The Laws of the Fifth Discipline

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In my previous journal, I went in pursuit of the culprit of the National City demise. But instead, I uncovered many more valuable insights about the “system” in which the company resides. Intrigued by this, I wanted to learn more… that is apply more of Peter Senge’s Systems Thinking to the financial crisis. And what better way to do this than to enumerate many of his Laws that he explains in his book, *The Fifth Discipline*.

1. **Today’s Problems Come from Yesterday’s Solutions**

   Senge explains: Often we are puzzled by the causes of our problems; when we merely need to look at our own solutions to other problems in the past. A well-established firm may find that this quarter’s sales are off sharply. Why? Because the highly successful rebate program last quarter led many customers to buy then rather than now.

   Recall the introduction of Journal 1, which perfectly illustrates the domino effect caused by yesterday’s solutions to many different problems: *After the dotcom bubble burst in early 2000, the United States became vulnerable to a deep recession. The September 11 terrorist attacks that followed in 2001 greatly exacerbated the weaken state of the nation’s economy. In order to remedy the situation, central banks around the world created capital liquidity by reducing interest rates and depressing risk premiums for investors who sought riskier opportunities to bolster their investment returns. Meanwhile, lenders—wanting to take advantage of the housing boom—loosened their strict lending policies and practices, approving subprime mortgage loans to borrowers with poor credit. Easy, cheap money coupled with consumers’ insatiable desire for the American Dream drove demand and, ultimately, the housing bubble to all-time highs in the summer of 2005, which eventually collapsed in August of 2006.*

   After reflection, I also realize that the economy is a balancing system as it is goal oriented and, the Fed is always seeking to stabilize it. Therefore, I created a Balancing Feedback Process diagram to the left, which reads as follows:

   There is a gap between the nation’s desired and actual economic health. In order to correct the gap (or stimulate the economy) the Fed adjusts interest rates, which increases demand for home loans and encourages banks and investors to take on more risk.
After this application, I can truly see that a Balancing Feedback Process is always operating to reduce a gap between what is desired and what exists.

2. **The Harder You Push, the Harder the System Pushes Back**

*Senge explains: Compensating feedback is present when well-intentioned interventions call forth responses from the system that offset the benefits of the intervention.*

According to Spero News’ article—*What are Real Reasons for the Financial Crisis?*, the CRA (Community Reinvestment Act) was given life during the Carter administration and empowers four federal financial supervisory agencies to oversee the performance of financial institutions in meeting the credit needs of their entire community, including low- and moderate-income neighborhoods. Whenever an institution wants to make virtually any change in its business operation, such as merging, opening up a new branch, or getting into a new line of business, it must first prove to regulators that it has made ample loans to the government’s preferred borrowers, those in low- and middle income neighborhoods who normally would not qualify for a loan. Lenders with low ratings can be fined by the government.

Many believe that the federal government was strong-arming banks to lend money to people who they normally would not make a loan, and in 1995 the Clinton administration pushed through revisions to the CRA that substantially increased the number and amount of these loans. All of the bad loans weren’t caused by the CRA, of course, but billions of dollars in CRA loans did go bad, as should have been expected.

3. **Behavior Grows Better Before It Grows Worse**

*Senge explains: Low-leverage intervention would be much less alluring if it were not for the fact that many actually work, in the short term. New houses get built. The unemployed are trained. Starving children are spared. Compensating feedback usually involves a delay, a time lag, between the short-term benefit and the long-term disbenefit.*

The CRA made the “American Dream” available to all, but, eventually, stuck banks with billions of dollars in bad loans, which was the crux of the subprime financial crisis.

4. **The Easy Way Out Usually Leads Back In**

*Senge explains: We all find comfort applying familiar solutions to problems, sticking to what we know best. But sometimes the solutions are less obvious.*

To date the bailout plan, or Troubled Asset Relief Plan (TARP) has not addressed the root problem of the financial crisis—foreclosures, which cause declining home values. The focus of the bill is to help the jumbo financial
institutions of Wall Street. Once financial institutions are out of trouble and the economy recovers, banks will now know the government is willing and able to bail them out in case business goes awry. So what’s to stop them from taking risks and continuing their practices in the future?

5. The Cure Can Be Worse than The Disease

Senge explains: *The long-term, most insidious consequence of applying non-systemic solutions is increased need for more and more of the solution. This is why ill-conceived government interventions are not just ineffective, they are addictive in the sense of fostering increased dependency and lessened abilities of local people to solve their own problems.*

At the time of the writing of this journal, the TARP solutions are non-systemic as they have only helped financial institutions, by infusing banks with capital. In order to fix the system, aid needs to extend to homeowners by stopping foreclosures. This will also help stabilize home values. What’s being done about regulation? Certainly there is more leverage in the system other than just giving banks more capital.

6. Faster is Slower

Senge explains: *When you are dealing with a complex social system, with things about it that you are dissatisfied with and eager to fix, you cannot just step in and set about fixing with much hope of helping. Systems Thinking is both more challenging and more promising than our normal ways of dealing with problems.*

Quick, someone call Secretary of Treasury Henry Paulson and debrief him on the benefits of Systems Thinking! The Troubled Assets Relief Act was just passed on Oct. 3, and already the Treasury has directly invested in nine of the nation’s largest banks. The Treasury department is also doling out funds to the banks it deems healthy enough to survive. It is rumored that the banks lucky enough to receive funding are promised more if they purchase a bad bank.

7. Cause and Effect are not Closely Related in Time and Space

Senge explains: *Most of us assume that cause and effect are close in time and space. If there is a problem in the manufacturing line, we look for the cause in manufacturing. If salespeople can’t meet targets, we think we need more sales incentives and promotions. If there is inadequate food, the solution must be food.*

In the case of the financial crisis, the government thinks the problem is the lack of liquidity in the marketplace. Therefore, the Treasury Department raised capital—$700 billion of tax payer dollars—to dump back into the system. Again I ask: *Is this the only leverage?* Thankfully, I have found information on the Internet that explains that there are other plans in the making, which are perhaps in more Systems Thinking mode and include the following:

- Mortgage-backed securities purchase program
Since I am already on page four and have several more journals to write, I realize that I must bring this journal to a close. However, it is clear to me that I could write volumes more on how the systems belonging to the financial crisis have violated the Laws of the Fifth Discipline over and over again. This journal is truly only the very smallest tip of the whole tip of the iceberg.

Without a doubt, the U.S. government has a challenging task ahead to fix this crisis. My only hope is that the Treasury Department begins to adopt a more systemic approach by affecting additional leverage such as regulation, homeownership preservations and declining home values as well as aid to the big financial banks of Wall Street. I just don’t think our nation can afford for the government to ignore Systems Thinking. And as I now know, and as Senge so eloquently states: We can only understand the problems of the system by contemplating the whole, not any individual part of the pattern. Systems Thinking is both more challenging and more promising than our normal ways of dealing with problems.

Sources: Spero News and Investopedia