make customers happy. It is not to serve as an employer of choice, nor is it to contribute to society. And it is not, importantly, to earn a fair return for shareholders, given all the other stakeholders. No - the sole purpose of the organization, according to shareholder value theory, is to maximize shareholder value by increasing its own stock price more or less forever.

This theory has, unsurprisingly, caused executives to turn their attention from the real market - where products are made, services provided, employees hired and customers served - to the expectations market - where stocks are traded and dividends paid. Executives have turned their attention from winning with customers over the long term to focusing on investors in the short term. It's incredibly damaging to real market performance and the executives themselves. The executives have to convince themselves that there is meaning in talking up their stock price to analysts, making deals with hedge funds and sweet-talking the financial press. There just isn't. It's all demotivating and unproductive.

It is like an NFL quarterback being asked to pay attention to the point spread instead of the actual game. This, of course, would never happen. The NFL imposes a strict and absolute separation between the real game (played on the field) and the expectations game (played through the betting lines in Las Vegas). On this front, there's a lot capitalism could learn from the NFL - America's top sports league in both viewers and profits. The impact of shareholder value theory will be explored in the next excerpt from Fixing the Game, available online tomorrow. Later this week, further excerpts will explore the lessons capitalism can learn from the NFL.