THE NEW change equation

Many leaders who want their companies to change look for a quick and easy formula. **Michael Jarrett** believes such an approach is flawed from the start. Far better, he argues, to understand how change really happens.

It is not the strongest of the species that survives, nor the most intelligent that survives. It is the one that is the most adaptable to change. – Charles Darwin

Change means different things to different people. To the CEO, it may mean increasing profits, cutting costs, or saving the business; to you or me, it may mean no more or no less than keeping or losing our job. That is why change is so profoundly unsettling. And the less control we have over the change, the more unsettling it tends to be.

Of course, not every organizational change is job-threatening. A dictionary definition of change is "the act or an instance of making or becoming different; an alteration or modification". This suggests, entirely accurately, that change comes in many shapes and sizes. Indeed, the word *change* is used to cover a multitude of situations: everything from the mundane – putting on a pair of clean socks – to the profound physiological alterations that occur during midlife. Organizational change, too, comes in different degrees and guises. I distinguish between four main types:

Temporary change For a time, it looks as if things are going to change, but the organization reverts to type and nothing happens. Any initiative quickly peters out, often after creating false hope. The organization is simply not ready for change.

How often have you seen the Big Bang approach to change, in which considerable time and effort is placed on announcing the forthcoming strategic agenda and how everyone will gain from the benefits – yet life remains the same? In such instances, the illusion of change substitutes for any reality. More damp squid than big bang. Employees feel disappointed and let down. It's something they have heard before. Soon lethargy and mistrust seep in and turn to chronic cynicism. The situation becomes toxic; only radical surgery can fix it.

Incremental or process change This sort of change aims to provide some small improvements. It is easy and quick to implement, and you get quick returns. The risk of failure is low, but so are returns in terms of benefits. Incremental change means operating within strict controls to gain efficiencies from your company's system of organization. Fine-tuning a winning formula usually characterizes this type of change.

You know the sort of thing. In one study, for example, a call centre in Sunderland increased its productivity by 20 per cent by introducing simple measures that included staff training and the implementation of new software. Similar results of incremental changes and training showed increased sales. Overall, in this separate study the company produced an extra $110.25 per month per sales agent, for a 500-seat call centre. Over a year, that translated to an estimated $661,500 in sales. This sort of incremental change is useful – worth having, certainly – but unlikely to transform the organization's competitive position.

Special report

Organizational restructuring Here, the change focuses on fundamental systems, structures and relationships within the business. The introduction of a new sales force to increase market penetration is a typical example. These changes can take up to a year to embed depending on the scale. The risks increase, but so do the rewards.

Supermarkets that add an online distribution channel are examples of this form of change. The UK retail chain Tesco was among the first to move to an Internet strategy on a large scale in the retail grocery market. In the initial phase, it meant restructuring the company's distribution channels to get the best returns from its existing assets. The company tended to pick groceries from existing stores that acted as local hubs. It had to implement new structures and systems to meet the needs of its new online customers.

Transformational and cultural change Programmes of this nature aim to redefine the organization's strategic direction, cultural assumptions and identity. Examples include IBM moving from hardware to software, Polaroid moving from film to digital photography, and BT moving from telecoms to becoming an Internet provider. Larger-scale change initiatives such as these yield greater returns, but the risks – and stakes – are also much higher.

Nissan was a car company in deep trouble at the beginning of the 2000s. It had $17 billion of debt and looked like another casualty on the rocks of change. Carlos Ghosn took the company reins and completely transformed it. Within four years, Nissan was one of the world's most profitable automakers. The cultural and strategic changes Ghosn implemented marked a transformational change. He took a deep cut at the heart of the organization's DNA and rewired it to meet the challenges of the fiercely competitive and cost-conscious auto industry.

Readiness for change

In my experience, one of the things that goes wrong with change programmes (again and again!) is that organizations and leaders fail to reconcile or even understand their internal capabilities and the complexity of their external worlds. They either respond to a change in the external environment without thinking of the internal repercussions or attempt to force through changes that make sense internally but no longer fit the context.

It doesn't have to be this way.

Managers who achieve successful change do something different. They may not consciously know they are doing it, but they are doing it all the same. They are selecting an appropriate change strategy, one that matches their internal capabilities and their external challenges. My research shows that the best predictor of the success or failure of organizational change is *readiness for change.*

What do I mean by this term? Readiness for change applies at the philosophical level – being open to and prepared to embrace change; but it also applies at the practical level. Readiness applies to those organizations that have developed a set of core dynamic and internal capabilities that allow them to adapt when faced by external demands. It is the precursor to those organizations that gain strategic agility. Basically, successful change is a function of how well an organization's internal capabilities – its management capacity, culture, processes, resources and people – match the requirements of its external environment, the marketplace.

The secret to the management of change is not only what happens on the outside – it is how we respond on the inside: as leaders and as organizations. This is the essential lesson of managing change. To make change stick, we must have organizational readiness. In Louis Pasteur's words: "Chance favours the prepared mind." It is also true that organizations with high levels of readiness favour change.

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So if you want to succeed at introducing change, you need to understand that different situations demand different strategies of change. Simply put, you need to appreciate the change equation: *internal capabilities + external environment + strategic leadership = a change strategy.*

Look inside

How does a leader successfully implement far-reaching changes across an organization in the face of external dramatic demands? This was a question I asked Richard Ward, who served as CEO of the International Petroleum Exchange (IPE). Richard started his career as a scientist and an academic. His razor-sharp thinking meant he quickly grasped the complexities and rhythm of the business world and was able to spot trends. So, was he fully prepared for what happened when he announced, in spring 2005, that the IPE oil exchange would be changing from "open outcry" on the floor of the exchange to electronic trading using terminals?

The change – a seemingly inevitable update given technological advances and increasingly global finance – met with unexpectedly →

Special report

→ violent opposition. At one point, Richard found himself seized by the throat and pinned to the wall of the men's toilet. At the other end of the burly hands was one of the traders from the floor of the exchange. He was six feet tall and all he could see was the end of an era.

The trader had worked at the exchange boy and man. He was good at his job and made outstanding money. It was his life. The "open outcry" on the floor represented years of tradition and ritual – men in strangely coloured coats, shouting and accepting bids in a cacophony of yells and excitement. But, to say the least, he was not prepared for change. Nor was the organization he was part of.

The context was a true reflection of Adam Smith's "invisible hand" of capitalism: information was widely known by all; exchange was at a fair price; there were lots of buyers and sellers. It was a perfect market driven by the animal spirits of supply and demand. Now someone was going to change it all and replace it with electronic placing. Why replace a perfect system for one that was, granted, even more transparent, quicker and easier to do business, and that allowed instant access to aggregate data? What was Ward thinking?

Indeed, many of the traders on the floor rejected the Big Brother changes and regarded the switch to electronic placing as heresy. They saw no advantages in the new system. It would take the heart and soul out of the process, they argued. It meant the end of an era. They announced their intention to fight the change to the bitter end, and they did.

Let's be clear. The idea of moving to electronic placing was a good strategic decision. The trends and moves at other major markets, such as the New York Stock Exchange, meant that IPE needed to respond to the times. So, it was a sensible strategy, but waiting in the wings was the potential for it unravelling into chaos and despair.

Given the patent need for change and the internal opposition, how did Richard Ward and his team make it work? Clearly, they had a long haul. Along the way, he successfully helped to navigate two strands to the change strategy. The first was the external environment. Constant vigilance and extensive networks provided him and his small change team with the information and resources they needed to structure the right deal within the current climate of hostile competition, a drive for cost saving, and the onslaught of technology across the world's major bourses. Operating and negotiating with a network of agents, brokers and stakeholders maintained good relationships in the market.

Managing the internal capability was also part of his secret. The need for change was properly communicated and understood, thus addressing initial major concerns. They closed the trading floor, provided more access points through computer terminals to increase the transparency and speed of trading, reduced errors and provided a secure base for the market. He involved internal stakeholders and eventually managed to find the critical mass to make the changes work.

The changes took place in a hostile environment, but the top team managed the external and internal worlds of the organization – and produced a successful outcome. The secret to their success: devising a change strategy that aligned and developed their internal capability with the pressures of the external demands.

Ward is not alone. He was smart enough to react and correct things, but his experience emphasizes the point that most strategies fail not because of strategic analysis but because of poor implementation. Preparing an organization *internally* is absolutely essential to the change equation.

Look outside

There are at least five external factors that also affect a change strategy. These may be outside of your direct control, but you *can* influence them. Essentially, these external dependencies change the rules of the game and the way companies create value. Often, when external factors threaten, the challenge is to change or die. There are a number of different types of external challenge. They include the following:

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Failure to keep up with changes in disruptive technology For example, Polaroid's failure to respond to the threat of digital photography led directly to the company's decline. Failing to keep pace with changes in your industry can take you by surprise and lead to competitive advantage suddenly disappearing. Look at how IBM lost its advantage in its traditional hardware market. Even so, it is a positive role model for what can be achieved through change – witness its reinvention over the last decade from hardware to consulting.

Reliance or dependency on other organizations for crucial resources or assets Think of outsourcing: you can find yourself locked into particular situations and expectations in which who owns what and who is responsible may be impossible to establish. This happens more regularly than you might think. A rail company with which I worked had previous and long-standing investments that meant that the infrastructure was slow to respond to new demands in transport. The company couldn't do what it wanted.

New political and legislative demands Deregulation in the US airline industry led to established companies such as TWA failing to survive. The Sarbanes-Oxley Act of 2002 increased industry concentration among the major US accounting firms. Privatization in some countries is a shock to the system for public-sector organizations.

Underestimating competition from unexpected places Many petrol stations now offer food, for example, and compete directly with small grocery shops. Microsoft developed the Xbox in part to stop Sony coming into its space through the back door of the online Sony PlayStation. Microsoft (with some $60 billion in revenue) did the same in bidding for Yahoo against Google, a company that is considerably smaller (around $20 billion) but one that continues to be perceived as a strategic threat. Some of the biggest threats to financial-service organizations in the United Kingdom come from large supermarkets like ASDA, Tesco and Marks & Spencer. These high-street brands can offer retail lending to consumers much easier than traditional channels can.

Environmental volatility, market and economic trends and other contingencies The tumult in global stock markets starting last October made it clear just how fast things could change for companies overnight. Yet, head-spinning change is always a risk. I recall undertaking a large consulting assignment for a Malaysian oil company at the end of 1995. In just three weeks, the Malaysian ringgit spiralled downward, losing nearly 25 per cent of its value. When there's a mega-shift in the marketplace, individual firms have little or no control over their fortunes; and it is industry or economic shock waves that finally determine those parts of the market that survive and those that die.

These are just five of the innumerable external factors that can directly influence a change strategy. While no company or its leaders can alter, for example, the devaluation of a national currency, what's critical is for leaders to be aware of – *and be ready to compensate for* – such major external events. A ship that leaves port with no plan or provisions for a major storm is a doomed vessel.

Look for leadership

A lack of strategic goals for change is also a major point of concern. Without the big strategic planks and the road map that follows, change is impossible to achieve. The strategic goal sets the compass for change and provides a beacon for the organization to steer by. All of this comes down to the presence or absence of one factor – leadership.

The insurance industry is populated by companies that stand or fall by how well they can manage change. Insurance companies are always asking a standard question: *what is the best way to manage large and unpredictable risks?* This was precisely the issue that focused the mind and energy of specialists and managers at Swiss Reinsurance, one of the world's largest reinsurance companies. The company actually rephrased the standard question into one that was directly relevant to their own success: how can unusual risks be underwritten by placing them back on the open financial markets?

Hurricanes in Florida or floods in the Indian subcontinent are infrequent but major events. Techniques in alternative risk transfers marked a small but new territory, and the group had restructured to make its mark there. The company set up the Financial Services Business Group (FSBG) in 2001, and an integration programme swiftly followed to capture the benefits as quickly as possible. Most commentators agreed there was scope for these types of products but mobilizing the market would not be easy. Every minute mattered.

FSBG set up a small change team to make the transition as smooth as possible. Jacques Aigrain, head of the group, did all the right things to start with: he set out the strategy with his top team and created an organizational structure to draw on the advantages of the group's core competencies in reinsurance and investment banking. The agenda for change was clear, and everyone started to go through the usual step models of change: creating a sense of urgency, building a guiding coalition, and so on. But it soon became apparent that, in this case, small steps would not allow the company to make the required leap. Bold leadership was required.

Aigrain, working with the company's CEO, John Coomber, did many things. Among those that made a difference, the company joined forces with the Centre for Health and the Global Environment of Harvard Medical School and the United Nations Development Programme and actually hosted a conference that brought *all* major players in the insurance world together. As summarized by referenceforbusiness.com: "World leaders in the fields of business, government, and science met in late 2003 and in the spring of 2004 to discuss, define, and strategize. Among those present were representatives of Swiss Re, the Allianz Group, AON, Goldman Sachs, JP Morgan Chase, Johnson & Johnson, BP, and the Association of British Insurers.... As a result of the discussions the participants stated that they would work to increase their knowledge of these new risks to identify proactive responses. They agreed to work individually and in concert."

And, to their credit, Swiss Re did all this while also becoming a better member of society. It committed itself to a 10-year programme to become "greenhouse neutral" by combining emission reduction measures aligned with investment in the World Bank Community Development Fund. One news source declared that Swiss Re thus established itself as the world's largest financial services company to set such a goal. But such leadership was not easy. It never is.

On the very page of the Swiss Re website announcing that Aigrain would succeed Coomber as CEO, there is a telltale statement about how the company views the need for *constant* change as the only way to cope →

→ with numerous factors affecting any insurance business. Swiss Re provides an 18-bullet-point list of items the company needs to watch carefully (see right). The list is worth including here, as it helps to make a key point.

I cite the bullet-point list to demonstrate that wise leaders plan appropriately for both *internal* and *external* factors that can influence a company's destiny. Or, as Swiss Re says at the bottom of the webpage: "These factors are not exhaustive. We operate in a continually changing environment and new risks emerge continually." Thus, perhaps the first and most important thing that leaders must attune themselves to is to disavow, once and for all, the myth that change is simple to understand and can be managed by logical, incremental steps.

Factors to watch

- Cyclicality of the reinsurance industry
- Changes in general economic conditions, particularly in our core markets
- Uncertainties in estimating reserves
- The performance of financial markets
- Expected changes in our investment results as a result of the changed composition of our investment assets or changes in our investment policy
- The frequency, severity and development of insured claim events
- Acts of terrorism and acts of war
- Mortality and morbidity experience
- Policy renewal and lapse rates
- Changes in rating agency policies or practices
- The lowering or withdrawal of one or more of the financial strength or credit ratings of one or more of our subsidiaries
- Changes in levels of interest rates
- Political risks in the countries in which we operate or in which we insure risks
- Extraordinary events affecting our clients, such as bankruptcies and liquidations
- Risks associated with implementing our business strategies
- Changes in currency exchange rates
- Changes in laws and regulations, including changes in accounting standards and taxation requirements, and
- Changes in competitive pressures

Source: www.swissre.com

Myth of change

The myth of change is that it can be done in steps. This assumes it is a planned, controlled process. My experience is that major change is interactive, complex and nonlinear, undermining all traditional assumptions of change management. Emotions *will* run high, as will political machinations. Change is emergent; it cannot be controlled.

Forget the books and articles that espouse that change is easily managed. This view is based on fundamental assumptions about the world: stability, certainty, homogeneity, and centralized sources of power and authority. We now live in a fast-changing, post-modernist world; complexity, uncertainty and difference are parts of the norm. Sources of power as well as expectations of employees and consumers have shifted; today, emergent, interactive processes yield results. Wise leaders avoid simple-step models.

Today the environmental landscape can shift quickly, unexpectedly. Models of change that use recipes provide useful frameworks but are insufficient. They can be static, unresponsive to outside influences and oversimplified. They can miss many subtleties and undercurrents; in some cases, following steps can do more harm than good. Thus, change models need to be contingent upon a firm understanding of the external environment and a grasp of your internal choices. Change is a function of external dynamics and internal capabilities; and, significantly, success or failure is often determined by the interaction between the two. Strategic leadership must be present or the interaction between external events and internal capabilities will never synchronize into success. There is, indeed, no easy formula for managing change. This, however, is the new change equation.

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