

# Leadership lessons from Global Financial Crisis



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Dear Members,

Hope you found reading our e-review released in September titled 'Learnings from the Global Financial Crisis' insightful, in which we brought to you a scholarly article written by Md. Manauwar Alam and Anuj Jain final year students of NMIMS. Through oversight, the name of the second co-author was not mentioned. We regret the error.

The article in this e-review deals with 'Leadership lessons from Global Financial Crisis' and is written by Col. Raman, Reader at Dr. V. N. Bedekar Institute of Management Studies, Thane. Col. Raman highlights how key failures in leadership across several global organizations during the meltdown act as warning signals, so that organizations could avoid such strategic errors. Col. Raman also highlights how recessions provide an opportune time for organizations to build a strong base for the future.

Warm greetings for the season and wishes for a joyous Deepavali.

**Best regards,**



**Abhijit Phadnis**  
**Chairman, Editorial Board**

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## **RECESSION - A CRISIS OF LEADERSHIP**

### **Executive Summary**

This paper seeks to identify and list out the key failures in leadership across several global organizations during the meltdown. It tries to give the causes for crisis in leadership leading to situations that could have been avoided and prevented the downfall of organizations and should therefore serve as a warning for organizations in future. Finally it shows how a recession is actually an opportunity for leadership to increase its accountability by promoting programs in order to modify financial behaviors that directly support the board's agenda to cut expenses while increasing margins. By adopting such approaches, the leader can put in place programs and behaviors that not only rapidly improve short-term financial outcomes, but also put in place a framework for longer-term increases in profit quality and financial performance.

### **Introduction**

The world watched with utter shock and dismay, the unfortunate events of September 2008 when the US market saw its worst time in several years leading to the fall of many stalwarts of its financial empire. Notable among them was the filing for bankruptcy by Lehman Brothers. Others who suffered severe losses were Bears Sterns, Fannie Mae and Freddie Mac. The amount of money that vanished as a result of the stock market crash on a single day that month was close to \$1.2 trillion – which is more than double that of the cost of the US campaign in Iraq to date. The immediate reaction to this was that the US Government went into frenzy, trying to bail out the financial institutions in order to save the economy. However, the cascading effect was felt so strongly in stock markets all over the world that it led to a recession in most economies across the globe and shattered the confidence of many major financial institutions. This led to a meeting of G-20 nations in April 2009 to take decisive steps in order to bring back confidence of the world at large, take responsibility for the actions and suggest long-term solutions for the future.

A major overhaul of the entire financial system has resulted since, to include greater transparency and reduce profligacy amongst the higher echelons of the corporate hierarchy. A new world order is now in the making, but whether it will be merely a cosmetic change to the capitalistic order that led to this crisis, or a lasting solution to the problem, only time can tell. However, what emerged clearly at the G-20 meeting was that there was a need to establish cooperation between countries and develop a financial framework that met international standards of ethics and transparency.

## **What caused this crisis?**

The immediate cause was the collapse in American house prices, which had doubled between January 2000 and August 2006, and have since fallen by 20%. More than 1% of American households have defaulted on their mortgages.

Almost a quarter of mortgages were "sub prime" meaning they were not verified as credit worthy and financed by the issuing of "residential mortgage-backed securities" rather than by traditional bank loans. The bonds were then sold to investors, pension funds and councils all over the world. Those buyers have since lost not just their anticipated interest but also much of their principal.

The bonds were also used by lenders to raise money through repo agreements - a contract in which one finance company sells another a bond in return for cash, and is then obligated to buy the same bond. By August 2007, so many households had defaulted that the bond prices began to plunge, and suddenly lenders refused to accept them as collateral for loans.

The wholesale money market collapsed, and the credit crunch began. The long-term cause of the crisis was the dramatic growth in private debt in America - from a low of 37% of GDP in 1945 to 290% now - and across the OECD. The sub prime fiasco was the final stage in a process that has seen lending extended to progressively riskier and less viable borrowers.

This final lending spree drove both stock and house prices to historically unprecedented levels, from which they are now falling, bankrupting both borrowers and lenders.

The long-term problem is that buyers of these bonds are getting far lower returns than they expected from their investments. The money they used to buy the bonds has essentially been lost. They will have far less income - and far less capital - than they had anticipated and may face bankruptcy.

The more immediate problem is that, when the financial bubble was at its biggest, these bonds were the mainstay of the repo trade. Now no one wants to buy a bond in case the seller is unable to buy it back as promised. The repo market has therefore dried up, and the bonds are effectively worthless.

If they were instead valued at what they could be sold for, which was next to nothing, the recorded value of those companies' assets would fall, making them effectively insolvent and unable to lend. Their managers live in dread of some event forcing them to do that - such as a distress sale by a company trying to avoid bankruptcy.

This is why the US rescue plan was devised: to buy these toxic bonds, euphemistically called "troubled assets", before the financial institutions were forced to value them.

## **Failure of Leadership - “ the rot at the top”**

Wharton management professor Peter Cappelli says this type of lapse in leadership dates to the 1980s when companies began to focus on aligning executive incentives with shareholder interests. He believes an excessive focus on individual financial goals, at the expense of managing in the best interests of the company overall, is at the root of the leadership debacle that has rocked the financial services sector.

Cappelli says, “too many managers simply choose not to lead”. He says managers believe that if they hire smart people and provide huge financial incentives for individual results, management of the firm will take care of itself.

Surveys by MBA students who had worked in finance, and particularly in investment banking, according to Cappelli, indicate that managers in these fields are particularly harsh and ineffective. These managers provide little feedback, expect long hours in the office even if they are not productive and destroy an employee's work-life balance. The long hours make up for management's lack of discipline and planning. All the problems were smoothed over by bonus money, based on individual performance. According to Cappelli, "Taking risks to achieve one's individual targets, even if it puts others or the organization as a whole in danger, seems acceptable. Covering up failures becomes the norm."

Top-level managers too often focus narrowly on issues that concern their organizations and do not pay enough attention to what is going on across their industry. According to Prof Donaldson of Wharton in the Department of legal studies and business ethics, “these problems are so tightly connected to broader problems in the overall financial services and banking industries. Everybody in those industries needs to be better attuned to slowly percolating [crises] and ethical issues."

One thing that can be told with confidence is that the next big ethical disaster to befall an organization is going to be one that will affect most of the people on the board of directors and the top management, too as predicted by experts. . "That's all the more reason for being more vigilant and for setting up processes, especially at the top levels of leadership, to allow people to talk about some of these things that are hard to talk about."

In today's business climate, it often takes the board of directors to make a course correction when a company is on an illegal or irresponsible heading, according to Prof Cappelli. But that happens rarely, and typically only if some of the board members are veterans of the period before executive compensation was tied to stock price. They are more likely to recognize and point out "that what's going on now is peculiar." But he's hopeful about the new generation of business leaders who entered

the workforce over the past 10 years and are more oriented toward working in groups. They are not likely to let extreme individualistic behavior push entire markets into taking ever-bigger risks just because their competitors are doing so. Cappelli attributes this mind-set to changes in the educational system initiated at the request of business, which needed more people who were able to attack complex problems in a team structure. "It's not so difficult now to talk about a team-based, effort-and-reward system in which a group takes responsibility rather than just an individual."

Prof Donaldson has helped companies develop a system in which a trusted senior executive is designated as a sounding board for employees who don't want to put their careers at risk with a public campaign, but are concerned about broad-based unethical behavior. Many firms have ombudsmen, but they are usually lower down in the corporate hierarchy. He suggests that companies should designate a senior manager to be open to these types of conversations in order to assess and protect against potentially damaging reputational risk.

U.S. businesses need to be aware of what a tribe in New Guinea called "mokita," or the truth that everybody knows but agrees not to speak about, Donaldson advises. "When it came to sub prime and many of the other problems that have tripped up Fannie Mae and Freddie Mac and so many others, there was mokita."

Eric Orts, a Wharton professor of legal studies and business ethics, worries about the so-called "moral hazard" created when financial services companies get a government bailout to stave off widespread economic disaster. Such rescues may contribute to weak leadership, because "markets for efficient organizations work only when they are allowed to correct and punish mistakes and mismanagement. ... Some of the current examples of very large government bailouts are setting bad precedents for the future." He concedes some bailouts may be necessary to prevent a broad collapse of the financial system, but the need to take such extreme measures is a clear indication that a regulatory overhaul is necessary to reduce the long-term economic risk to taxpayers.

### **Recession - A Blessing In Disguise (actually)**

Great leaders must however, understand that the current financial crisis is the ideal time to create and nurture leadership development. Great changes in most spheres of human activity are often born out of crisis, rather than in better times when predictability breeds satisfaction and complacency.

Many studies show that firms that come out of a recovery in a position of advantage and this tends to keep it far into the recovery period. This is because they go into recessions strong: they managed their finances conservatively in good times and have ample cash on hand entering bad times. But even if

that is not the position, one can still turn this recession to advantage by thinking and acting strategically in ways that challenge one's ingenuity, openness and leadership habits more than one's finances. The following tips can prove very useful to leaders during trying times:

- (a) **Always keep an open mind** A recession is no time to close your own thinking. In fact, it is time to open it up. Even if you had a winning formula going into the recession, allow yourself the privilege of questioning your assumptions. Always ask yourself: "What if..." and explore possibilities. Connect with leading idea creators whoever they may be. Read more than ever before, look for trends and ideas that you have never explored before. Spend a little of that money that you have earned in better times to go to a conference you think you would have skipped before because it was not core to your business – new ideas, new approaches and new people will be perceived at the edge of your vision, not the center. Make yourself understand and use the social networking technology you have been ignoring because it really and truly will open up your world. Use these insights not only to understand your own situation better, but to anticipate problems that your best of future customers might be facing. It will also allow you to connect into that now famous "crowd" that really does have some good ideas.
- (b) **Invite the best people whom you know:** This way you will build empathy and loyalty with your customers and other key stakeholders. You never know when you may need their support or sufferance as this recession drags on. It is also very likely that they will have some good ideas for you. Customers influence strategy when their needs and experiences connect to employees throughout your organization. That may have been happening before – but do you still understand each other? Their needs have doubtless changed. Make sure you still know each other.
- (c) **Look to engage each and everyone:** The temptation to huddle down with your exclusive group of trusted advisors may overwhelm you. Don't do it. Take some advice from anyone and everyone. You need to engage others within the organization in developing your strategy. Why? Because each member of the organization also wants to survive, and may be able to add a lot to the strategic process if you let them have a voice. This is true especially if the organization has experienced a lot of change in respect of downsizing or restructuring.
- (d) **Encourage strategic thinking at all levels:** Strategic leadership also requires embedding strategic capability throughout the organization. Strategy is often delegated upward to the CEO or senior management team, which have a legitimate responsibility to shape the direction of the entire company. But strategic thinking comes when employees at all levels of the company not

only understand where the company is going, but they are excited by it, remember it, and know what to do to make it happen in their day-to-day decisions. They will have valid points of view about how the strategy will be operationalized internally, including which difficulties need to be overcome and how.

Remember: great companies are built over decades, and recessions come and go. If you act as if you are in it for the long haul in terms of your own thinking, and your relationships with customers, employees, the community and investors, you are much more likely to make it there.

### ***Tips for good leadership***

We're in the midst of the worst economic crisis in decades, and many people in leadership positions haven't seen anything like it before. Very often, leaders make decisions out of fear of what could happen instead of crafting a plan to ensure that everyone stays on track through the bad times. Surviving a recession can feel a bit like sailing without sails, so here are a few tips to help you stop, think and weather the crisis:

- (a) **Seek to manage Anxiety:** Workplace cultures are sensitive. Employees get nervous when the economy turns sour: They wonder if they'll have a job tomorrow, let alone next week. If it isn't managed properly, such anxiety can pervade a business and have disastrous ramifications. Leaders have to assume a role beyond juggling their usual responsibilities to curtail fears about the future
- (b) **Take that well deserved Break:** Even though leading an organization through a recession requires special effort, working yourself to death won't make it any easier. Don't be afraid of daydreaming during a long overdue break. Recent research has found that the human brain is actually working overtime to solve problems during daydreaming. So, go ahead and take that break to clear your mind. It might be a much better way to solve dilemmas than focusing on them all day.
- (c) **Learn to Delegate:** Learning to delegate work is important because it means that someone else is doing what you've probably done for years. Most leaders don't delegate because, at some level, they believe they can do the work better and faster. This thought process isn't useful and can reflect a micro-management style that is especially hard to maintain when times are tough, and employees are nervous. There is a link between feeling comfortable delegating work and emotional intelligence. Perceptive leaders are better at reading people's natural talents and letting them take risks.

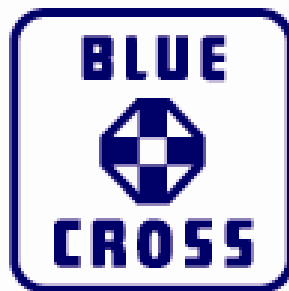
- (d) **Rediscover the art of Simplicity:** Human beings often do things a certain way out of habit, not because it brings about the results we want. Many leaders are so busy that simplicity gets lost in their approach to work, but hard economic times can be a reality check for businesses and make inefficiency obvious. The "Keep it Simple, Stupid" (KISS) principle has been around for a long time for a long time with a reason.
- (e) **Restructure now :** Above all, leaders must create well-knit, confident teams to survive the recession, but there's no point in following the above principles if you have the wrong employees. Consider the time you spend trying to make difficult employees fit in with your workplace, instead of investing time into ensuring your business can work towards its larger goals. Take the time to get good people in place now, and with so many talented people out of work, this may be the best time to think about hiring. The recession will end, and when it does, you will want to emerge with the best team.

## Conclusion

In this paper, we have seen how greed can cause a global crisis and what its cascading effects can lead to. We also now know how adversity can be used to come out stronger and wiser and how leaders can learn from their mistakes. Lastly, we must remember that every cloud has a silver lining and this period of tough times has taught us to realize that we can do with much less than we think we need and that there are many things that can be enjoyed in life that do not cost a penny. Most important, we have learnt the value of time and how it can be utilized effectively.

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