IBM Institute for Business Value

The *yin yang* of financial reform

Embracing maxims to enable financial stability and healthy financial innovation

Overview

Regulatory reforms that were triggered by the financial crisis intend to address imbalances in the global financial system. However, these reforms have yet to fundamentally resolve structural tensions in the system. We believe distractions due to market uncertainty and an absence of trust among market participants further inhibit recovery and healthy growth. To mitigate unintended consequences, participants must work together to commit to new maxims – principles that spur a new mindset and guide specific actions.

In early 2009, we published "The *yin yang* of financial disruption," which identified inherent structural tensions within the global financial system and key maxims needed for progress in the new era.[1] Now, we revisit the topic of financial disruption to gauge progress in a currently fragile system. As in our prior report, we focus on a systemic "*yin yang*" – or set of opposing forces – that exists between financial stability and healthy financial innovation. This time, we examine it in the context of financial reform while considering the global system's future stewardship. We believe market participants worldwide should embrace new maxims and commit to change today by rationalizing their portfolio of activities, addressing areas of operating model weakness and transforming destructive organizational cultures.

Today's post-crisis world

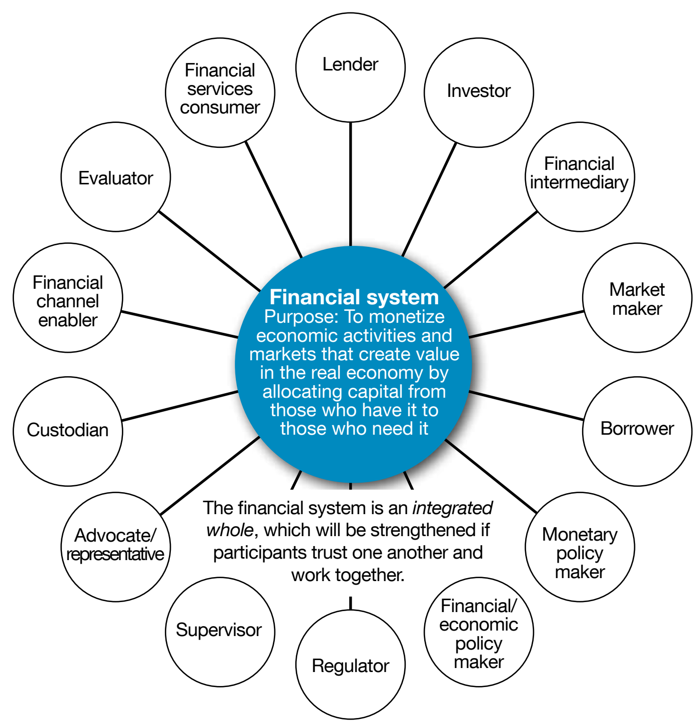
Since the Lehman collapse, a number of changes designed to avoid future crises have occurred – and some progress has been made through structural and operational reforms. However, despite progress, the post-crisis atmosphere has been rife with uncertainty – from uncertainty regarding potential regulatory reforms to questions regarding the very future of some industries. This situation has created distractions from the very necessary task of resolving the structural tensions at the root of the crisis. Although all parties want the same thing, a lack of trust is impeding cooperation.

Avoiding unintended consequences

To balance the *yin yang* of healthy innovation and financial stability, we believe financial leaders must adopt eight new maxims:

1. A shared frame of reference and aligned measures
2. Incentives balancing "returns to society" and "returns to shareholders"
3. Recognition that progress in the new era is not a zero-sum game
4. Transparency, systemic intelligence and proactive management across the system
5. The mindset, insight and means to move beyond today's "herd mentality" and lead
6. Cohesive, streamlined and relevant supervision and regulation
7. Flexible models enabling innovation as powerful instruments of confidence
8. Commitments – "units" of trust – between their makers and their recipients that restore confidence.

When adopting the maxims, market participants must have a clear understanding of and appreciation of their roles in the overall system. No single participant should act without recognizing the system as a whole (see Figure).



Source: IBM Institute for Business Value.

Figure 1: **No single participant should act without recognizing the *system.***

Taking action in support of new maxims

We believe organizations can begin creating an environment where devotion to the maxims is a given by implementing actions that support three main goals:

1. **Rationalize the portfolio:** Governments, banks and financial markets firms must streamline their portfolios according to the organization's role. To effectively do so, participants need to gain consensus on the maxims and pursue reform based on global risk levels and contribution to growth. In addition, they need to identify duplicative or conflicting entities or regulations and underlying legislation.
2. **Adapt the operating model:** In a 2009 survey, 80 percent of financial industry executives cited business and operating model uncertainty as something that keeps them "up at night."[2] Although this "identity crisis" sounds negative, it presents a significant opportunity for organizations to reflect on the emerging regulatory environment and to take advantage of the development of new models, rather than be hindered by them.
3. **Reform destructive cultures:** Destructive cultures can arise from extreme organizational shifts such as mergers or acquisitions or in more subtle ways. For example, a culture clash exists between divisions that are in the business of assuming risk versus those responsible for reducing risk. To overhaul destructive internal cultures, organizations should adopt management structures that provide employee incentives promoting long-term goals and relationships.

A new chapter in financial history

As historians reflect on the recent global financial disruption, might it be viewed as a turning point? If financial system participants can move beyond their distractions and embrace new maxims for change, the crisis could indeed be considered a catalyst that ultimately set the stage for a vital and sustainable global financial system.

How can IBM help?

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