

Coping with complexity:
Leadership in financial services



Foreword

Dear Colleague,

Unprecedented complexity is reshaping the financial services industry. On the most obvious level, changing regulatory structures, evolving customer expectations, and profound demographic shifts are complicating the external environment. But factors internal to organizations, such as product proliferation and unchecked innovation, have also contributed to complexity, and to what has been widely viewed as a systemic breakdown in the industry.

On the surface, it is tempting to view each of these influences as discrete challenges. For example, how will a specific new regulation complicate current strategy and processes, and what can leaders do to help their organizations navigate most effectively the resulting change? But viewing this factor in isolation can distort our understanding of the real cause and effect. A regulatory environment can shift because of the unintended consequences of new products, or due to the changing expectations of customers, or both. Each can lead to events that make headlines, leading to a counter response and the start of what could become a self-perpetuating chain of cause and effect.

The common reaction, in an environment awash in complexity, is to revisit the levers most often used to change course in response to market developments – improving corporate governance, revamping talent processes, as well as creating new risk management plans and capabilities. However, while these levers remain important, oversimplification and a single-minded focus on doing these things better will not necessarily enable a company to plan and respond cohesively in a complex system like today's financial services marketplace.

This point of view, which is based on Deloitte's experiences in providing services to our clients as well as a fairly exhaustive review and synthesis of related secondary research, suggests that managing complexity is everyone's business. Regardless of professional level, role, or location, addressing the market's intricacies should become a truly collective endeavor. We highlight seven leadership principles that we believe can help leaders and their organizations in their efforts to succeed in the new environment. Some of these principles are familiar, some less so, but the increasingly sophisticated marketplace demands that leaders consider all of them.

Beyond these principles, however, lies another message. Much like DNA, the values, competencies and motivations – or "VCMs" – of individuals are the true building blocks of organizational behavior; these are the basis for real improvement across an organization's many dimensions. From the C-suite to interns, the entire workforce is influenced by its individual VCMs. These have an impact on the outcome of change initiatives and an organization's capacity to adapt, yet they are often overlooked in the leadership dialogue. You may have the best talent processes in place, for example, for attracting innovators and future leaders into your company. But if the creativity and initiative of these individuals is straitjacketed by a culture that worships obedience and conformity, then those enviable talent resources may go for naught. The seven principles, executed with complementary organizational values, competencies and motivations, are a potent tool for effecting necessary change – and so dealing with complexity.

Whether your organization is confronting crises on a regular basis or looking for new opportunities from consistently steady ground, we hope this point of view will help you and your organization in your efforts to adapt to today's changing marketplace.



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Complexity in financial services

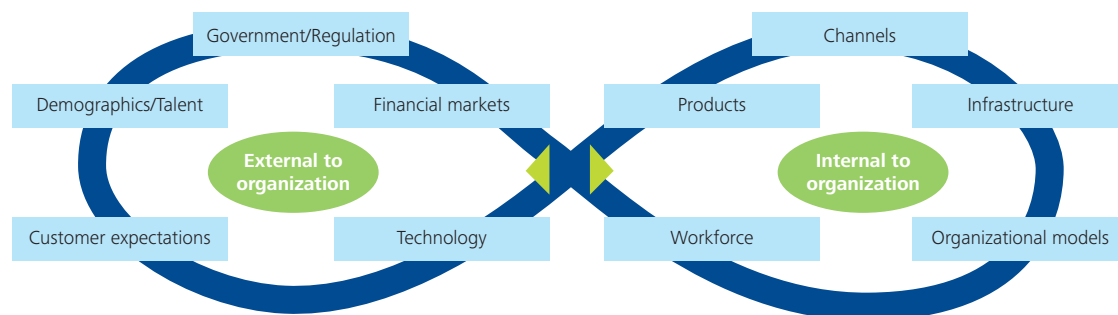
Chronic complexity — brought about by a rapidly changing marketplace, a tightening regulatory environment, evolving consumer demands and profound demographic shifts — is reshaping the financial services industry and introducing additional demands on leadership at all levels. Changing marketplace realities can challenge even the most skilled or accomplished executives.

Effective leadership in today's unpredictable financial services environment hinges more than ever on an organization's ability to read the changing marketplace and understand the impacts of decisions and their outcomes. Considering today's financial services industry as a complex adaptive system can help leaders and their organizations begin to make sense of the environment. While this sounds like a reference from an undergraduate biology text, it has relevance in this business environment: interdependent elements interact in an unplanned, non-linear fashion, and minor events can spur disproportionately large repercussions.¹

At the industry level, complexity proliferates in government and regulation, financial markets, technology changes, customer expectations, and shifting demographics. Within financial services organizations, complexity abounds across products, channels, infrastructure, organizational models, and the changing workforce.

It is tempting to view and react to each of these influences on its own: What complexities are being introduced by customer expectations, for example, and then what steps can leadership take to guide the business through those challenges? But interconnections between these elements can blur the line between cause and effect. For example, customer expectations may drive demand for innovative products, but innovative products may also be the result of accelerating technological development or changes in the regulatory environment. Likewise, a regulatory environment can shift because of the unintended consequences of those new products or the changing expectations of customers, creating a self-perpetuating chain of cause and effect. (See Figure 1.)

Figure 1. The financial services industry as a complex system



Source: Deloitte Research, Deloitte Services LP

As a result, leadership based on presumed linear relationships among these factors quickly becomes an exercise in over-simplification. Just as it is difficult to isolate individual influences in a natural system, a focus on a single set of change factors — e.g., mastering emerging technologies without regard to customer expectations or next year’s federal regulations — can turn into a futile endeavor. The increasing web of connections confronting the financial services industry is challenging leaders and their organizations, and their ability to react successfully to change.

Figure 2 lists some of the external and internal factors that can contribute to complexity and the resulting challenges

presented for leadership. Given these formidable challenges, companies need to consider new ways to approach leadership at all levels.

Many events within the financial services industry are better viewed through the perspective of a complex adaptive system. The vast number of interconnections and domino effects are often too big to trouble shoot. Unlike technical problems that can typically be “solved with knowledge and procedures in hand,”² the complexity of the financial services industry requires organizations to create within themselves the capability to adapt to — to understand, to stay on top of, and to influence — an increasingly sophisticated environment.

Figure 2. Examples of external and internal complexity and challenges to leadership

	Key characteristics	Challenges to leadership
External		
Government/Regulation	<ul style="list-style-type: none"> Government investments in companies Increased domestic and global regulation International Financial Reporting Standards 	<ul style="list-style-type: none"> Federal government becomes a key stakeholder Changing regulatory guidance Increased transparency and disclosure
Financial markets	<ul style="list-style-type: none"> Accelerating financial innovation Increased volatility and contagion Globalization of capital markets 	<ul style="list-style-type: none"> Hidden risks in financial innovation Heightened focus on capital management Changing investor profiles
Technology	<ul style="list-style-type: none"> Advances in infrastructure for processing trades Growing role in operational efficiency Rapid pace of change 	<ul style="list-style-type: none"> Increased risk of technological breakdowns Heightened risks from offshoring and outsourcing Adaptation to technological change
Customer expectations	<ul style="list-style-type: none"> Rising demand for innovative, customized products Reduced risk and fervent search for greater return Demographic shifts and globalization 	<ul style="list-style-type: none"> Growing demand for product information Attaining growth despite thinner margins Improving customer experience
Demographics/Talent	<ul style="list-style-type: none"> Shrinking supply of core labor segments Four generations in the workforce Increasing technology fluency 	<ul style="list-style-type: none"> Managing succession planning Changing demands for work-life expectations Growing need for virtual and real-time communication
Internal		
Products	<ul style="list-style-type: none"> Increased complexity of instrument design Expanding, diverse customer needs 	<ul style="list-style-type: none"> Valuation and risk management Guiding meaningful innovation
Channel	<ul style="list-style-type: none"> Multiple and complex channel options More channel partners and/or alliances 	<ul style="list-style-type: none"> Seamless channel integration Increased reputational risks
Infrastructure	<ul style="list-style-type: none"> Limitations of legacy systems Rising demands of data management processes 	<ul style="list-style-type: none"> Systems integration and scaling Information security
Organizational models	<ul style="list-style-type: none"> Growing complexity of design dimensions Consolidating and changing business models 	<ul style="list-style-type: none"> Overcoming coordination challenges Flexibility and adaptation
Workforce	<ul style="list-style-type: none"> Increasingly diverse and global workforce Retiring baby boomers; rise of Gen X/Gen Y 	<ul style="list-style-type: none"> Management of diverse and global workforce Changing expectations of employees

Source: Deloitte Research, Deloitte Services LP

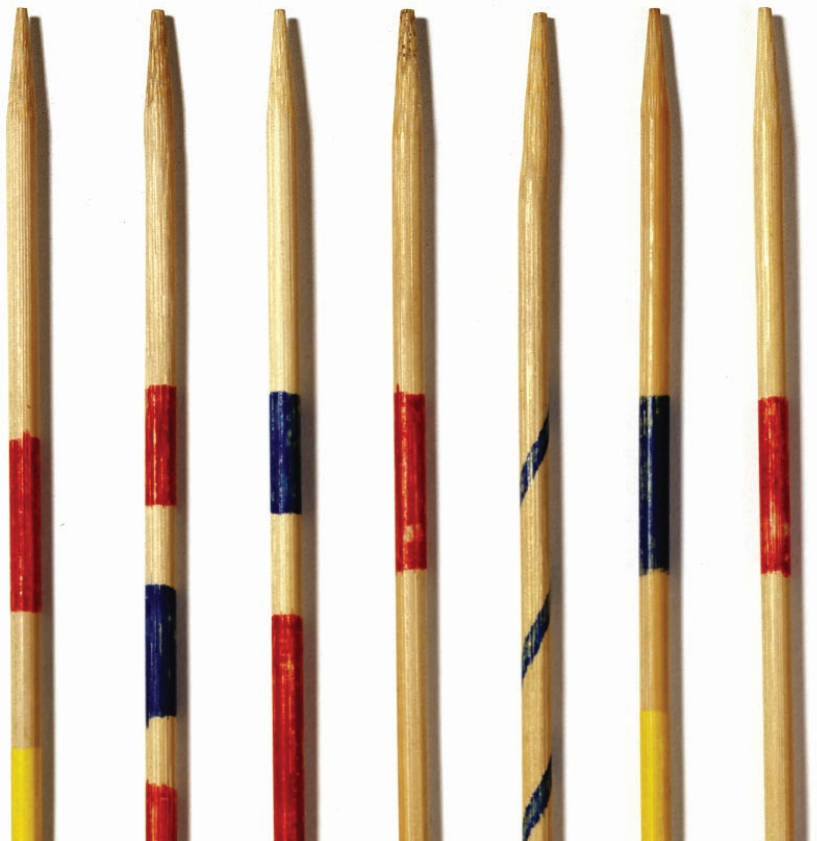
Adapting to complexity

Overwhelming levels of complexity can make it easy for leaders and their organizations to oversimplify their assumptions in search of straightforward answers. Instead, they should consider making conscious and continuous efforts to understand the deep connections between people, entities, and events. This can help them identify patterns, anticipate trajectories, and develop appropriate responses to the marketplace's myriad interconnections.³

Adapting to the sophistication of today's business environment calls for a holistic approach. To this end, this report puts forth seven leadership principles that provide a common language and frame of reference for navigating complexity. Values, competencies and motivations, or "VCMs," influence the way leaders and their organizations act on these principles and do their jobs. In addition, leaders should consider identifying the areas of their

organizations that will enjoy the greatest impact from their efforts to better manage complexity. These organizational levers — including intelligence and risk management, corporate governance, business models, talent processes, and organizational culture — are the areas that allow these principles and VCMs to permeate organizations and tangibly impact day-to-day operations. While this is far from an exhaustive list, we believe these areas have the most influence in improving an organization's ability to cope with complexity.

Collectively, the leadership principles, the VCMs, and the organizational levers form a holistic tool for leaders and their organizations to consider in their efforts to deal with the dynamism of the marketplace. Together, these interconnecting elements serve as a lens that can be used to discern the complexities of an otherwise overwhelming financial services environment.



Seven leadership principles

A consistent set of leadership principles (see Figure 3) provides organizations with a common language and a shared frame of reference that can help codify responses to complexity. Seven principles are discussed in this paper. The first three principles describe basic conventions for leaders and their organizations; while familiar, today’s marketplace warrants their reexamination. These are a critical foundation for any leader in the financial services industry, even in the absence of daunting complexities. In contrast, the next four principles directly address the complexities that are plaguing the industry.

Our discussion of the seven principles includes illustrative examples of their application to organizational levers, which in a sense, are the arenas for action. For example, a company might respond to complex challenges by changing its business model or reassessing its decision rights and executive committee responsibilities. Each of these responses might have impact and strong consequences, but its effectiveness is shaped by the VCMs cultivated by leadership.

Figure 3. Seven leadership principles for adapting to complexity

<p>1. Articulate a vision and secure enrollment.</p>	<ul style="list-style-type: none"> • Articulate a compelling and credible vision that inspires action toward a desired state of change. • To fulfill the vision, secure deep enrollment, for example by communicating the vision as a compelling personal opportunity. • Demonstrate genuine personal commitment.
<p>2. Build trust with clear communications.</p>	<ul style="list-style-type: none"> • Communicate with candor to safeguard against a lack of information and a culture of speculation, blame-shifting and self-protective behavior. • Secure trust through clear, consistent messaging that addresses organizational whisperings as well as a broad set of stakeholders.
<p>3. Cultivate authentic leadership and value creation.</p>	<ul style="list-style-type: none"> • Proactively seek candid and inclusive leadership assessment for improving self awareness. • Move the organization toward long-term value creation, understanding that metrics and incentives can help balance the intrinsic and extrinsic motivations of individuals in the organization. • Safeguard against biases in judgments and decision making and demonstrate a resolution-oriented mindset, viewing crisis as opportunity.
<p>4. Address the swampiness inherent in business issues.</p>	<ul style="list-style-type: none"> • Adopt a mindset that grasps the messiness inherent in real-world business issues instead of oversimplifying them. • Complement technical analysis with the organization’s reflective capacity and make mid-course corrections as necessary.
<p>5. Uncover and work with paradox and tension.</p>	<ul style="list-style-type: none"> • Ask wicked questions to uncover latent assumptions and spot contradictions or biases inherent in an issue or situation. • Embrace integrative thinking: hold conflicting ideas in constructive tension and seek creative resolution.
<p>6. Tune into the shadow system.</p>	<ul style="list-style-type: none"> • Use informal networks to gain deeper insights into people’s perceptions and behaviors; where innovation occurs; and barriers and enablers for collaboration and execution. • Identify the appropriate network archetype to deploy for optimal connectivity, depending on the strategic objectives and nature of work within a given organization.
<p>7. Recognize, prioritize, and mobilize for potential crises.</p>	<ul style="list-style-type: none"> • Pre-empt emerging threats through systematic deployment of the RPM (recognition, prioritization and mobilization) process throughout the organization. • Reinforce the RPM process with candid inputs from individuals. • Be mindful of cognitive biases that could lead to ignoring or underestimating risks.

Source: Deloitte Research, Deloitte Services LP

Principle 1: Articulate a vision and secure enrollment.

Uncertainty, ambiguity, and complexity can compromise an organization's efforts to establish a clear vision and may push leadership into a reactive mode when faced with rapidly changing conditions. Over the last several years, studies indicate that nearly one half of managers do not trust their senior leadership, do not believe leadership has a credible plan, nor have confidence in leadership's ability to carry out a plan.⁴ While the importance of this principle is no different in complex environments than it is in simpler ones, the difficulty of implementing it increases significantly.

However, a vision can only come alive if leaders secure "enrollment" by inspiring followers to voluntarily commit. To this end, effective leaders often connect to the emotional needs of employees by conveying their vision as a compelling opportunity to fulfill a personal concern.⁵ John F. Kennedy was acutely aware of this. Given apprehensions about the Russian Sputnik program, he claimed that the proposed space program "may hold the key to our future on Earth."⁶ Furthermore, a leader's personal commitment to a vision should match his or her convictions, given that people who "sense that they are being manipulated... are less likely to commit themselves, and much less likely to [exhibit] breakthrough performance."⁷

Principle 1 in action

Crafting a meaningful vision that achieves buy-in from employees and external stakeholders is an important first step in effective leadership. For example, today's business environment suggests that financial services leaders reconsider and improve their enterprise-wide approach to risk management. A well-articulated approach will help embed risk in strategy development as well as day-to-day decision making; establishes organization-wide attitudes toward risk tolerance, time horizons, financial innovation, and breakdowns; and develops a credible plan for dealing with crises.

At a time when most of the industry was bullish about mortgage-related investments, the chief executive officer of a leading global financial services company took a contrarian stance. His open and dialectical approach to risk management encouraged his deputies to confront him with their views and debate issues central to the functioning of the bank. Moreover, the deputies' understanding of, buy-in and adherence to the CEO's vision of acceptable risks prompted the deputies to shun risky products, even if it meant sacrificing short-term profits. The CEO thereby gained access to important information early on and was able to tell the chief of securitized products to reduce exposure on sub-prime holdings. As a result, as compared to its rivals, the company avoided incurring additional losses, and it became one of the strongest banks on Wall Street.⁸

Conveying a sense of urgency, appealing to personal goals, and demonstrating commitment are additional ways leaders can garner support and achieve a vision. In our risk management example, leaders can demonstrate commitment by identifying key roles, responsibilities, and authority. For example, organizations might provide the chief risk officer access to the board, grant the officer the authority to oversee or veto transactions, and establish processes for issue escalation and resolution.

Recent events are also focusing additional attention on the roles and responsibilities of boards. Boards should now consider formulating a shared vision for governance processes and expectations for dynamics within the boardroom. This requires clear, consistent attitudes toward risk tolerance and time horizons, the board's role in safeguarding the interests of multiple stakeholders, and the impact of changing investor profiles.



Principle 2: Build trust with clear communications.

Complex environments can often lead to friction when divergent opinions or difficult situations emerge due to an incomplete understanding of issues and a lack of obvious answers. Resolving tension and fostering cohesion hinges on a clear communication style that builds trust. Leadership can play an important role in encouraging individuals in the organization to freely voice their concerns when they sense a change in the environment or potential conflicts. Leaders can foster a culture of truthful communication by asking questions such as: “Is there an angle we haven’t yet discussed? Is there anything simmering below the surface that we need to talk about before we break up?”⁹ Clear communication can promote a culture of shared responsibility for an organization’s future, regardless of people’s titles, especially when dealing with breakdowns.

By extension, a lack of information can be dangerous: “[P]eople left in the dark fill the void with their own — mostly negative — interpretations of events... [resulting in a] culture...poisoned with speculation, blame shifting, and self-protective behavior.”¹⁰ Leaders cannot afford to ignore the impact of organizational whisperings. Replacing the rumor mill with a culture based on trust and honesty hinges on clear and consistent communication from leadership at all levels.¹¹

Principle 2 in action

Leaders at all levels of an organization should learn to expect that breakdowns are increasingly likely to occur in a complex environment. In today’s marketplace, technology has enabled news to travel faster than ever, thereby shortening the timeframe for responding to crises from days to mere hours. Consider, for example, an online trading services firm that experienced a database breach, compromising private customer information; a computer company that experienced delays in deliveries; or a company that inadvertently released millions of lead-tainted toys.¹² Each of these breakdowns potentially threatened a company’s reputation, and hence required leaders to be trained in handling such situations and in communicating with clarity to rebuild trust.

An organizational culture that supports open discussions — and removes incentives for speculation, blame-shifting, and self-protective behavior — can foster the truthfulness and clarity that businesses need when dealing with difficult issues.¹³ The success of one leading financial services company has often been attributed to such a culture. Unlike many of its peers that are hierarchical, this institution has a flat structure in which partners are expected to speak to everyone, including first-year analysts. Senior management encourages and expects disagreement and dialogue across functions — for instance, between traders and risk managers. Typically, it solicits the bad news first. Such practices promote a culture of trust and remove the fear of persecution. The organization further ingrains communication into its culture through a widely accepted but unwritten rule that all voicemails must be responded to within 24 hours, whether they come from the chief financial officer, a client, or an analyst.¹⁴ Interactions that cut across formal relationships can contribute to a unique culture that stays attuned to emerging risks and opportunities.

Admitting to mistakes and communicating effectively with external stakeholders can be crucial to organizations’ attempts to build trust. For example, Johnson & Johnson, the maker of Tylenol, was able to overcome negative consumer and media reactions to product contamination with a public relations campaign that has since become a business school staple. During the crisis, the company seized the opportunity to use media coverage to openly communicate its position and disseminate warnings to the public.¹⁵ As a result, leadership rebuilt trust with stakeholders and preserved the long-term value of the business. Yet, given the evolution of communication channels and the advent of social media, even a well-orchestrated, single-channel reaction is insufficient. Companies now need to manage their brands across multiple diverse mediums in order to overcome the potential for reputational damage. Social media further underscores the complexity of communication today and strengthens the need to bring clarity and trust to the internal and external voice of leadership.

Principle 3: Cultivate authentic leadership and value creation.

Leaders can adapt to complexity by remaining open to experimentation, committing to learning, and demonstrating behaviors that are consistent with espoused values, which are constantly being challenged. In fact, a study conducted by Bill George et al. found that successful leaders do not possess any universal traits, skills, or styles. Rather, they work hard to understand and develop themselves. They become “authentic leaders” by reflecting on their life experiences, seeking honest feedback through formal and informal support networks, and balancing their monetary and non-monetary incentives. Collectively, these behaviors enable them to build trust, secure enrollment, and drive long-term results for their organizations.¹⁶

Leading in a complex environment calls for authenticity — leaders and teams who are mindful of their weaknesses and what they don’t know. Blind spots often reveal themselves in the form of well-known biases, such as over-optimism and loss aversion, which can also lead to decisions that impede long-term, authentic value creation. Over-optimism can cause managers to generate unrealistic, inflated forecasts that lead to over-allocation of resources. Loss aversion, or the tendency to avoid losses rather than to pursue gains, can lead to inaction and under-commitment of resources. Authentic leaders demonstrate a strong awareness of these potential blind spots and understand the need to inject fresh experience or analysis, introduce debate, and self-impose strong governance to safeguard against biases in judgment and decision making.¹⁷ These actions can help create a resolution-oriented organizational culture that finds opportunities in crises.

Principle 3 in action

Business models and governance processes often focus on short-term objectives reinforced through internal, target-based budgeting and compensation systems, and capital markets that reward meeting quarterly targets.¹⁸ By focusing excessively on the short-term, organizations may unintentionally make decisions that destroy, instead of create, long-term authentic value.

A Japanese automaker embedded the notion of authenticity and long-termism into its culture and talent processes by committing itself to a spirit of continuous improvement and respect for people. These documented management principles serve as a reminder that financial performance and incentives should be balanced with non-monetary incentives. Leadership at this automaker encourages honest feedback and empowers employees at all levels to alert management to production breakdowns with a sense of urgency, and strive together toward effective resolution. Leadership became well known for not compromising quality, even if the pursuit of quality slows down the pace of growth. Additionally, the organization ingrained long-termism into its business model by combining strategic plans that span many decades with an ongoing focus on short-term objectives.¹⁹

However, recently many customers along with the media criticized the automaker for compromising quality in the headlong pursuit of growth through high volumes. Straying from its core values and plagued with product recalls, the company began to slip in consumer-quality surveys and lose its competitive edge. In response, leadership promised to correct quality problems through a “customer-first” program and lengthen product development times, if necessary. While some of the company’s quality problems appear to be resolved, competitors capitalized on the opportunity by making improvements in the quality of their products to gain market share.²⁰

The example of the Japanese automaker illustrates one potential outcome related to digression from the goal of authentic value creation, to a narrow goal focused on growth in volume. Companies that find themselves in a similar situation can benefit by taking a closer look at refining structures — including reward packages, value systems, strategic planning initiatives, etc. — to create checks and balances and drive a more balanced growth strategy. In the financial services industry, pressure from regulators is likely to reinforce the need for such refinement.

Additionally, talent processes should encourage leaders at all levels of an organization to proactively submit themselves to periodic 360-degree feedback to uncover competency gaps and biases in their decision making. For example, Michael Dell, founder of Dell Computers, used 360-degree feedback to identify and address mismatches between his management style and the needs of his workforce.²¹ This exercise can send a powerful signal to an organization that leaders are committed to improving themselves and building a culture of accountability.

Principle 4: Address the swampiness inherent in business issues.

Driving in the United States is (more or less) a predictable experience. With uniform traffic signals, vehicle controls, and road markings, and a common understanding of the concept of the “right of way,” a driver can rely on a uniform set of principles to arrive pretty much anywhere unscathed.

Driving in India, by contrast, introduces complexities into the process. The rules of engagement — right of way would be charitable — at an intersection in one part of India may be quite different elsewhere. While knowledge of traffic laws is important, even a well-versed, non-native driver will find out just how much he or she does not know about the realities of Indian traffic. This “swampiness” — “tangled, complex problems composed of multiple systems that resist technical analysis”²² — describes the environment in which financial services companies now operate. Financial services leaders and their organizations should therefore resist the temptation to trivialize complex issues. Even for the most seasoned leaders, complex problems create adaptive challenges that can entail loss, conflict, risk, stress, and creativity.²³

Business leaders can combat swampiness by developing their ability to adapt to unfamiliar scenarios. As organizations deal with swampiness, they can supplement planning and technical analysis with a deep interpretation of experiences and make mid-course corrections as necessary. This reflection can benefit organizations, as “people can think about what they are doing, pool their thoughts and feelings in the service of learning about the organizations, and then use this learning in the way they manage themselves in their roles.”²⁴



Principle 4 in action

Recently, Clayton Christensen and Michael Raynor described the concept of “strategic flexibility.”²⁵ Fundamentally, strategic flexibility is a response to uncertainty: Leaders should commit to a plan, but they should do so before precisely knowing the market, regulatory environment, and other factors that will affect profitability and market share. Strategic flexibility entails creating and evaluating a portfolio of options — new businesses, new products, new services — and positioning a company to pursue different options.

With regard to the organizational levers referenced in this report, strategic flexibility is quite important. It can directly affect risk — e.g., one way to manage the risk of your competitor gaining an insurmountable competitive advantage with a new service is to become an investor in an emergent leader in that new service. Similarly, strategic flexibility can guide governance decisions and a company’s business options. Consider, for example, a prominent technology company that invested heavily in a single platform. Rather than diversifying its investments to combat the marketplace’s inherent uncertainty, it placed all of its competitive eggs in a single strategic basket. As a result, the company suffered significant losses when the platform failed to take hold in the industry.²⁶

In contrast, Johnson & Johnson charged its corporate venture capital arm, in conjunction with its Corporate Office of Science and Technology, with creating strategic flexibility for its operating divisions. Through an investment portfolio of hundreds of millions of dollars, the president of the corporate venture capital arm seeks to ensure that the 200-plus operating companies “are connected in the right ways to the emerging technologies that could shape their competitive futures.”²⁷ For example, the corporate center gives an operating unit access to new technologies that could enable it to pioneer innovative products and scale operations if the market takes off. The company has thereby created a basket of strategic options across a plethora of businesses. Thus, the company is able to balance the benefits of strategic commitment against the risks associated with inflexibility.²⁸

Another way that organizations can deal with swampiness in the business environment is to focus on spotting opportunity without getting tangled in day-to-day distractions. For example, one non-bank organization figured out how to thrive in the payments arena of the banking industry. Recognizing the extremely complex value chain dominated by banks, it focused on identifying unmet customer needs to define and offer an innovative and compelling value proposition to its customers. This focus enabled the company to develop a stored value system that has become popular with consumers and merchants because of its ease of use, convenient payment options, speed, cost effectiveness, and strong fraud-monitoring features. The company built sticky relationships with its customers and took away market share in the online payment market by effectively piggy-backing on the existing bank payments infrastructure.



Principle 5: “Uncover and work with paradox and tension.”²⁹

Solutions to messy problems can arise when leaders ask difficult questions — often referred to as “wicked questions” — to uncover latent assumptions and spot contradictions or biases through innovative framing.³⁰ Asking and answering wicked questions requires “integrative thinking”:

“[Integrative thinkers] have the predisposition and the capacity to hold in their heads two opposing ideas at once. And then, without panicking or simply settling for one alternative or the other, they’re able to creatively resolve the tension between those two ideas by generating a new one that contains elements of the others but is superior to both.... It is this discipline — not superior strategy or faultless execution — that is a defining characteristic of most exceptional businesses and the people who run them.”³¹

Integrative thinking involves a four-step process. First, when evaluating an issue, organizations need to actively seek less obvious — but potentially relevant — factors. Then, they need to consider the relationships between variables and analyze causality. Next, they should envision an architecture that considers how various decisions affect one another. Finally, they need to resolve tensions between opposing ideas and generate innovative solutions.³² Effective integrative thinking can help resolve inherent paradoxes and elicit creative solutions.

Examples of wicked questions:

- How can we use breakdowns to drive innovative ideas?
- How can we reward our employees for achieving sales targets without driving behaviors that lead to the destruction of value?
- Why do we recruit the most talented board members, and then not engage them sufficiently?

Principle 5 in action

Wicked questions can bolster an organization’s risk management by exposing hidden assumptions about products, customers, counterparties, pricing and valuation, off-balance sheet vehicles, innovation, and investor appetite. Furthermore, they can help businesses abandon the status quo in favor of alternative solutions.

Boards can ask wicked questions to uncover biases, such as the halo effect,³³ by asking whether or not success in the marketplace is actually attributable to sound leadership and strategy execution. Especially when leaders try to account for organizational success, such assumptions are easy to embrace as fact.

Organizations are trying to resolve the inherent tension that businesses face when trying to drive high productivity in the execution of core job functions and simultaneously engendering a culture of innovation to stay competitive. For example, some companies are using innovative, people-centric strategies to build employee loyalty or drive innovation in the airlines, internet, and software industries. One internet company resolves the inherent tension between fostering productivity and promoting innovation by asking managers and technical employees to devote 10 to 20 percent of their time to innovation. The organization established a “Director of Other” role, which is responsible for holding individuals accountable for this target and ensuring that innovative ideas pass through a rigorous qualification process. Combined with a formalized budgeting of time, this strategy helps ensure that time spent on innovation does not compromise time dedicated to core business activities. This creative solution to fostering innovation has paid off in the form of new products and features,³⁴ as well as strengthened retention and engagement.

Principle 6: “Tune into the shadow system.”³⁵

The “shadow system” encompasses the myriad relationships that exist outside the formal hierarchy found in organizational charts and can help leaders uncover hidden information inherent in a complex environment. Leaders can use informal networks to comprehend people’s perceptions and behaviors, understand how innovation occurs, drive appropriate connectivity to reduce inefficiencies across functions and hierarchies, boost performance, and identify barriers and enablers for collaboration and execution.³⁶ However, driving appropriate connectivity to boost productivity requires a deep understanding of the various types of networks that exist. Organizations can deploy different types of networks, depending on their strategic objectives and the nature of the work they want to accomplish.

Principle 6 in action

Organizations can use informal networks to improve risk-related information flows, overcome coordination challenges across silos and geographies, uncover hidden assumptions and improve scenario planning, use diversity of perspectives to foster process improvements, and identify barriers to securing enrollment from followers. Informal networks can also empower boards with candid input on performance and improve succession planning by identifying experts and high performers.

Continuing with the example of the leading global financial services company in the discussion of the first principle, the CEO of the company frequently connects with individuals outside the formal chain of command to garner information on emerging threats. He often calls on managers at different levels to gather information and makes unannounced appearances at meetings. While some may consider this practice disruptive, the organization has come to expect it from leadership and has accommodated this practice given the benefits. Through such discussions, he was forewarned of rising late payments in the sub-prime market and risks associated with CDOs and SIVs.³⁷

A deeper and more formalized understanding of informal networks can supplement the matrix models often found in financial services organizations and may lead to improved coordination across geographies, products, and customer types. Research-based companies in the software and pharmaceutical industries, for example, are using informal networks to overcome silos and drive innovation. A large pharmaceutical company masterfully used a broad range of internal and external networks to transcend silos and develop an innovative cancer drug. External networks with scientists helped the organization identify the specific cancer that would most likely respond to the new medication as well as hospitals that would host patient trials. Internal connections fostered frequent brainstorming sessions between scientific disciplines and strengthened the organization’s manufacturing efforts across geographies.³⁸ These customized response networks went a long way toward addressing the complexity inherent in difficult problems.



Principle 7: Recognize, prioritize, and mobilize for potential crises.

The web of deep and intricate linkages across internal and external complexities can breed fragility and increase the likelihood of breakdowns.³⁹ Traditional scenario and contingency planning may not be enough to avoid crises. Organizations may need to be more disciplined and, at the same time, more flexible. One approach that is gaining success in the marketplace is “RPM,” a disciplined, three-step process of recognition, prioritization, and mobilization, which can help organizations plan for “predictable surprises.” Predictable surprises share three attributes: some people within an organization are aware of them, they worsen over time, and they turn into crises when key decision-makers don’t respond quickly enough to them.⁴⁰ As an example of a predictable surprise, in their book, “Predictable Surprises: The Disasters You Should Have Seen Coming and How to Prevent Them,” Max Bazerman and Michael Watkins presented detailed analyses of the September 11 attacks, pointing to specific instances where they had accurately predicted major problems.

Financial services leaders can improve recognition of predictable surprises and complement risk management models with intelligence gathered from informal networks and a culture that supports freedom to voice concerns. Additionally, they should be mindful of psychological vulnerabilities or cognitive biases that could conceal risks. For example, some organizations become too optimistic about their performance and the magnitude of potential problems. Others may consider evidence that supports the beliefs of an organization’s leadership and dismiss contradictory data.⁴¹

The prioritization of threats should consider “high-probability disasters sometimes do not occur and low-probability ones sometimes do.”⁴² Therefore, leaders and organizations should perform cost-benefit analyses to prioritize and mobilize resources that mitigate their most salient threats.

Principle 7 in action

Systematic planning for predictable surprises – based on realistic scenarios, candid input from formal and informal networks, and an enterprise-wide view of risks – can improve an organization’s risk management. For example, an enterprise-wide view of risk can bolster the RPM process by overcoming redundancies, inefficiencies, inconsistencies, and coordination challenges by standardizing risk, controls, and testing procedures. Additionally, risk mitigation may require a protocol for communicating emerging risk exposures to senior management and mobilizing resources.

As the housing market declined in late 2007, the leading financial services organization referred to in the discussion of the second principle safeguarded its exposure to mortgages and related securities. First, it recognized unexplained anomalies in its models through strong dialogue between traders, risk managers, and senior management. Then, it proactively prioritized their importance and evaluated the potential risks in its portfolio. Finally, it mobilized resources to reduce its holdings.⁴³

An organizational culture that abides by the RPM process would therefore actively encourage people to speak up. Individuals at all levels of an organization should remain vigilant for predictable surprises. All too often, employees fail to communicate potential threats, “often out of fear of rocking the boat or being seen as troublemakers.”⁴⁴



Values, competencies and motivations

Collectively, we believe the seven leadership principles can help financial services companies navigate the myriad complexities that have faced the marketplace. However, they don't address the human dimension, namely individuals' values, competencies and motivations, which collectively define an organization's unique culture and drive actual organizational improvement. These play a critical role in influencing individual leadership style, including judgments, the use of power, and openness to multiple perspectives. The influence of these principles and VCMs extends to leaders and other individuals throughout the entire workforce.

Several studies indicate a relationship between an organization's performance and the deliberate development of its culture.⁴⁵ Problems can occur when leaders fail to detect the culture that permeates their organizations in the form of unwritten rules. "... [U]nwritten rules are not good or bad. They are just appropriate or inappropriate given what the organization is trying to achieve."⁴⁶ By understanding the implicit VCMs that influence organizational behavior, leaders can better decipher unwritten rules to build deeper connections with individuals throughout their organizations. Leaders play a critical role in transforming these unwritten rules into

an explicitly stated set of balanced VCMs. This exercise can help leaders communicate and engrain acceptable behaviors, including risk tolerance, communication style, entrepreneurship, collaboration, and issue resolution throughout their organizations. (See Figure 4.)

A Japanese automaker formalized and embedded its desired VCMs into the organization by creating its own "way" of managing people and projects. The organization identifies two key values – continuous improvement and respect for people. To this end, the organization tries to develop corresponding competencies, including teamwork and managerial breadth and depth. These values also appear, for example, in the way the company rotates employees through different jobs in order to build its workforce's experience base. The company focuses on appealing to intrinsic motivations, such as team performance, product quality, and customer satisfaction. These VCMs have played a critical, reinforcing role in helping the company foster a culture of truthfulness in communication and cultivate long-term value.⁴⁸ As noted in the discussion of Principle 3, straying from these VCMs has had a somewhat detrimental impact on the company's performance.

Figure 4. The role of VCMs in influencing organizations and their people⁴⁷

VCMs	Influence on people
<p>Values "Values are constructs representing generalized behaviors or states of affairs that are considered by the individual to be important."</p>	<p>Attitude toward resolution of problems, interpersonal relationships, ethical behavior, and choice of pathways to achieve individual and organizational success.</p>
<p>Competencies A competency is "an underlying characteristic that leads to superior or effective performance."</p>	<p>Self-awareness that leadership is a learned skill that is level-agnostic, understanding and evaluating multiple perspectives, making judgments and decisions, and leadership style.</p>
<p>Motivations <i>Extrinsic:</i> monetary compensation, having power, having a title, public recognition, social status, winning over others, etc. <i>Intrinsic:</i> personal growth, satisfaction of doing a good job, helping others develop, finding meaning from efforts, being true to one's beliefs, making a difference in the world, etc.</p>	<p>Short-term vs. long-term objectives, one's own needs vs. needs of others, needs of the organization vs. needs of external stakeholders, leadership style, use of power, teammate's style, and relationships established, and design of performance metrics and incentive mechanisms.</p>

Source: Deloitte Research, Deloitte Services LP

By periodically reassessing an organization’s actual versus desired VCMs, leaders can continuously improve the effectiveness of their organizational levers and day-to-day operations. Figure 5 explains how VCMs can impact the focus and performance of organizational levers.

VCMs can also play an essential role in the successful execution of leadership principles. If leaders can align their organization’s VCMs to their leadership principles, they can better drive desired behaviors from their workforce, including improving individuals’ abilities to evaluate new opportunities, deal with breakdowns, and make day-to-day decisions. By staying mindful of this mutually reinforcing relationship, leaders can improve the effectiveness of organizational levers, find the root of problems and identify appropriate responses.

To make this more tangible, consider the hypothetical case of how two organizations trying to implement the same leadership principles in the area of risk management could experience two markedly different outcomes due to differences in their VCMs. Both companies would like to make substantive changes in driving an enterprise-wide approach to risk management by articulating a vision and securing enrollment; building trust with clear communications; tuning into the shadow system; and recognizing, prioritizing, and mobilizing for potential

crises. However, their VCMs lead to dramatically different outcomes.

Company A: The organization focuses on attracting top quality talent at all levels, and it has a relentless drive for excellence. The company prides itself on building a culture of accountability, integrity, and teamwork. Even top management subjects itself to periodic 360-degree feedback and admits to mistakes. These values are reinforced through merit-based reward structures that are balanced by a healthy concern for the enterprise and for colleagues. The organization is committed to training and developing its entire workforce and expects everyone to be a leader. At the same time, it cultivates skills that can also improve team performance. The VCMs that permeate Company A breed a culture that fosters meritocracy and individual accountability at all levels.

Company B: A few highly trained decision-makers at the top provide the marching orders for the entire workforce. Those outside this tightly knit group are not privy to strategic discussions and decision making, creating a gap between top management and the rest of the organization. There is an excessive focus on individual performance and monetary compensation for all, but it is only minimally balanced with an organizational culture that values the needs of the enterprise as it pursues revenue and profit. At the front lines, carrying out orders

Figure 5. Examples of how VCMs shape organizational levers

	Values (Attitudes toward...)	Competencies	Motivations
Risk management	<ul style="list-style-type: none"> • Risk taking and time horizon • Vulnerabilities and breakdowns 	<ul style="list-style-type: none"> • Planning for predictable surprises • Awareness of biases 	<ul style="list-style-type: none"> • Performance metrics • Monetary compensation
Corporate governance	<ul style="list-style-type: none"> • Constructive candor • Diversity of the board 	<ul style="list-style-type: none"> • Asking wicked questions • Demonstrating strategic flexibility 	<ul style="list-style-type: none"> • Shareholder expectations • Corporate social responsibility
Business models	<ul style="list-style-type: none"> • Flexibility • Customer-centricity 	<ul style="list-style-type: none"> • Spotting disruptive innovators • Using informal networks 	<ul style="list-style-type: none"> • Multiple stakeholders • Sustainable value
Talent processes	<ul style="list-style-type: none"> • Diverse and global workforce • Fair treatment of employees 	<ul style="list-style-type: none"> • Teaming across diverse groups • Developing future leaders 	<ul style="list-style-type: none"> • Recognition and rewards • Civic and environmental activities
Organizational culture	<ul style="list-style-type: none"> • Innovation and ethics • Multiple perspectives 	<ul style="list-style-type: none"> • Improving communication • Managing conflict and debate 	<ul style="list-style-type: none"> • Engagement • Diversity programs

Source: Deloitte Research, Deloitte Services LP

is the most highly valued competency. A majority of the workforce lacks the motivation or capability to question leaders' decisions or to provide meaningful analysis to uncover potential problems, but is strong in execution. This combination of VCMs has cultivated a culture that is a machine in the marketplace and highly reliant on its central leadership.

Implementing leadership principles

Due to the different VCMs that permeate these organizations, efforts to implement leadership principles to improve risk management will likely result in dramatically different outcomes. Below, we describe some possible examples of outcomes for Company A and Company B.

Company A: As it tries to achieve its vision of an enterprise-wide approach to risk management, it easily secures enrollment. Individuals across all levels of the organization are invited to debate the issues. The entire workforce sees risk management as critical to safeguarding the value of the enterprise. They voluntarily join the change initiative, are willing to offer their best effort to achieving the mission, and are committed to overcoming any roadblocks along the way. As risk assessment is a core competency of its workforce, the organization easily creates and communicates a consistent language and methodology of risk-related concepts across business units and geographies. Matching its commitments to its convictions, the CEO and board create the role of chief risk officer (CRO) who reports directly to the CEO. As individuals across different roles encounter and recognize emerging risks, communication is center stage. They are comfortable raising difficult issues and overcoming silos to make sure the appropriate individuals are alerted. News quickly reaches the CRO and other senior leaders. When they learn of these threats, they leverage the collective knowledge of a risk intelligent culture to better understand the risks and evaluate the potential costs. As safeguarding the enterprise is paramount, top management immediately mobilizes resources to mitigate these risks and is successful in achieving buy-in from individuals throughout the organization.

Company B: As it attempts to implement an enterprise-wide approach to risk management, securing enrollment is difficult. Individuals on the front lines have little transparency into the decisions of top management. As communication is not a well developed or highly valued competency, top management's message reaches the organization in a perfunctory way, and the message fails to permeate the front lines. Since top management has focused on hiring executors, the front lines are so immersed in executing daily tasks that they don't connect with leaders' efforts to take an enterprise-wide approach to risk management or even recognize emerging risks when they encounter them. The chasm between top management and the rest of the workforce further impedes the speed at which warning signs travel through the organization. When the threat eventually becomes apparent to top management, these internal factors hinder its ability to rapidly assess and respond to the situation. When external stakeholders start demanding explanations for signs of large-scale value destruction, top management frantically tries to recognize, prioritize, and mobilize against a deeper crisis. By the time management is able to piece together information to get a handle on the problem, the situation has spiraled into a crisis. As management tries to mobilize to prevent further spreading of the crisis, it is met with the challenge of coordinating across silos. Despite its best intentions, top management is ultimately ineffective in its risk management efforts, destroys large-scale value, and loses credibility in the marketplace.

The likely divergent fates of these two companies illustrate how VCMs — the building blocks that define an organization's unique culture — can help or impede organizational improvement. Blindly adopting leadership principles without a deep understanding of an organization's VCMs will likely compromise change initiatives and outcomes. By contrast, organizations that proactively shape their VCMs to support the implementation of leadership principles are better positioned to achieve desired outcomes.

The road ahead

Unprecedented interdependencies in the financial services industry may require a move away from the status quo of many leadership strategies, which tend to deal with complexity in a disjointed fashion. Instead, leaders may need to uncover and understand the interconnected root causes of complexity within their organizations and in the marketplace. We believe a focus on leadership principles and the right set of values, competencies, and motivations to support them can help leaders and their organizations systematically and holistically react to and manage their complicated competitive environments.

When applied to organizational levers, VCMs that are well aligned with the leadership principles we have described can help improve how an organization deals with complexity, driving strategic agendas and improving day-to-day operations. Additionally, this approach can help leaders diagnose breakdowns and foster a meaningful dialogue to determine corrective actions.

A focus on leadership principles and VCMs also suggests several fundamental questions:

- Is the company getting a full return on investment from its organizational levers? For example, it is possible to have superlative recruiting processes in place and the right capabilities on the ground, only to embrace an organizational values system that short circuits and squanders the unique potential of new talent? It may help to consider whether there are situations in which VCMs are working counter to the levers in place in your organization.

- Does the current organizational culture support desired change initiatives? Securing enrollment in order to achieve change is very much about VCMs — aligning the intrinsic and extrinsic motivations of the workforce to garner buy in. It can be desperately hard to effect governance changes or to implement new risk processes without broad-based motivation to make these work properly, or a common set of values that positions these changes as the best course for the company and those who work for it.
- What are the competencies needed to deal effectively with complexity? This may be the most difficult question to answer. As discussed above in the 'Company A versus Company B' example, if, for instance, analytical capabilities are required in this new environment, how is the company attracting and nurturing those capabilities? Does the organizational structure enable this or stifle it?

This is not an exhaustive list and the need to manage complexity will continue to grow, placing increased demands on organizations and their leaders. Even as this report goes to press, new regulations are making their way through Congress, and complexity continues to alter the playing field for financial services organizations. New marketplace realities require that all employees in an organization be skilled in managing the inherent interconnections of day-to-day business issues. Leaders should consider modeling this approach, comprising leadership principles and VCMs, across all levels of their organizations to help establish the systems and behaviors required for success in managing complexity in today's financial services industry.



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