BANKS, CREDIT AND CULTURE

Cross border lending and credit ratings, their effectiveness and the impact of cultural differences.

Volume 1

A thesis presented by

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In partial fulfilment of the requirements for the degree of Doctor in Business Administration

School of Management
University of Bradford

2005

Key words:

Banks, credit rating, Basel II, culture, agency theory, intermediation theory, cross border lending, information economics, adverse selection, and country risk.

Abstract:

Having the author been involved in banking and finance for almost 25 years, this thesis intends to reflect on the role of banks with emphasis on cross border lending and credit rating, their effectiveness and the impacts of cultural differences. Perhaps this would not differ substantially from a researcher or a scholar, yet the exploratory approach taken in this research will be somewhat different as it deliberately seeks to answer a number of questions relevant to practitioners in today's banking. In trying to achieve this goal, this thesis hopefully may find its way to international bankers wondering about the perspectives of their business in general and their profession in specific. It even may perhaps improve the understanding of their clients.

The Basel committee which published the new Basel II framework on bank regulation and supervision was the result of long and careful discussions, wide consultations and comprehensive impact studies. Whereas Basel II covers the entire risk profile and supervision of financial institutions, this research is limited to the cross border lending by banks to companies and provides the views from both practicing international bankers and their customers on their

expectations regarding Basel II, credit rating and the relevance of context and culture differences.

Bankers all over the world are being trained on how to read balance sheets, yet less attention is being paid as to by whom they are being created and how precisely these balance sheets came into existence, other than the accountancy standards applied.

Bankers furthermore seem to agree on the fact that credit risks in large part are related to the management competencies, effective corporate governance and integrity of management and organization. The argument could be made that the assessment of management capabilities, governance and integrity may be hindered in those cases where the culture is little understood.

In a three days conferences titled; "The Future of Relationship Banking", 80 senior executives from international banks and large companies were gathered in Punta del Este, Uruguay and were asked to speak about these aspects. A transcript of the conference is provided as annex to this thesis (Annex 1) and serves to triangulate the findings of the research. Main findings of three management papers were presented by the researcher during the conference. A survey was performed during the conference and in addition, through an online survey, in total over 100 practitioners in the field participated in the survey. Results show a variation of conclusions, but very especially seem to confirm the view, contrary to the approach taken in Basel II, that cultural differences and context are felt to be highly relevant in cross border lending.

What is a DBA;

The DBA or Doctor in Business Administration can be described as an alternative route to a doctorate (Ph.D.) in management. Whereas the profile of a Ph.D. student tends to be more academic, the profile of a DBA candidate and the nature of the research project are different. The DBA program at the University of Bradford is designed to attract practicing managers, who would use the workplace as a testing ground for their research. Ph.D. students often do not possess working experiences. The commonalities and differences are explained in the following table:

Table 1 Outline of differences DBA and PhD

<table>
<tr><td colspan="2">Common Ground DBA and PhD
• Academic Research-based degree
• Internationally recognized
• Four year program
• Internal and external supervision</td></tr>
<tr><td>DBA – Academic Professional</td><td>Ph.D. – Professional Academic</td></tr>
<tr><td>• Professional doctorate
• Peer Group meetings with fellow DBA’s
• Prepares for strategic business leadership or academic career
• Makes high calibre general managers
• Leading change
• Taught in the USA and UK</td><td>• Academic doctorate
• Solitary quest
• Prepares for Academic career
• Analysis
• For Academia
• Offered worldwide</td></tr>
</table>

(1) Adapted from Nimbas/Bradford DBA program 2001

Requirements of a doctorate thesis:

The term thesis refers to an orderly and scholarly presentation of an argument. It is the core submission to the examiners by a candidate seeking a research degree. Although there are no universal standards for a thesis, it usually requires students to make a substantial contribution to knowledge in a specific field of research. It should therefore also reflect the standards of originality required for a doctorate (University of Bradford, Butler module 1).

A thesis furthermore should take the reader through an argument and needs to be in conversation with existing literature in the chosen fields of research. Whatever the method used and whatever the problem investigated, we need to understand how other scholars and practitioners have thought about similar issues in the past and how we can build upon this understanding, sometimes referred to as a body of knowledge, to develop improved insights and methods and thus make a contribution to science, even if very small.

This is important and reading through the thesis you will regularly find references to other publications, such as books and academic journals and other public sources. The purpose of this is to guide the reader through the structure and the arguments of the thesis, such "in conversation" with previous findings. Academic requirements furthermore demand that only evidence and findings of research do matter and that personal opinions, feelings, or impressions should be avoided as much as possible.

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Acknowledgements:

My deepest gratitude to Dr. Josephine Borchert, President of NIMBAS and Dr. Eva Niemann director of DBA studies at NIMBAS for their encouragement and for getting me started in this rather long, yet very stimulating four year journey. I am also deeply grateful to Professor Dr. Ruud Lubbers, three times former Prime Minister of the Netherlands, former professor of Globalization, and High Commissioner for Refugees of the United Nations (2001-2005) for having accepted me as one of his Ph.D. students at the Tilburg University for a period of two years.

Thanks to the many Lecturers and Professors of the University of Bradford during the two years of the MBA (graduated 1995) and the four year DBA program and especially Dr. Wendy Olsen who, during her courses on Philosophy of Research in social sciences and humanities, provided me with the most vital foundations upon which all knowledge and science rests and which has permitted me to see things differently and thus to learn. Thanks to my fellow DBA students of whom I have learned so much, whilst I enjoyed their originality, intellect and their immense source of positive energy. Special thanks to my very dear German friend, Dr. Oliver Breiden who has been very helpful in assisting with the technical implementation of on-line survey. Similar expressions of gratitude are extended to my dear friend Dr. Craig Allen, who smartly combines teaching at the University with surfing in Hawaii and who has been helpful with the technical approach for the statistical part of the research.

I should especially mention the support received from the colleagues of FMO (Financiering Maatschappij voor Ontwikkelingslanden) in The Hague, The Netherlands and DEG (Deutsche Entwikkelungs Gesellschaft) Cologne, Germany, and in particular Mr. Nanno Kleiterp, Chief Operating Officer of FMO and Mr. Hendrik Luhl, Managing Director Latin America of DEG, for their encouragement, contributions and financial support in order to organize a three-day conference in Punta del Este, Uruguay (March 2004) during which almost 80 senior executives from international banks and companies from Germany, United Kingdom, The Netherlands, Belgium, Brazil, Argentina and Uruguay gathered. I thank all the participants in my research for having participated in interviews and in surveys in order to be able to complete this research.

I also thank all those who have willingly accepted to give presentations during the Punta del Este conference on topics which were without exception related to this DBA thesis and for having taken the time and energy to read through one of the several management papers on the various subjects. I would like to thank in particular the following persons for having made their contributions during the conference: Mr. Ricardo Zervino, actual President of Fanapel S.A. and former Minister of Finance of Uruguay; Mr. Rafael Bonasso, Commercial Director Rabobank International; Mr. Janos Bonta, Regional Manager Latin America FMO; Mr. Karl Weinfurtner, First Vice President DEG;

Mr. Daniel Bertone, General Manager Asociacion de Cooperativas Argentinas; Mr. Roberto Gazze, CFO Vicentin S.A.I.C.; Mr. Bengt Hallqvist, former President Volvo Latin America, co-founder and President of the Brazilian Association of Corporate Governance; Mr. Jan Portegies, Senior Investment Office FMO; Mr. Fred Arnold, Senior Vice President KBC Bank; Mr. Juan Diego Ferres, Director Granol; Mr. Paul van Heerde, Managing Director ING Bank; and Mr. Hans Hanegraaf, Director Global Head Soft Commodities Fortis Bank.

My gratitude and warmest feelings for my colleagues and partners, who have unconditionally supported my ambitions with this research. Very special thanks to Psychologist Lic. Maria Sola, for having assisted me with the research, the documentation, the interviews, and the surveys and for her help revising and correcting the various drafts and papers. A very similar expression of gratitude is extended to my secretary of over 15 years, Mrs. Nathalie Rippe, without whom I would have gone astray so often.

Thanks to some of the giants of science on whose shoulders I have tried to rest and to gain some humble knowledge.

To Professor Dr. Richard Welford who has inspired me all along as supervisor to my research project and stimulated me as one of the most inspiring economists I have ever met: thank you for everything.

Last but not least, thanks to my very dear parents and all other members of my family and friends for always having questioned my intellectual capabilities. In this way they became a source of inspiration.

I have dedicated this work to my children Moshe and Capone who have been my prime motivators all along.

And thanks to you Fiona for being where you are.

“The ideas which are here expressed so laboriously are extremely simple and should be obvious. The difficulty lies, not in the new ideas, but in escaping from the old ones, which ramify, into every corner of our minds” (J.M. Keynes, The General Theory, l973).

“The facts all contribute only to setting the problem, not to its solution” (L. Wittgenstein, Tractatus, p. 149).

Chapter 1. Introduction and development of Theory

1.1. Introduction:

The relationship between banks, credit rating and culture is not an area that has been thoroughly explored by scholars and practitioners. Cross border lending, however, cannot be undertaken without crossing cultures. This research explores this particular relationship (lending to other cultures) but first seeks to explain the role and position of banks, through combining existing economic theories.

New international regulation, referred to as Basel II, strives to improve on existing international standards (Basel I), which only set minimum capital standards for banks, and tries to implement by 2006, in over more than 100 countries, a new set of rules which seeks to balance capital adequacy with the specific risk profiles of the banks. It does not require national supervisors to impose capital requirements automatically, but they have significant flexibility to determine how best to ensure that banks are sufficiently capitalized relative to their unique risk. To measure the risk of the individual banks, internal credit ratings systems are being developed which must ensure that risks are appropriately measured and accounted for. Here lies one of the problems.

Grunert *et al* (2005) have found that even in domestic lending, the role of non-financial factors in internal credit ratings remain ambiguous, whilst the eligibility of financial factors as inputs for internal credit ratings is widely accepted. Analyzing credit file data from four major German banks, they found evidence that the combined use of financial and non-financial factors leads to a more accurate prediction of future default events than the single use of each of these factors. It is argued in this thesis that in case of cross border lending, these non-financial factors may be even more relevant.

The role of culture and the ways of coping with its differences with its differences is still being debated. In the field of cross-cultural studies, scholars still argue on concepts and adequate or inadequate methodologies, whereas practitioners in business and politics continue to display relative little interest in its concept and consequences. “Possibly one of the many reasons why the culture concept has been resisted”, Hall (1960), writes, “is that it throws doubt on many established beliefs. Fundamental beliefs..... are shown to vary widely from one culture to the next. It is easier to avoid the idea of the culture concept than to face up to it”.

Prominent publications in cross cultural studies are reviewed and an understanding of the relative strengths and weaknesses of the different methodologies in this field is being sought. Key authors in the field are Hall, Hofstede, Kluckhohn & Strodtbeck, Landis, Lewin, Segalla and Fischer, Trompenaars and Hampden-Turner. The argument will be made that within the context of banks and credit – culture seems to be receiving little attention from practitioners (as well as scholars) which in part is reflected through the Basel II accords, but also can be easily observed through day-to-day practices. Bankers all over the world are being trained on how to read balance sheets, yet little attention is being paid as to by whom they are being created and how precisely these balance sheets came into existence, other than the accountancy standards applied, but even there existing research suggests that cultural factors come in play.

Bankers furthermore seem to agree on the fact that credit risks in large part are related to the management competencies, effective corporate governance and integrity of management and organization. The argument can however be made that the assessment of management capabilities, governance and integrity may be hindered in those cases where the culture is little understood. In other words, how do bankers evaluate management of another culture, if they understand little of it?

1.2. The background of the research:

After having spent more than 25 years in international banking as regional manager (Rabobank) responsible for Latin America and later on as a General Manager in Argentina, the author moved on to become an advisor of the board of several rather large Latin American companies. All of these companies were dependent on external finance, mainly from European Banks. Whilst travelling with these clients throughout Europe, he noticed that it took them years to realize how different each of these European countries actually was. Later, similar experiences were observed whilst travelling with European bankers through the different countries of Latin America: there, too, differences were notable between one country and/or region and the other.

These experiences led him in 1998 to take part in the creation of DBA Corporate Finance S.A., a company constituted in Montevideo, that has since its beginning successfully worked in the Mercosur countries (Brazil, Argentina and Uruguay) advising companies on their approach to international financial markets, multilateral agencies for project financing and - mainly - European financial institutions for their medium-term and working capital requirements.

This has allowed the author to gain further experience and insight into the relations of companies with their international banks. The role of the company and its managers focuses on the appropriate design and implementation of strategies in order to ensure the optimization of the relationship between the client and international banks and other multilateral institutions. As an intermediate, DBA Corporate Finance S.A. builds on relationship, know-how and “know–who”, in order to ensure that companies are able to attract the best available financial services. It can only be successful as a good intermediary if it fully understands the objectives, motivations, possibilities and limitations of both parties. They have learned, to a relative extend, that they need to fully capture and understand what works and what does not, given the complexity of human relations and also given the volatility with which Latin American markets have operated in recent years. Several of these countries have since the outbreak of the Latin American debt crisis (1982) gone from crisis to crisis.

At the same time they have witnessed in the last decade a high consolidation of the European banking sector, which has limited the number of European banks considerably. In connection with this process and an increasing number of financial crises, an overemphasis on investment banking during several years and subsequent bank losses world-wide, further regulation in the banking sector has led banks to have become more restrictive in the way they perform their lending functions. These processes are the result of discussions and the accord by the Bank for International Settlements, known as Basel II, which effectively will require all major financial institutions in the world (as of 2006) to use (more) sophisticated credit models. This new paradigm in international finance seeks to better regulate and control the lending by banks, and will place a heavy emphasis on the ability of financial institutions to assess credit risk.

This research will first be reviewing the question of why banks exist, the role and functions they perform, as well as relevant economic theories. This is considered important as banks continue to be the main source or channel for international lending. Explanation is being provided as to why this seems to be the case. Secondly, there will be a short review and understanding of what Basel II, credit rating and credit modelling implies and also a review of their relative strengths and weaknesses. Credit ratings are expected to gain in importance because of their potential use for determining regulatory capital adequacy and banks' increasing focus on the risk-return profile in the commercial lending. Thirdly, this thesis will provide a literature review on cultural studies, in order to explore why perhaps this field has not gained too much influence in the field of international finance thus far.

Strangely enough to the author of this thesis, culture and coping with its differences is still debated. Even in the particular field of cross-cultural studies, scholars still argue on concepts and adequate or inadequate methodologies, whereas practitioners in business and politics continue to display relative little interest to its concepts and consequences. Hall (1960) writes: "Possibly one of the many reasons why the culture concept has been resisted is that it throws doubt on many established beliefs. Fundamental beliefs..... are shown to vary widely from one culture to the next. It is easier to avoid the idea of the culture concept than to face up to it".

All these experiences have led to this research which is embedded in practice (empirical) and which focuses on practitioners from both the banking as well as the corporate world. This is in order to explore whether the implicit views underpinning the direction of Basel II are shared by the colleagues in the field.

1.3. Research problem and hypotheses:

The key argument of this research is that within the context of banks and credit – culture seems to be receiving little attention from practitioners as well as scholars. This is in part reflected through the Basel II accords, but can also be observed in published work in the field of finance. Bankers all over the world however seem to agree on the fact that corporate credit risks in large part are related to the competencies of management of companies and organizations. The argument can however be made that the assessment of management capabilities may be hindered in those cases where the culture is little understood. In other words, how do banks evaluate management of another culture for example, if they understand little of it?

1.3.1. On the notion why banks exist

Banking has existed and has stood the test of time for thousands of years and given the fact that their key function has been an intermediary one, this could not have been otherwise possible had markets not been imperfect till this very day. The first sign of banking originated in Babylon some three thousand years BC. They started out in temples and palaces and, even today, banks are mainly housed in impressive buildings in order to provide the perception of credibility, trust and solvency. This status alone has never been enough, as already during the Reign of Hammurabi (1792 – 1750 BC) banking operations were regulated – and thereby protected – through laws.

Throughout history, banks have had arguable positions in societies and it was Jesus Christ (30 AD) as mentioned in Mathew (21.12) who overturned the money changers tables in and around the temple. Still today many feel banks to be a necessary evil, instead of a public good. History on banking records numerous crises, individual as well as national, from time to time causing profound and prolonged consequences to societies. At the centre of most financial and economic crises we always find the banks. Banks exist by the grace of a whole framework of laws, regulations, and supervisory institutions, both at national as well as international level, which – altogether - make them rather different from other businesses.

The paradigm used in the theory of financial intermediation will be reviewed. Since the early experience of the deposit-taking institutions of the 19th century, banks have issued debt instruments that are accepted as means of exchange and payment on the basis of a fiduciary relationship among the agents using them, and between the agents and the issuing banks.

Supplying transaction and portfolio management services is what defines banking according to Fama (1980), while Kareken (1985) emphasises the central role of banks in managing the payment system. Corrigan (1982) adds to these functions the banks' twofold role of backup sources of liquidity for all enterprises in the economy and of transmission mechanism for monetary policy. Borsonne (2001) expanded the theory elaborating on the key functions of banks consisting of liquidity, credit and integrated functions, which resulted in circuit theory, emphasising the unique character of banks of creating money and that money creation makes banks differ from any other intermediaries (Bossone 2001). Intermediation theory helps to understand how intermediaries operate, but fails to answer more fundamental questions as to why.

In understanding these aspects of why banks exist, both transactions cost theory as well as agency theory is considered to be of fundamental importance. Transaction cost theory (TCT) rests on two essential assumptions about economic actors engaged in transactions: bounded rationality and opportunism. Bounded rationality means that those who engage in economic transactions are extendedly rational, but only limitedly so. Opportunism according to Williamson (1985:47) includes lying, stealing and cheating, but it more generally refers to the incomplete or distorted disclosure of information, especially to calculate efforts to mislead, distort, disguise, obfuscate or otherwise confuse partners in an exchange. TCT does not assume that all economic actors are always opportunistic. Rather, all it assumes is that some of these actors may have opportunistic behaviour and that it is costly to distinguish those who are prone to opportunism from those who are not. TCT explains why organisations exist and that, sometimes, the cost of managing economic exchanges across markets is greater than the costs of managing economic exchanges within the boundaries of an organisation. This simple logic seems to have worked for banks. TCT also has its limitations as it focuses on cost minimisation, whereby economising is more fundamental than strategizing (Williamson 1975). It furthermore neglects the role of social relationship in economic transactions (highly relevant for banking) that discounts the impact of social relationships and culture. Granovetter (1985) for example pointed out that transactions are influenced by expectations that are formed by the history of the relationship.

Given the complexity of banks, their large history, the central role in economies, and the interdependency of various relationships, agency theory comes in play and helps analyse what motivates different principals and agents to organise themselves in the ways they do. Agency relationships occur whenever one partner in a transaction (the principal) delegate authority to another (agent) and the welfare of the principal is affected by the choices of the agent (Arrow 1985). Applied to the banking sector – the general public delegates authority to the government – and through it to the central bank, or other supervisory institution (agent) – and the welfare of the principal (the public) is affected by the choice of the agent (Central Bank). Secondary is the principal - agent relationship between the central bank and the individual bank, whereby the Central Bank (principal) delegates authority to the individual bank (agent) in order to control and monitor branches, internal processes, and management. The delegation of decision making authority from principal to agent is problematic in that: (1) the interest of principal and agent will typically diverge; (2) the principal cannot perfectly and costlessly monitor the actions of the agent; and (3) the principal cannot perfectly and costlessly monitor and acquire information available to or possessed by the agent. Taken together, these conditions constitute the agency problem – the possibility of opportunistic behaviour on the agent's part that works against the welfare of the principal. Arrow (1985) notes two essential sources of agency problems: moral hazard, which he equates to hidden actions, and adverse selection, which he equates to hidden information, a not uncommon phenomena in the relationship between Central Bank and banks. Moral hazard involves situations in which much of the agent's actions is either hidden from the principal or is costly to observe. Thus, it is either impossible or costly for the principal to fully monitor the agent's actions.

Barth *et al* (2004) provide helpful insights in the supervision of banks and agency problems, indicating, first, that banks are costly and difficult to monitor. This leads to too little monitoring of banks, which implies sub-optimal performance and stability. Official supervision can ameliorate this market failure. Second, because of informational asymmetries, banks are prone to contagious and socially costly bank runs (Argentina 2001, Uruguay 2002). Supervision in a situation such as this serves a socially efficient role. Third, many countries choose to adopt deposit insurance schemes. This situation (1) creates incentives for excessive risk-taking by banks, and (2) reduces the incentives for depositors to monitor banks. Strong, official supervision under such circumstances can help prevent banks from engaging in excessive risk-taking behaviour and thus improve bank development, performance and stability.

Alternatively, powerful supervisors may exert a negative influence on bank performance. Powerful supervisors may use their powers to benefit favoured constituents, attract campaign donations, and extract bribes (Shleifer and Vishny, 1998; Djankov *et al.*, 2002 and Quintyn and Taylor, 2002). Under these circumstances, powerful supervision will be positively related to corruption and will not improve bank development, performance and stability. From a different perspective, Kane (1990) and Boot and Thakor (1993) focus on the agency problem between taxpayers and bank supervisors. In particular, rather than focusing on political influence, Boot and Thakor (1993) model the behaviour of a self-interested bank supervisor when there is uncertainty about the supervisor's ability to monitor banks. Under these conditions, they show that supervisors may undertake socially sub-optimal actions. Thus, depending on the incentives facing bank supervisors and the ability of taxpayers to monitor supervision, greater supervisory power could hinder bank operations (Barth *et al*, 2004).

Intermediation theory, transaction cost theory and agency theory combined helps us understand why banks exist and why they appear to have been doing so for more than 5.000 years.

1.3.2. On credit and credit rating:

Credit risk, or the risk of default, has always been a major topic of concern for banks and other financial intermediaries, and any agent committed to a financial contract for that matter. While concern for the possible default of counterparty on an agreed-upon financial contract is centuries old, modern techniques and models have arisen in the last decades that help master the problem. An outline of the differences between external and internal rating systems and the influence of Basel II accords (Bank of International Settlements) will be provided in chapter 2, section 2.2, in order to stress the relevance and the connections between both. Whereas external credit rating has existed for already 100 years, only in recent years have banks started to formalize their own internal credit rating, urged by changing regulatory frameworks.

Before credit rating and credit ratings agencies came into play, all financing was either done on a transactional basis, i.e. commodity finances for example, or on the basis of a relationship between borrower and financier. At the beginning of the relationship, as in Stiglitz and Weiss (1981), there is no possibility to select borrowers according to their quality. Hence, problems of adverse selection and moral hazard have to be considered. It will be questioned whether Basel II improved regulation will help to resolve these problems, and – in addition - to what extent they may become counterproductive to the suggested strengths and the position of housebanks[1] (relationship banking) – in a close long-term relationship with the borrower.

The issuance of bonds by corporations is a 20th-century phenomenon. It started at the beginning of the century, at approximately the same time that the first papers and articles were published on the analysis of accounting ratios, as a means of diagnosing the financial strength of a company. By the 1920s, this approach had been commercialised and specialised firms were offering their services, and promoting the merits of ratio analysis. This was also

[1] A growing body of literature, both theoretical and empirical, has focused on the role of relationship lending as a determinant of corporate performance. In an early contribution, Cable (1985) relates the rapid path of industrialization and economic growth in 19th century Germany to the active role of its banking system. In particular, close connections between industry and their major banks, or housebanks, is credited with some of industrialization success in the late 19th century. Tilly (1989) reports results on the contribution of German universal banks to industrial investment in large corporations. His findings support the view that housebanks play an important, and largely positive, role in the process of corporate control, and of industry-wide merger activities.
In this literature, a housebank is regarded as the premier lender of a firm, being equipped with more relevant, and more timely information than any "normal", nonhousebank institution. Furthermore, a housebank is more committed to its client, enlarging their role as financier if the firm faces sudden and temporary difficulties. The importance of long-term commitment in the bank–customer relationship is stressed by Mayer, 1988 and Hellwig, 1989 and Boot and Thakor (1994), just to name a selection of the extant relationship lending literature.

the period when Moody's (1909), Standard and Poor (1916), and other agencies had started to rate public debt issues. Over the last 30 years, the introduction of new financial products has led to the development of new methodologies and criteria for credit rating: Standard and Poor (S&P was the first rating company to rate mortgage-backed bonds (1975), mutual funds (1983) and asset-backed securities (1985).

A credit rating is not, in general, an investment recommendation concerning a given security. In the words of S&P, "A credit rating is S&P's opinion of the general creditworthiness of an obligor, or the creditworthiness of an obligor with respect to a particular debt security or other financial obligation, based on relevant risk factors." A rating in Moody's words is ...an opinion on the future ability and legal obligation of an issuer to make timely payments of principal and interest on a specific fixed income security." Moody's ratings of industrial and financial companies have primarily reflected default probability, while expected severity of loss in the event of default has played an important secondary role. While the rating agencies use similar methods and approaches to rate debt, they sometimes come up with different ratings of the same debt investment. In their studies of the credit rating industry Cantor and Packer (1994) have illustrated this. This issue of ratings differences is an important one. It raises two questions. First, to what extent is the rating quantitatively based and what is the role of judgement? The second question concerns the independence of the rating agencies. Since the rated companies pay to be rated, there is a perceived danger that business pressures will affect the process.

Furthermore, many question the influence of rating agencies, especially given the fact that their influence on markets is considered to be very high (especially in rating countries) and, on the other hand, the fact that there are effectively only three major ones, who dominate approximately 80% of the market.

The dominant paradigm seems to suggest that by increasing application of technology and modelling, whilst measuring credit risk, in large part inspired by market developments, such as derivative market development, globalisation, the liberalisation of financial markets, and, last but not least, that by applying stricter controls, through Central Bank and Basel II regulation, credit risk and secondary systemic risks may be better managed.

It will be argued in this thesis that evidence so far has not confirmed the same. Ferri *et al* (2001) suggested moreover that the Basel II proposals would increase the volatility of capital needs of banks in non-high-income countries vs. high-income countries' banks. In fact, bank and corporate ratings in non-high-income countries appear to be strongly related –in an asymmetric way – to changes in sovereign ratings. We have seen financial sectors in emerging markets being severely affected, despite often above-average Basel II capital adequacy, whereas – for example – the German financial sector, has continued operating without seemingly much sense of urgency with an average Tier 1 capital ratio of only 6.8%, which is less than half the 13.4% of OECD banks excluding Japan, according to The Banker (2003). What this seems to indicate is that Basel II may further enhance the gap between OECD and non-OECD countries.

Chapter 2 section 2.2 of this thesis also intends to illustrate to which extent the dominant paradigm in this particular field seems to reinforce the belief that improved regulation and an even more refined approach to credit and credit rating, both internal as well as external, may improve agency costs. It has been suggested that for the particular field of finance and, consistent with the positivist paradigm – especially the functionalist approach –, the field seems to run the risk of producing more and more facts confirming a status-quo of the science and its belief systems. Any adequate analysis of the nature and role of the mathematical language in finance necessarily requires fundamental understanding of the worldviews underlying the views expressed with respect to the nature and role of language (Ardalan, 2002)

Ardalan (2002) recommends serious conscious thinking about the social philosophy upon which finance is based and of the alternative avenues for development. The knowledge of the different paradigms is of paramount importance to any scientist, because the process of learning about a favoured paradigm is also the process of learning about what that paradigm is not. The knowledge of paradigms makes scientists aware of the boundaries within which they approach their subject. Each of the different paradigms implies a different way of social theorising in general, and finance in particular.

Academic finance can gain much by exploiting the new perspectives coming from other paradigms. An understanding of different paradigms leads to a better understanding of the multi-faceted nature of finance. Although a researcher may decide to conduct research from the point of view of a certain paradigm, an understanding of the nature of other paradigms leads to a better understanding of what one is doing. Knowledge of finance is ultimately a product of the researcher's paradigmatic approach to this multifaceted phenomenon. Viewed from this angle, the pursuit of financial knowledge is seen as being as much an ethical, moral, ideological and political activity as a technical one. A purely functionalist approach however, runs the severe risk of believing that it is only a technical activity.

Basel II and the direction which it has taken indicate that there will be more regulation and control on banks and finance, with the intent to more appropriately manage and understand risks. It will be argued here that there are serious drawbacks to the universal approach taken, thereby measuring with seemingly different standards toward OECD and non-OECD countries. Publications of recent years on credit defaults – especially high profile cases in OECD countries -, instability of financial- and capital markets and their participants, all seem to demonstrate problems of asymmetry of information, including adverse selection and moral hazard, as well as agency cost. All these facts seem to indicate that more and better regulation currently in the making will not be able to resolve these challenges.

1.3.3. On cross cultural differences:

Cross-cultural research deals primarily with the similarities and differences between cultures. The best research of this kind is multicultural (e.g., more than three cultures) in focus and more than likely deals with fairly basic psychological processes. Intercultural research tends to focus on the penetration by a member of one culture into another culture. So, while cross-cultural research has a fairly long history in psychology (Klineberg, 1980), intercultural studies are fairly recent. This thesis will mainly cover cross-cultural research.

In most Western languages, “culture” commonly means “civilisation” or “refinement of the mind” and in particular the results of such refinement, like education, art, and literature. Hofstede (1991) describes this as culture in the narrow sense, sometimes referred to as "culture one". Cultural as “mental software”, however, correspondents to a much broader use of the word which is common among social anthropologists: this Hofstede (1991) describes as "culture two" and is the catchword for all the patterns of thinking, feeling and acting, overt and covert behaviour explicit and implicit. Not only those activities supposed to refine the mind are included in culture two, but also the ordinary and menial things in life: greetings, eating, showing or not showing feelings, keeping a certain physical distance from others, making love, or maintaining body hygiene. Culture understood in this way deals with much more fundamental human processes than culture one.

Everybody looks at the world from behind the windows of a cultural home and everybody prefers to act as if people from other countries (cultures) have something special about them, but that home is normal. Unfortunately, there is no normal position in cultural matters. “Possibly one of the many reasons why the culture concept has been resisted”, Hall (1960), writes, “is that it throws doubt on many established beliefs. Fundamental beliefs..... are shown to vary widely from one culture to the next. It is easier to avoid the idea of the culture concept than to face up to it”. In addition, “the concepts of culture ... touch upon such intimate matters that they are often brushed aside at the very point where people begin to comprehend their implications” (Hall, 1960).

Chapter 2, section 2.3., reviews some of the more prominent publications, deals with some of the relative strengths and weaknesses of the different methodologies in research, and outlines some of the current issues in cross-cultural research. Hall (1976) describes his views on low- and high context cultures (very much in line with Trompenaars’s dimension of universalism and particularism) and suggests that if one could get behind the scenes one would find context dependant results in the majority of research projects. Western science, according to Hall (1976) is striving for replicability and rigor in methods and is conducted with a view to eliminating context.

Clearly there are many relations of previous findings to the current research. Adhering to the Dionysian approach to research, different research findings will be combined as to approach this research embedded in the proper context of the field of banking and credit, thereby considering that all theoretical models are incomplete.

The focus of this research could not be otherwise than exploratory, given that the relationship between culture and cross border lending has not been investigated thus far. Explanation is being sought as to why this could be the case.

The research is moderate in its ambition, as it will hopefully provide for an indication –a direction at most- in which ways culture and its differences influence banking and credit.

1.4. Methodology:

According to Hall (1976), it is never possible to understand completely another human being: and no individual will ever really understand himself – the complexity is too great and there is not enough time to constantly take things apart and examine them. This is the beginning of wisdom in human relations. However, understanding oneself and understanding others are closely related processes. To do one, you must start with the other, and vice versa (Hall, 1976 page 69). This observation by Hall serves as one of the perspectives on which this thesis has been built.

Fay (1996) suggests that there is no self-understanding without other-understanding, and the extent of our self-consciousness is limited to the extent of our knowledge of others. To identify others as different requires that we also identify the ways we are similar. Much social thought consists of oppositional categories, such as the case in cross cultural research (self versus other, particular vs. universal, insider vs. outsider etc). The same dualistic thinking mars meta-theories in the philosophy of social science: atomism vs. holism, cause vs. meaning etc. Fay (1996) warns against those pernicious dualisms and argues that such thinking promotes an “either – or” mentality in which one category precludes it’s supposed opposite. Often, one side of a dichotomy depends on and invokes the other – in which case the dichotomy is subverted.

Within the context of this argument and this thesis it is perhaps illustrative to quote van Deventer and Imai (2005) in their book: Credit risk Models and the Basel Accords, (page 135), where referring to different researchers having found the different levels of statistical significance, the write;

“What we do believe is that quantitative credit models provide cheaper, faster and more accurate indices of credit quality than the traditional credit analysis practiced by most financial institutions”.

It can be argued here that depending on the context they may be right. This would be the case in a large domestic market such as the USA, where financial institutions using large databases for consumer lending (credit card business, mortgage lending), as well as for the credit market to the small and medium sized companies, can be efficient users of (sophisticated) credit models. This may perhaps not be the case with the larger issuers of debt instruments, such as for example the cases of Parmalat, Enron, Worldcom and the like (Economist, 2005). A similar argument can be made for cross border lending.

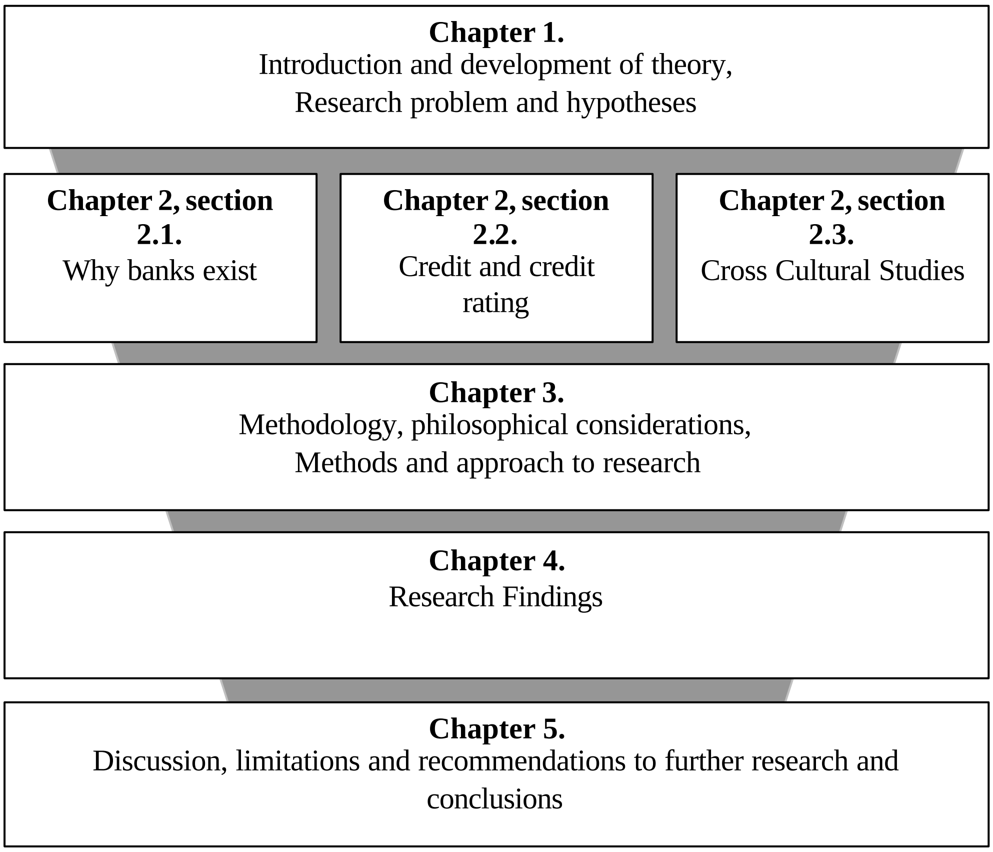
The other pillar perhaps is the philosophical perspective referred to as relativism, which is the doctrine that states that either experience (in the case of epistemological relativism) or reality (in the case of ontological relativism) is a function of a particular conceptual scheme.

Epistemological and ontological relativism taken together imply that so deep are the differences which separate those within different frameworks, that their experiences and beliefs would be fundamentally incommensurable (Fay, 1996). This branch of thinking and research, to which the author of this thesis subscribes, claims that things are different from different points of view and the idea that different viewpoints are equally valid. Moreover, contrary viewpoints may well be equally valid across particular and peculiar societal settings.

This research has been guided by the idea that the objective of this research is exploratory; it aims to be a qualitative enquiry and an advisable first step to be taken before a real enquiry –a quantitative enquiry– can be undertaken. The hypotheses formulated and the applied methodology, which will be explained further, both combined, intend to establish a reasonable and plausible argument as to whether practitioners share the view that cultural impacts influence the effectiveness of cross border lending and whether further credit rating (of hard factors), as a result of Basel II, will sufficiently, according to Grunert *et al* (2005); “alleviate asymmetric information problems between borrowers and lenders”.

1.5. Outline of the Thesis:

Figure 1 Outline of Thesis



1.6. Hypotheses and key assumptions:

According to Titscher *et al* (2000) hypotheses are predictions that relate to a particular population, where no general validity is being claimed. Research hypotheses are tested on particular objects of investigation that are representative of the populations in question.

Titscher *et al* (2000) describe three assumptions derived from this approach:

1) Hypotheses can only be tested by those investigations that are either designed as censuses or that target a representative sample.

2) The question of how the target population is to be defined arises from the assumptions that drive the particular research.

3) It is only possible to make statements about the particular population through controlled sampling.

Please find below a summary of the entire key hypothesis and sub-hypotheses;

H.1.1. In general banks seem to be very competent with regard to understanding risks.

H.1.2. Clients of banks would be benefited if banks were rated in terms of client’s satisfaction.

H.1.3. The long history in banking and the lack of alternatives means that banks will continue to exist for many more years.

H.1.4. With current supervision and regulation on banks one can be confident about low systemic risks.

H.1.5. Banks play a crucial, mostly constructive role within the world economy.

H.1.6. With increased knowledge and modern techniques in finance the role of relationship in bank -client relations will diminish.

And the sub-hypotheses;

H.1.6.1. Most companies tend to act opportunistically in their bank-relations.

H.1.6.2. Banks are considered by most clients as a necessary evil.

H.16.3. Housebanks play an important and largely positive role in the process of corporate control; and borrowers with a strong bank–borrower relationship receive more competitive credit on average.

The role of rating agencies such as Standard and Poor's, Moody's and Fitch-IBCA has increased during the last decades. Both country credit ratings as well as company credit ratings have become indispensable tools in today' s finance.

H.2.1. The role of credit rating agencies generally can be described as constructive and a valuable complementary tool.

H.2.2. Credit rating agencies, despite their long history and expertise do not really possess competencies, which may prevent default risk.

H.2.3. The role of credit rating agencies should be more critically assessed and their influence (oligopoly) in finance should be reduced.

H.2.4. The credit analysis process of a credit rating agency and those of a housebank are comparable in terms of depth and quality.

H.2.5. The new Basel II regulations, to be implemented in 2006, will further contribute to a better risk management and control of financial institutions and markets.

H.2.6. The new Basel II regulations carry the risk of a further widening of the gap between high income and low income countries.

Following the above chapter on the topic of cross cultural research, the following hypotheses were formulated:

H.3.1. Cultural differences have played a role in there having been so many accidents (defaults) throughout history in international finance.

H.3.2. If the bank does not understand the cultural context of a particular country or region, it becomes highly doubtful it will understand the risks.

H.3.3. Capabilities to make friends, combined with common sense ensure healthy bank-client relations.

And sub-hypotheses;

H.3.3.1 Clients of banks would be benefited if banks were rated in terms of clients' satisfaction.

H.3.3.2. The commitment of most relationship banks depends largely on the weather (Umbrella whilst the sun is out, requesting it back when clouds appear).

The following key assumptions have been applied to the research:

Hypotheses were derived from literature study and brought to the test in a survey amongst both bankers and their clients, all of which are active in cross border lending. Some of the concepts and hypothesis were discussed and worked out during a three-day conference where 80 executives from banks and companies were gathered, also for the purpose of this thesis.

The sample can be considered representative for banks and companies active in cross border lending.

Cross border lending is highly regulated through Central Bank and BIS regulation, and (internal) credit rating, its effectiveness and the impacts of cultural differences is considered problematic, as to the expected positive effects of further regulation through Basel II (2006).

Although the relevance of culture differences has been studied by many scholars, no previous studies have been found on the relationships between cross border lending and cultural differences.

Given this identified gap in the specific field of banking and finance and culture studies, the objective of the research could not be other than exploratory.

1.7. Summary:

The research project focuses on the various aspects which may be considered important within the relationships of cross-border lending, both at the level of companies as well as for the banks. Very especially regarding the way in which banks – and supervisors – believe the evaluation of the quality of the borrowers should be conducted. It was felt that (more) attention should be paid to soft factors, especially to understanding the cultural background and the culture concept itself.

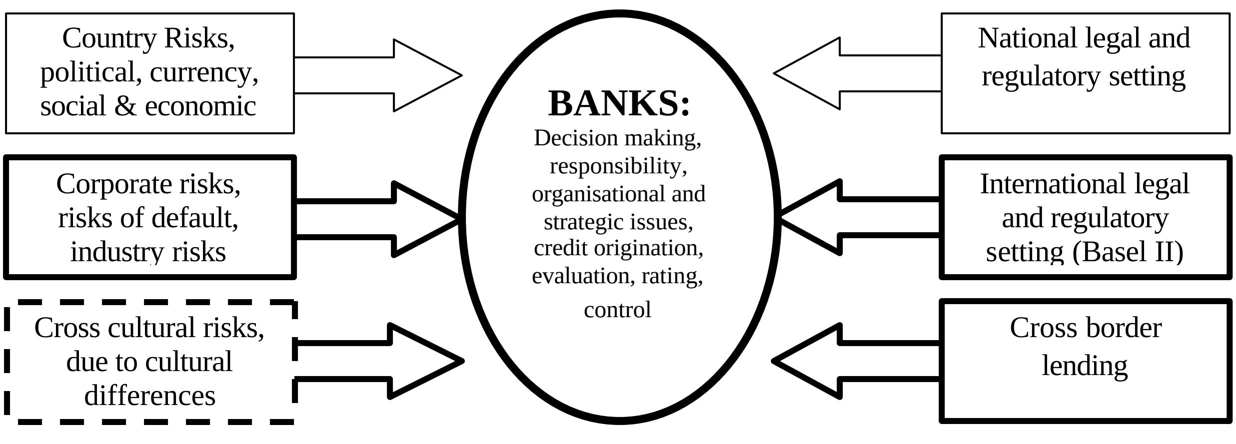
Secondly, the research focussed at the relationship between credit ratings agencies and banks, the role of credit rating agencies and their effectiveness.

Thirdly the objective of this research has aimed at what can be expected from the implementation of Basel II. Markets, especially those operating in cross border lending, are not yet convinced about the possible positive outcome of this new regulation, as it seems to produce more regulation and control. No consideration seems to exist within the new Basel II framework as to the soft factors (Grunert *et al*, 2005), including the cultural differences, whilst evaluating credit risk.

1.7.1. Conceptual framework to the research:

As can be observed from the conceptual framework given below, cross border lending is a complex field, which demands careful processes and controls. In this thesis, cross border lending is limited to the lending by banks to companies across borders. Given the specific responsibility of banks towards their depositors, their stakeholders, the regulatory authorities and perhaps society at large, due consideration needs to given as to if credit is being granted and risks are being assumed.

Figure 2 Conceptual framework



As can be derived from the above figure, cross cultural risks resulting from cultural differences are not considered by regulators and banks. This research explores whether the exclusion of these risks is considered acceptable by practitioners. At the same time, it seeks to understand whether the other implicit views underpinning the Basel II accords are being shared.

Similar to capital market investors that rely on credit ratings provided by ratings agencies (Moody's, Standard & Poor and Fitch IPCA), banks assign internal credit ratings to appraise the creditworthiness of their borrowers. In both cases, ratings can be interpreted as a screenings technology that is applied to alleviate asymmetric information problems between borrowers and lenders (Grunert *et al*, 2005). Internal credit ratings for corporate borrowers represent the basis for loan approval, pricing, monitoring and loan loss provisioning. Traditional rating or conventional evaluation of creditworthiness can be based on the following aspects:

Financial factors:

- Solvency of the borrower
- Profitability of the borrower
- Liquidity of borrower
- Cash flow generation
- Debt to equity ratio's
- Size of the company in terms of sales

Non financial factors:

- Management capabilities of the companies, including reputation and corporate governance
- Industry perspectives, including market position, competition, risks of new entrants, government regulation, environmental issues
- Country risks to be duly separated in sovereign risk, political risks, transfers risks and corporate risks.
- Transaction risks, such as structure and availability of collateral

Consideration of non-financial factors is beyond controversy (see Basel Committee on Banking Supervision, 2000a and Basel Committee on Banking Supervision, 2001). There is however a lack of quantitative research on this issue (Günther and Grüning, 2000). With respect to these “soft” factors, bankers often refer to their experience and distrust the sole use of financial criteria. A first investigation of the importance of soft information in borrower-bank relationship is conducted by Berger *et al.* (2002) and Stein (2002). Depending on bank size, Berger *et al.* (2002) explore a bank’s ability to act in projects that require the evaluation of soft information. They find that small banks are more capable of collecting and acting on soft information than large banks. Stein (2002) points out that decentralized banking hierarchies are likely to be more attractive when project’s soft factors are to be evaluated.

CHAPTER 2 LITERATURE REVIEW

Section 2.1. - WHY BANKS EXIST

2.1.1. Introduction:

This section will first be reviewing the question of why banks exist, the role and functions they perform, as well as relevant economic theories. This is considered important as banks continue to be the main source or channel for international lending. Explanation is being provided as to why this seems to be the case. In section 2.2. there will be a short review and understanding of what Basel II, credit rating and credit modelling implies and also a review of their relative strengths and weaknesses. Credit ratings are expected to gain in importance because of their potential use for determining regulatory capital adequacy and banks' increasing focus on the risk-return profile in the commercial lending. Thirdly section 2.3. of this Chapter provides a literature review on cultural studies, in order to explore why perhaps this field has not gained too much influence in the field of international finance thus far.

Throughout the author's 25 years in banking and finance, he seldom came across a colleague interested in the origin of banking. This appears to confirm the popular view that bankers seem to have a short memory, yet a very long horizon.

Interestingly, the author has spent most of his career in the international trade and commodity finance and according to the data provided by Davies and Davies (1998) this seems to be the start – and the basis upon which banking – and later on money and credit, was built. Actually lots of economic theory is built on commodity principles (Smith, Walras, and Keynes). Keynes (1953 p.222), for example, explains the money rate of interest, to be nothing more than the percentage excess of a sum of money contracted for a forward delivery, e.g. a year hence, over what we may call the "spot" or cash price of the sum thus contracted for forward delivery. He uses the spot and forward prices of wheat to explain this concept.

It would be impossible to reproduce all the facts from Davies (1998) yet some of the more relevant occurrences related to banking and credit, are outlined below.

2.1.1.1 Key conclusions from the history of banking – and banks:

> "Everything has been said before, but since nobody listens we have to keep going back and beginning all over again". - André Gide, French critic (1869 – 1951)

And so this seems to be holding truth also for banking. The first sign of banking originated in Babylon some three thousand years B.C. and started out of temples and palaces that provided safe places for the storage of valuables.[2] Still today banks are housed in the mostly

[2] Pythius (600 BC) and Pasion's (career 394-371 BC) were two of the first prominent bankers, the first being referred to as a merchant banker, and the later, Pasion, becoming the wealthiest and most famous Greek banker, gaining his freedom as a slave. Already at 200 BC, reference is made to the prominent banking centre Delos, a

impressive buildings in order to provide the perception of credibility, trust and solvency. To this extent they try to reflect the temple and palace status of bygone days. Yet, this status alone was never enough, as already during the Reign of Hammurabi (1792 – 1750 BC) banking operations were regulated – and thereby protected – through laws.

Clear reference to macroeconomic policies is made in reference to the Reign of Diocletian (Rome 284-305) making vigorous attempts to halt inflation. Direct controls of prices and wages were mentioned, as well as a failed introduction of new coinage, whilst the older coins remained in use. Market forces already at that time appeared to be too strong. Successful, however, was the introduction of the world's first system of annual budgets.

Some five hundred years later China first introduced paper money, which was only learned of by Marco Polo (1275-1292) when he lived in China. The Chinese also were the first to allow too many note-issuing institutions, which led to the first recorded hyperinflation in 1166. It took China however approximately 300 years for this experiment to finally lead to hyperinflation. A more recent example of similar magnitude would be Argentina, which during 1989 – 2003 lived through a comparable experience.

History on banking records numerous crises, systems being tested, system failing, systems rising. Not only economic problems as inflation and hyperinflation, changing monetary systems, speculation

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combination of a magnificent harbour and housing the famous temple of Apollo. A normal rate of interest during those days would be 10%.

[Tulip mania (1634-1637)], but also numerous individual, national as well as international banking crises follow (including bank panics 1837 US, 1857 world wide, 1873 US and Germany, 1890 Barings first crises from over investments in South America, 1907 international banking crises starting in New York, 1929 Wall Street Great Crash, 1982 Latin American debt crisis, 1991 BCCI, 1993 Beginning of Japanese Banking Crises, Argentina 2002 largest sovereign default in history), and several attempts for long lasting monetary unions (Latin Monetary Union – 1865-1926), Scandinavian Monetary Union (1873-1924), European Monetary Union and single currency (2002 - .....).

At the centre of each of these crises we always find the banks. From the first European bank founded in 1401 in Barcelona, to the financial powerhouses that rule financial and capital markets today, some observations seem to have remained stable over time. Caprio and Klingebiel (1996, 2003) report on 117 systemic banking crises (defined as much or all of bank capital being exhausted) that have occurred in 93 countries since the late 1970s. They also report, in addition, 51 borderline and smaller (non-systemic) banking crises in 45 countries during that same period. Their findings furthermore indicate that most episodes of insolvency are caused by a mixture of bad luck, bad policies – both microeconomic (regulatory) and macroeconomic – and bad banking. Banks mainly work with other people's money, and do so with fragile capital bases. This, in times of crisis, easily provokes panic and liquidity shortages. Banks continue to market a perception of trust, of solvency, which when called upon massively, usually does not stand the test, leading to yet another crisis.

Banks exist by the grace of a whole framework of laws and regulations, which makes them different from other businesses. When a banking crisis occurs, depositors and taxpayers usually end up paying for the damage. This, too, tends to indicate that banks are special.

2.1.2. Economic perspective on banks:

Information economics and banking theories provide us with various insights into why banks exist in the economy. The key theories, besides classical and neo-classical economic theories, are transaction cost theory, and intermediation theory in combination with agency theory. Assuming these theories apply, banks exist because they perform certain special functions that no other financial institutions can replicate.

For decades, researchers have studied the question of why banks exist (transaction cost theory) and have made considerable progress in developing banking theories (Diamond (1984). The critical role banks perform in economies becomes most obvious and can be understood well in times of economic crisis and reference can be made to more recent events, for example the Asia crisis (1997/1998), the prolonging Japanese economic crisis, the Argentine financial and economic crisis (2001) (source: The Economist). In each of these examples banks have played a crucial role: One of the causes of the Asia crisis was the fact that local banks appeared to have granted abundant amounts on financing large economic groups, whose debts could not be serviced when economic growth slowed down. The Japanese banking crisis was a direct consequence of Japanese banks over-extending finance to many Japanese companies, including those operating in real estate until the real estate bubble burst. This caused the Japanese banks to drop from once being the largest banks in the world to the rather insignificant status of today. Argentine banks had for years been buying Argentine government bonds and other sovereign debt instruments, until the Argentine government defaulted on its debt servicing, as a result of impossible high interest rates to refinance its already too high debt, and sky rising public deficits. In all three cases it has been taking years for the banks (tax payers, stockholders, depositors and the like) to make up for the bad loan portfolios incurred by the banks during the good times, causing tremendous damage to local, regional and often international economies. It could be argued here that the role of banks - at least in these examples – have had a net negative impact on the economies at hand, and this for a considerable long period of time.

Although many may take the existence of banks for granted, in a ”perfect” world, where savers could channel their surplus funds to borrowers (or other investments) without friction, financial intermediaries such as banks would not be needed. As a corollary, banks’ existence must be motivated by certain economic frictions, so that banks, as financial intermediaries, can provide some value added from the special functions they claim to have. At the core of the value added, is dealing with information problems with borrowers, caused by the moral hazard behaviour. Because the lender must evaluate a borrower's creditworthiness, banks' investments in information technology, human resources, and (risk management) systems, allow them to achieve scale economies making them more efficient than others. Banks are furthermore considered credible monitors because their returns are more predictable due to the diversification effects of making large numbers of loans (Diamond, 1984). A similar argument can be made to those who wish to place their savings with banks, without having to bother too much about the related risks.

Despite last decades' "financial innovation" and emphasis on investment banking, whereby banks were increasingly active in origination of loans without putting the loans on their own balance through either securitization of their assets or outright sales trying to shift from interest-based income to fee-based income, we still (again) have lending at the core of the banks. As illustrated in the previous chapter, historically we have always found the lending function or transformation function at the heart of the banking operations even before the coinage was introduced. Obviously, lending starts after the individual or institution obtains the resources to be able to lend. Theory on lending often refers to this function as the transformation function; transforming deposits of money (irrespective of which form) to loans. An often referred to paper has been Corrigan (1982) in his essay: *Are Banks Special?* As president of the US Federal Reserve Bank he argued that specialisation of financial institutions had worked well and, at least in some cases, that specialisation may still be more efficient and may also better serve the public interest. This view is associated with the historical separation of banking from commerce and from investment banking. In general, this "separation doctrine" in banking grew out of concerns about concentration of financial power, possible conflicts of interest, and the appropriate scope of risks banks should incur in the face of the special trusteeship falling on institutions that engage in the lending of depositors' money. He furthermore specified what makes banks to be special and gave three characteristics that distinguish banks from all other classes of institutions -- both financial and non-financial.

Banks offer transaction accounts.

Only banks issue transaction accounts; that is, they incur in liabilities payable on demand at par and readily transferable by the owner to third parties. The owner of a transaction account can demand and receive currency in the face amount deposited in the account; write a check in the full amount of the account; or perhaps most importantly, he can transfer the full amount of the account to a third party almost instantaneously by wire transfer. The liquidity, mobility, and acceptability of bank-issued transaction accounts permit our diverse economic and financial system to work with the relative ease and efficiency to which we are accustomed. Moreover, in periods of financial stress, the capacity to quickly move transaction account balances to third parties acquires special significance by providing elements of flexibility and certainty in making and receiving payments that help to insure that financial disruptions do not spread. Individual banks can also create these highly liquid and mobile balances through their lending function. The capacity to "create" liabilities with these characteristics is vital to the ongoing needs of commerce, but it takes on special significance in periods of financial stress.

Banks are the backup source of liquidity for all other institutions.

Banks' ability to supply credit and liquidity, particularly in situations where other institutions or markets may be unwilling or unable to do so, arises because the deposit-creating function of banks (in tandem with banks' relationship with the central bank) provides an element of credit and liquidity elasticity which is not immediately available to other institutions. As a matter of fact, the extent and frequency with which banks have had to directly rely on extraordinary funding by the central bank (either through the discount window or via open market operations) has been quite limited. In the normal course and even in periods of stress, individual banks, and the banking system as a whole, are able to provide necessary liquidity because of their ability to quickly fund loans through a variety of market sources including the domestic and foreign interbank market, RPs, the issuance of large certificates of deposit (CDs), and so on. For many banks, access to these markets has become the primary source of bank liquidity. Virtually all other financial markets and other classes of institutions are directly or indirectly dependent on the banking system as their standby or backup source of credit and liquidity. Banks can fulfil this function for a variety of reasons, including their relative ease of access to deposit and non-deposit sources of funding. This role of banks as a standby source of liquidity takes on special significance in periods of stress and in this light underscores the importance of rigorous and impartial credit judgements by banks.

Banks are the transmission mechanism for monetary policy.

There is a direct link between banks and the central bank arising in part from the central banks' lender of last resort function. More broadly, the fact that banks are subject to reserve requirements places the banking system in the unique position of being the transmission mechanism, through which the actions and policies of the central bank have their effect on financial market conditions, money and credit creation, and economic conditions generally. To put it somewhat differently, the required reserves of the banking system have often been described as the pivot upon which the monetary authority operates monetary policy. The reserves in the banking system also serve the complementary purpose of providing the working balances which permit our highly efficient financial markets to function and to affect the orderly end-of-day settlement of the hundreds of billions of dollars of transactions that occur over the course of each business day. It is clear that these essential characteristics are highly complementary and furthermore that it is the relationship among them that best captures the essence of what makes banks special.

2.1.3. Definition and understanding of banks:

Barron’s Dictionary of Banking Terms (2000) defines a bank as an organisation, usually a corporation that accepts deposits, makes loans, pays checks and performs related services for the public. The US Bank Holding Company Act of 1956 defines a bank as any depository financial institution that accepts checking accounts (checks) and makes commercial loans, and its deposits are insured by the federal deposit insurance agency. A bank acts as a middleman between suppliers of funds and users of funds, substituting its own credit judgement for that of the ultimate suppliers of funds, collecting those funds from three sources: checking accounts, saving and time deposits; short term borrowings from other banks; and equity capital. A bank earns money by reinvesting these funds gathered from depositors and other sources mainly in loans. An investment bank manages securities for clients and for its own trading account. In making loans, a bank assumes both interest rate risk and credit risk; market rates may rise above the net interest margin a bank earns on its portfolio and investments, and borrowers may default.

The above description only refers to the general definition, there are, however, a wide range of different types of banks. Some specific types of banks are explained here below (adapted from Barron’s 2000). Besides, in literature on banks one finds that authors often do not precisely explain what type of bank, banking sector or activities and functions are considered whilst discussing the notion and role of banks:

Saving bank – the most traditional form of banking, whereby the institution accepts deposits (grain or money) and invests or issues loans or other basic credit instruments.

Retail bank – banking services offered to the general public, (individuals and households) and these include different types of accounts and loans, residential mortgages, deposit services, investment advice and (relative standard) products, credit card and sometimes insurance. Usually retail banking is a high volume business with many services providers competing for market share.

Wholesale bank – banking services offered to corporations and institutional customers such as pension funds, government agencies, but also other banks. Services include lending, different types of accounts (cash management, online banking services) commercial mortgages and can contain, depending on the bank's strategy: investment, merchant and commercial banking services.

Investment bank – sometimes this type of banking (mainly US banks) is concentrated in one specific banking organisation, and the services include sale and distribution (new offering) of securities, usually buying securities from the issuer as principal and assuming the risks of distributing the securities to investors. The process of purchasing and distributing the securities to the investors is known as underwriting. The Glass-Stegall Act of 1933 (shortly after the outbreak of financial crisis) prohibited commercial banks from underwriting securities and required banks to sell their underwriting affiliates, because of abuses by some commercial bankers in selling securities (this seems a recurring theme over times). The 1933 act was removed by the Gramm-Leach-Bliley Act of 1999, which authorised commercial banks again through affiliated companies (ensuring the existence of so-called Chinese walls) to underwriting commercial paper, corporate debt, and equity securities.

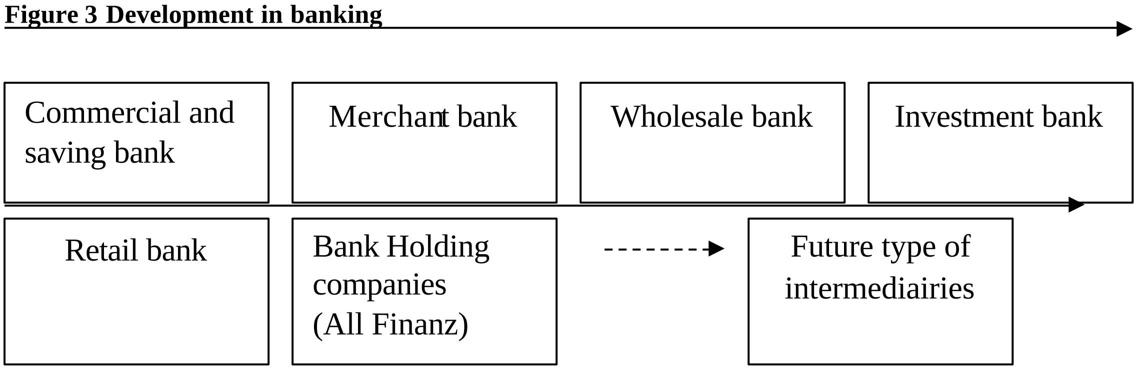
Merchant bank – A type of banking mainly recognised in Europe as a separate banking type, which invests its own capital in leverage buy-outs, corporate acquisitions and structured finance transactions. Merchant banking is a purely fee-based business, where a bank assumes market risks, but no long-term credit risk. In France this banking type is referred to a banque d'affaire, and holds considerably more powers than its British counterpart.

Commercial bank – a full service bank, which can entail both retail and wholesale banking. Many commercial banks supply loans, accept deposits, provide different account services and provide trust services, trade finance, and international banking.

Bank holding company – entity controlling one or more commercial banks, investment advisory as well as insurance related services. The widening of the scope of services became possible thanks to the Gramm-Leach-Bliley Act of 1999. This opened the possibilities for a financial holding company to have different functions under one – holding – structure. Citibank has become a good example lately. In Europe these institutions are often referred to as All-Finanz groups, holdings which contain both an insurance company as well as a banking arm. Allianz Group, ING Group and Fortis Group are good examples.

The above mentioned classification of banks brings us to the following historical sequence of bank type:

Figure 3 Development in banking



2.1.4. Why do organisations exist?

Classical and neo classical theories, beginning with Adam Smith, point to the amazing ability of markets to co-ordinate economic production and exchange at very low costs and without government planning. Simply stated, Smith's fundamental proposition was that an economy could be co-ordinated by a decentralised system of prices (the invisible hand). Given that markets are so effective in co-ordinating economic exchanges, it has always been a bit of a mystery why not all exchanges are managed by markets, i.e. why economic exchange (such as lending and borrowing) would ever be managed through firms (Coase 1937). Remarkably, an answer to the question "why do organisations exist?" was formulated by Ronald Coase (1937) in *The Nature of the Firm*, where he claimed that the reason why organisations exist is that, sometimes, the cost of managing economic exchanges across markets is greater than the cost of managing them within the boundaries of an organisation. This simple logic seems to have applied to banks.

The costs of using the price system involves such activities as discovering what prices are, negotiating contracts, inspection and settling disputes. The most lasting contribution of Coase's work was to place transaction costs at the centre of the analysis of the question why firms exist and to suggest that markets and organisations are (mutually exclusive) alternatives for managing the same transactions. *The Nature of the Firm* was most cited and little used, by Coase's own admission, and this early lack of influence stems largely from Coase's failure to make his approach operational, and his lack of precision about which transactions will be left to the market and which will be internalised within firms (Barney and Hesterley, 1996). Later theorists addressed these deficiencies by developing a more complete model of the costs using a market to manage economic exchanges. This work has come to be known as transaction costs theory, and it is Williamson (1975) who answers and approaches what is now considered to be the core of transaction costs economics. The transaction cost theory rests on two essential assumptions about economic actors (be they individuals or firms) engaged in transactions: bounded rationality and opportunism (Barney and Hesterley, 1996). Bounded rationality means that those who engage in economic transactions are "intendedly rational, but only limitedly so" (Simon 1947: xxiv).

Opportunism is also a departure from the behavioural assumptions used in mainstream economics. While traditional economics assumes simply that economic actors behave out of self-interest, TCT assumes the possibility of self-interest seeking with guile (Williamson 1975:26). For Williamson (1985:47), opportunism includes lying, stealing and cheating, but it more generally refers to the incomplete or distorted disclosure of information, especially calculated efforts to mislead, distort, disguise, obfuscate or otherwise confuse partners in an exchange. TCT does not assume that all economic actors are always opportunistic. Rather, all it assumes is that some of these actors may have opportunistic behaviour and that it is costly to distinguish those who are prone to opportunism from those who are not. Stiglitz (2000) claimed that information economics over the last 25 years has – beyond a wealth of specific results- changed the way we think about many aspects of economic theory and quotes Hayek (1945) that the central problem of economics was a problem of knowledge or information: "the utilization of knowledge not given to anyone in its totality". Stiglitz, in the same paper (2000), explains that the equity markets do a better job of risk sharing than do bond markets or loans. Yet relatively little new capital is raised through equity, and few countries have stock markets with diversified share ownership (which would presumably do better at spreading risk). Why – Stiglitz asks, is equity not more widely used? Information economics provides a convincing set of explanations.

In economies where companies' books cannot be well audited – which includes most developing countries – the costly state verification model provides a convincing explanation for the limited use of equity.

When insiders in a firm have more information than outsiders – a not uncommon situation – then the controlling insiders' willingness to issue equity conveys a (noisy) signal that says that on average the shares are overpriced, and the market responds by lowering the price (conversely when firms buy back shares). Once it is recognised that for whatever reasons firms have limited access to (or choose to make limited use of) equity - then certain consequences follow. Firms resort to borrowing in order to raise funds; they may (and typically do) borrow enough so that there is some probability of bankruptcy. Issues of what happens when bankruptcy occur come to the fore – and determines in part how much the firm is willing to borrow. If bankruptcy imposes a cost on shareholders or managers, then firms will act in a risk-averse manner, explaining some of the seemingly anomalous behaviour of firms. Here, Stiglitz illustrates the important connection to the asymmetries of information between principals and agents, and unintendedly also demonstrates the weaknesses of his argument, as we are now writing in 2005 and capital markets are not what they used to be at the time he wrote this article (Stiglitz, 2000). It could also be questioned whether in current banking practice - despite technology and innovation – there is sufficient acknowledgement of the problems of "asymmetric" information, opportunistic behaviour (of all participants) and the consequences of TCT and Agency theory. Not just involving markets and participants but likewise the role and function of banks themselves.

Illustrative is the fact that during the 1870-1970 period, transactions costs consistently increased. This seems to go hand-in-hand with the increase of the role of services in economies as illustrated in the following paragraph.

In modern economies, transaction costs have become equally (and perhaps more) important than production costs. This is quite a development considering that early economic theory focused entirely on production costs assuming that transaction costs did not exist. It has become relatively more sensible to do research in transaction cost dynamics rather than production cost dynamics. This is perhaps also contributing to the surge of interest for research in corporate governance that clearly has more to say about transaction cost dynamics rather than production cost dynamics.

The method used to calculate the numbers in the table below is roughly this: For each sector in the national account, the number of workers in different occupations and a percentage of transactional work in each occupation are estimated. Then the salaries of these workers are used to calculate the transactional part of the GDP in each sector. The weighted average of these figures is the numbers shown in this table. To illustrate, the following occupations have been deemed to be 100% transactional: accountants, lawyers and judges, personal and labour relations, farm managers, managers, clerical, sales workers, foremen, inspectors, guards, police, military, and postal service. Industries with many non-transactional jobs are agriculture, mining, construction, manufacturing, and even transportation.

Table 2 Development transaction costs

Year	Transaction costs from private sector	Transaction costs from public sector	Total transaction cost sector in % of US GDP

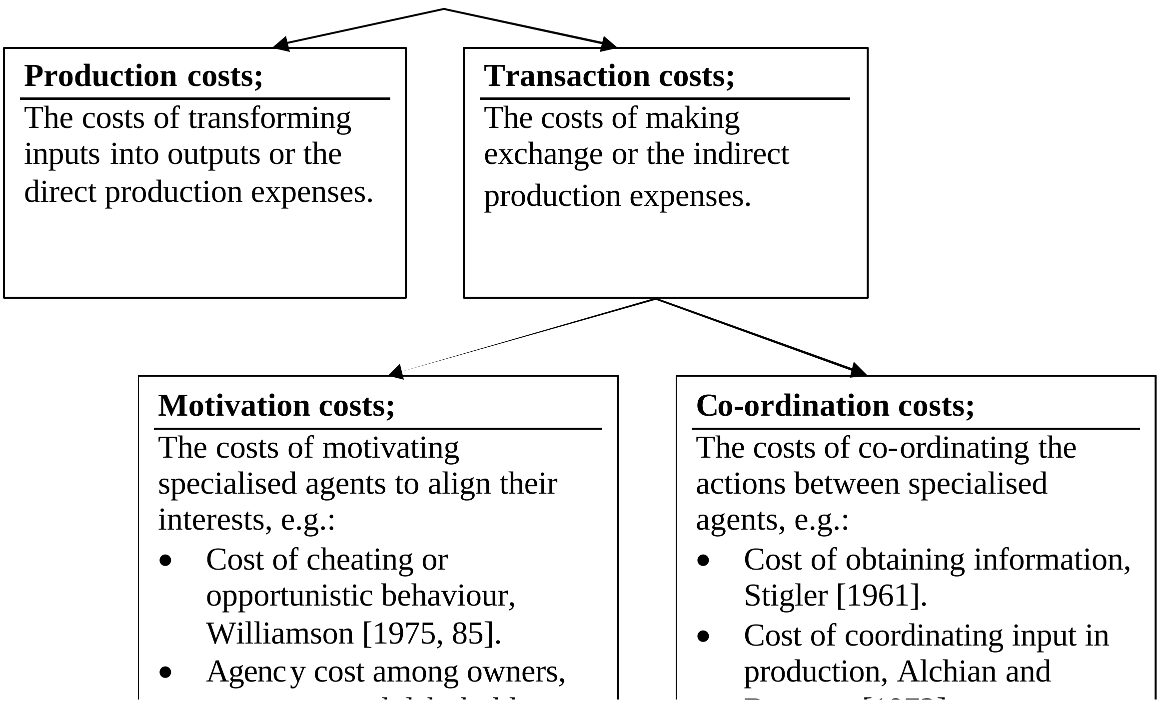
1870	22.5%	3.6%	26.1%
1890	29.1%	3.6%	32.7%
1910	31.5%	3.7%	35.2%
1930	38.2%	8.2%	46.3%
1950	40.3%	10.9%	51.2%
1970	40.8%	13.9%	54.7%

Source: Wallis, J., and D. C. North (Nobel laureate in economics) [1986, page 121]. "Measuring the Transactions Sector in the American Economy," in Long Term Factors in American Economic Growth, S. Engerman, and R. Gallman eds., University of Chicago Press.

2.1.5. Decomposing costs into transaction costs and production cost:

Introduction: This exhibition shows how total production can be decomposed into production costs and transaction costs. Furthermore, transaction costs can in turn be decomposed in motivation costs and co-ordination. The definition of production and transaction costs is found in Wallis and North [1986, page 97]. They use the term "transformation cost" instead of "production cost".

Figure 4 Decomposing transaction costs



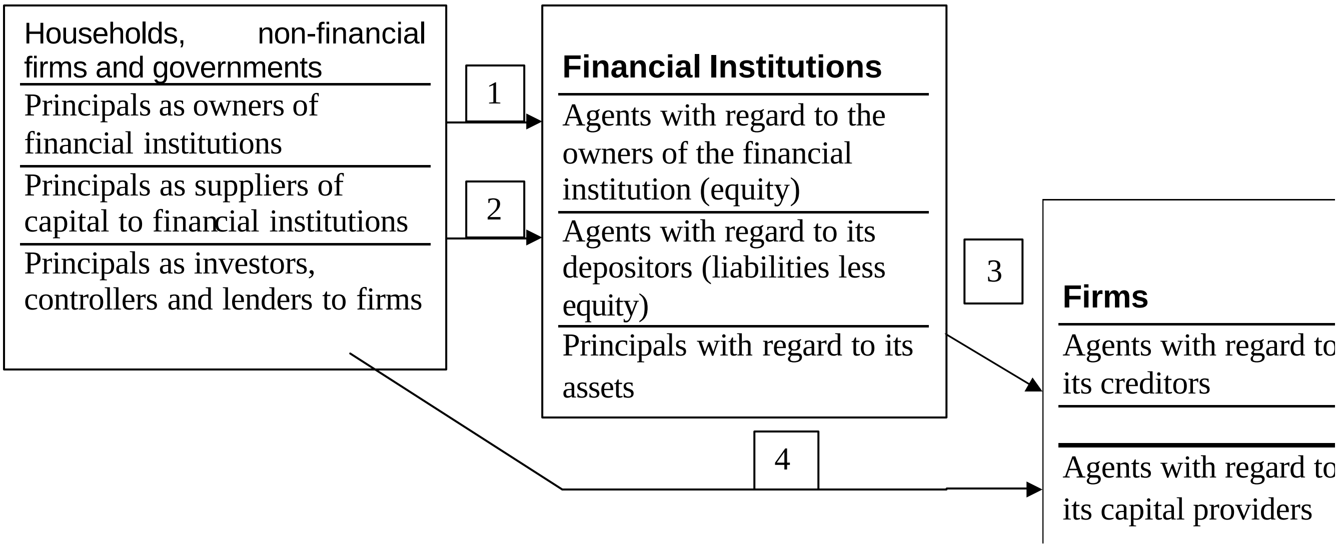
Note (1): Figure adopted from H. Mathiesen, /www.encycogov.com 1997.

2.1.6. The financial system and its agency relations:

In order to answer the question of why banks exist, it is suggested that besides understanding TCT, it is also necessary to develop a profound understanding of principal – agent relationships which exist in these markets. In order to be able to understand these relationships, you will find below a chart that outlines which general relations exist.

The arrows represent capital flows. The corporate governance literature usually focuses on relation [3] and [4]. Indeed, relation [3] is becoming more important since financial institutions finance an increasing fraction of the average firm's total capital - more than 50% in most OECD countries.

Figure 5 Agency relations



Note (1): Figure adopted from H. Mathiesen, /www.encycogov.com 1997.

2.1.6.1 Basic economic players:

Agents: People who get paid to execute a job for other people (the principals). In corporate governance the relevant agents are the managers and the directors. In the case of banking these would be the same

Principals: People who pay other people (the agents) to do a job for them. In corporate governance the principals usually are the owners of the firm. However, if for example the creditors are very powerful compared to the owners it may be more relevant to treat them as the managers' principals rather than the owners.

Particular : Of particular importance regarding banks, is in my view the role and responsibility of the Central Bank, who as an often independent government organisation acts as the agent to the public in executing its role. In case of banking crises often the agent-principal role is being put to the test (BCCI, Japan, Argentina, Uruguay).

2.1.7. Criticism of transaction cost theory:

Transaction cost theory has attracted its share of critics (Perrow (1986) and others. Of the many critical remarks directed at TCT, three are particularly central:

TCT focuses on cost minimisation; Williamson argued (1976); “economising is more fundamental than strategizing”, or put differently, economy is the best strategy. Resource based theory – for example – particularly takes exception to this emphasis.

It understates the cost of organising: The use of authority is assumed to resolve internal disputes more efficiently than the market (Jones and Hill 1988). Clearly this is not always the case. Lengthy and costly handling may often be more severe within a firm than between firms, as Eccless’s (1985) study of transfer pricing shows. Indeed, internal organisation is often susceptible to costly bargaining and influence behaviour. Even where authority may efficiently resolve some disputes, it also may be abused opportunistically (Dow 1987). Banks are typical – mechanistic organisations with very specific internal – by definition bureaucratic cultures, where internal politics, may be very important. Assuming that banks are special (Corrigan 1982) and historically have seldom been substituted by alternative forms of organisations or its transactions left to the market, seems to indicate that applying TCT alone would not sufficiently explain why banks exist.

It neglects the role of social relationship in economic transactions (highly relevant for banking): TCT seeks to adopt realistic assumptions of the human nature; but takes a decidedly calculative view (Williamson 1993a) of humans that discounts the impact of social relationships and culture. Granovetter (1985) pointed out that contrary to the atomistic view of economic exchange; transactions are influenced by expectations that are formed by the history of the relationship. These are highly relevant in banking services, as both status, as well as other aspects such as reputation, trust, confidentiality, standing, and yes, history of the relationship, are highly influential factors. Besides, friendship may trade co-specialised assets without hierarchy, a formal contract, or other tangible credible commitments, because they trust one another.

Despite these criticisms, the TCT answer to the fundamental question of why firms exist has been undeniably influential. Historically, economic theory viewed the organisation as irrelevant and unworthy of economic science (Stiglitz 1991), while organisation theory took the existence of organisation for granted. It is noteworthy that Corrigan (1982) has not made any reference to, for example, TCT and/or agency theory to explain why he believed banks were special.

2.1.8. Agency theory:

Agency theory draws heavily from the property rights literature (Alchian and Demzetz 1972) and to a lesser extent from transaction cost (Barney and Hesterly (1996). Like TCT, agency theory assumes that humans are bounded rational, self-interested and prone to opportunism (Eisenhardt 1989). The theories are also similar in their emphasis on information asymmetry problems in contracting and on efficiency as the engine that drives the governance of economic transactions (Barney and Ouchi 1986; Eisenhardt 1989). Agency theory however differs from TCT in its emphasis on the risk attitudes of principals and agents (Eisenhardt 1989).

As it originally developed, agency theory research focused on the relationship between managers and stockholders (Jensen and Meckling 1976). In this form, the theory has been used to analyse corporate governance, including issues such as the role of boards of directors and the role of top management compensation. More recently, agency theory has been applied to relationships between many stakeholders in a firm such as those between different managers within the same firm, between employees and customers (Grinblatt and Titman 1987), and between employees and different groups of stockholders and debt-holders (Copeland and Weston 1983). All these conflicts have important effects on a variety of attributes of organisations, including corporate governance, compensation and organisational structure.

Agency relationships occur whenever one partner in a transaction (the principal) delegates authority to another (the agent), and the welfare of the principal is affected by the choices of the agent (Arrow 1985). An obvious example is the relationship between outside investors in a firm and its manager. The investor delegates management authority to managers who may or may not have any equity ownership in the firm. Likewise – applying to the banking sector – the general public delegates authority to the government – and through this to the central bank, or other supervisory institutions (agent) – and the welfare of the principal (the public) is affected by the choice of the agent (Central Bank). Secondary is the principal - agent relationship between the central bank and the individual bank, whereby the Central Bank (principal) delegates authority to the individual bank (agent) in order to control and monitor branches, internal processes, and management. The delegation of decision-making authority from principal to agent is problematic in that: (1) the interest of principal and agent will typically diverge; (2) the principal cannot perfectly and costlessly monitor the actions of the agent; and (3) the principal cannot perfectly and costlessly monitor and acquire information available to or possessed by the agent. Taken together, these conditions constitute the agency problem – the possibility of opportunistic behaviour on the agent's part that works against the welfare of the principal. Jensen and Meckling view the agency problem as central to both economics in general and to organisation theory specifically.

It is worthwhile to point out the generality of the agency problem. The problem of inducing an agent to behave as if he were maximising the principal's welfare is quite general. It exists in all organisations and in all co-operative efforts – at every level of the management in firms (Barney and Hesterly (1996). The development of theories tries to explain the form in which agency costs take in each of these situations (where contractual relations differ significantly) and how and why they are born will lead to a rich theory of organisations which is now generally lacking in economics and the social sciences (Jensen and Meckling, 1976:309).

To protect the principal's interest, attempts must be made to reduce the possibility that agents will misbehave. In this attempt, costs are incurred. These costs are called agency costs. Total agency costs are the monitoring expenditures by principals, the bonding expenditures by agents, and the residual loss of the principal. The residual loss acknowledges that in many situations, it would be simply too costly for principals to completely monitor agents and too costly for agents to completely assure principals that interests do not diverge (Jensen and Meckling 1976). This logic also applies integrally to the relations between the public, the central bank (as supervisor, and agent to the public) and the banks operating under the supervision of the Central Bank. Agency costs and in particular residual costs can result extremely high in such cases whereby deposits are guaranteed through government guarantees (such is the case in many OECD countries), and in which a bank failure leads to the government (or government fund) having to pay for the deposits. There have been many examples in history illustrating this situation.

Assuming that agency costs exist, it is clear that principals have a strong incentive to minimize these costs (i.e. to minimize the sum of monitoring, bonding and residual agency costs). However, agents also have an incentive to minimize these costs. Where significant savings in agency costs are possible, these benefits may be shared between agents and principals. In the case of banks, clearly the agents (banks) in a particular setting have common goals in order to preserve the credibility of the system as a whole. Obviously this comes at a cost. And therefore, the principal and agent may have common interest in defining a monitoring and incentive structure that produces outcomes as close as possible to what would be the case if information exchange were costless (Pratt and Zeckhauser 1985).

Arrow (1985) notes two essential sources of agency problems: moral hazard, which he equates to hidden actions, and adverse selection, which he equates to hidden information (not uncommon phenomenon in the relationship between Central Bank and Banks). Moral hazard involves situations in which much of the agent's actions is either hidden from the principal or is costly to observe. Thus, it is either impossible or costly for the principal to fully monitor the agent's actions. This seems true for much of the trading that banks do for their own accounts, especially off-balance and so-called new products, such as derivatives. Stockholders or even directors, for example, might find it prohibitively costly to fully monitor the behaviour of their top management team. Indeed employment relation in general is one in which both effort and ability is difficult to observe. There are several high profile cases of bond, equity and/or derivative traders for which this has been the case.

Agency problems may also involve adverse selection. In adverse selection, the agent possesses information that is, for the principal, unobservable or costly to obtain. Consequently, principals cannot fully ascertain whether or not their interests are best served by agents' decision. At the most general level, principals and agents resolve agency problems through monitoring and bonding. Monitoring involves observing the behaviour and/or the performance of the agents. Bonding refers to the arrangement that penalises agents for acting in ways that violate the interests of principals and rewards them for achieving principals' goals. The contract between agents and principals specify the monitoring and the bonding arrangements. Indeed contracts are central in agency theory. Jensen and Meckling (1976) argue that most organisations are simply legal fictions that serve as a nexus for a set of contracting relationships among individuals. Within this nexus, however, firms adopt rules about monitoring and bonding. Given this general description of agency problems and their costly solutions, three important questions come to mind (Barney and Hesterly (1996) :

1) Why do principals delegate authority to agents, when they know that such delegation of authority will inevitably lead to agency problems?

Given agency costs, principals will not delegate authority to agents unless they find compelling reasons to do so. Sometimes there are no compelling reasons and single economic actors engage in a full range of economic activities. For example in proprietorships, small partnerships and closed corporations that operate on a small scale, it may be possible for a single individual to engage in the full range of economic activities from conceiving a business opportunity, obtaining the funding, and implementing all business decisions in exploiting that opportunity. More in general, one could also approach this dilemma by applying TCT. The decision for a firm to engage in outsourcing or not, involves the combination of agency problems and transaction cost theory, as well as direct cost efficiency, the outcome thereof not being static but a continuous dynamic process.

2) What specific monitoring mechanisms can principals put in place to minimize these agency problems?

Given the existence of agency costs, principals will find it in their self-interest to try to monitor agents (Eisenhardt 1985). One way that principals can try to monitor agents is by collecting relatively complete information about an agent's decisions and actions – an agent's behaviour. From this behavioural information, principals can thereafter form a judgment about the underlying goals and objectives of agents. In particular, principals can attempt to judge how similar their agents' goals and objectives are to their own goals and objectives. Obviously these guiding principals do very well apply to the principal – agent relationship between Central Bank and individual bank. Barney and Hesterly (1996) hold the view that monitoring agent's behaviour will rarely generate perfect information about the agent's decisions and actions, let alone about an agent's goals and objectives. This is especially unlikely if agents are engaging in relatively complex, highly unstructured tasks. As an alternative (or supplement) to monitoring agent's behaviour, principals can also monitor the consequences of agent behaviour. In general, monitoring performance or output is more efficient when tasks are not highly programmable (Eisenhardt 1985, Mahoney 1992). This too applies to the relationship between Central Bank and banks.

3) What specific bonding mechanisms can agents use to reassure principals?

The existence of agency costs suggests that principals have an incentive to monitor agents. However, agents also have an incentive to assure principals that they are behaving in ways consistent with the principals' interest. Recall that in many situations, principals and agents both absorb some agency costs associated with the delegation of authority. In general, principals can use bonding mechanisms to reassure principals. Frequently, bonding mechanisms take the form of incentives that agents create for themselves – incentives that make it in their self-interest to behave in ways consistent with the interest of principals. Obviously in the relationship between Central Bank (principal) and the supervised bank (agent) the bonding rests in the way the Central Bank allows the agent to perform the functions of the bank (through licence). If the agent fails to comply with the objectives and goals of the principals, the Central Bank usually has the authority to intervene the bank, and to have management of the bank removed from its position. It could be argued that this is a two-way relationship, in which also the Central Bank depends on its relationship with the public in its role as controller of the financial system and henceforth depends on the banks to duly perform their tasks. It is, as with most dilemmas, a question of equilibrium, i.e. a balance of power and interests.

Barth *et al* (2004) provide helpful insights in the supervision of banks and agency problems, indicating that, first, banks are costly and difficult to monitor. This leads to too little monitoring of banks, which implies sub-optimal performance and stability. These insights are consistent with the findings of Caprio and Klingebiel (2003), where they report on systemic banking crises in both non-OECD as well as high income OECD countries among which we find Japan (1991 – present), Finland (1991-1994), Norway (1987-1993), Spain (1977-1985), Sweden (1991), and for example on border-line non-systemic banking crises like in the United Stated (1984-1991) with the savings and loan institution, where 1,300 banks failed (costs US$ 180 billion or 3% of GDP).

Official supervision can ameliorate this market failure. Second, because of informational asymmetries, banks are prone to contagious and socially costly bank runs (for example Argentina 2001, Uruguay 2002). Supervision in such a situation serves a socially efficient role. Third, many countries choose to adopt deposit insurance schemes. This situation (1) creates incentives for excessive risk-taking by banks, and (2) reduces the incentives for depositors to monitor banks. Strong, official supervision under such circumstances can help prevent banks from engaging in excessive risk-taking behaviour and thus improve bank development, performance and stability.

Alternatively, powerful supervisors may exert a negative influence on bank performance. Powerful supervisors may use their powers to benefit favoured constituents, attract campaign donations, and extract bribes (Shleifer and Vishny, 1998; Djankov *et al.*, 2002 and Quintyn and Taylor, 2002). Under these circumstances, powerful supervision will be positively related to corruption and will not improve bank development, performance and stability. From a different perspective

Kane (1990) and Boot and Thakor (1993) focus on the agency problem between taxpayers and bank supervisors. In particular, rather than focusing on political influence, Boot and Thakor (1993) model the behaviour of a self-interested bank supervisor when there is uncertainty about the supervisor's ability to monitor banks. Under these conditions, they show that supervisors may undertake socially sub-optimal actions. Thus, depending on the incentives facing bank supervisors and the ability of taxpayers to monitor supervision, greater supervisory power could hinder bank operations (Barth *et al*, 2004). This has also been confirmed in a report (CSFI, 2005) where 440 respondents rank the rise of regulation to be the number risk facing the (banking) industry and the costs and distractions of regulation as well as the false sense of security it brings were the main reasons cited for its strong showing. The industry according to this report clearly believes that regulators are getting it wrong both from a cost perspective, driven by what banks see as an excessive focus on consumer protection, and from too much complexity, which is seen as killing competition and promoting a herd instinct in financial institutions (CSFI, 2005).

2.1.9. Criticism of agency theory:

Though the empirical evidence is on balance supportive of agency theory, important questions have been raised about the set of ideas. Foremost among these is that agency theory seems to adopt an unrealistic view of humans and organisations (Hirsch *et al.* 1990). In agency theory, humans are primarily motivated by financial gain. Much of the early research particularly ignored the other behavioural studies. Studies combining agency theory with ideas from other disciplines such as institutions theory (Eisenhardt 1988), equity theory (Zenger 1992) and social influence (Wade *et al* 1990 and Davies 1991) have yielded additional insights and questions about the theory. Another criticism of the agency theory is of a more philosophical nature. Perrow (1986) and others (Hirsch *et al* 1990) argue that agency theory has an inherent investor focus. This criticism is true of most research in the area, but as argued by Barley and Hesterly (1996), may not be inherent in the theory. The framework of agency theory is in itself neutral. It could just as well be used to examine issues that focus on the concerns of agents (Hesterly 1990).

After having discussed TCT and Agency Theory, the other theory which is relevant when looking at the banking industry over time, is intermediation theory. These three combined, then, give sufficient theoretical body as to be able to apprehend why banks exist.

2.1.10. Intermediation theory:

In the traditional Arrow–Debreu model of resource allocation, firms and households interact through markets, and financial intermediaries play no role. When markets are perfect and complete, the allocation of resources is Pareto efficient and there is no scope for intermediaries to improve welfare. Moreover, the Modigliani–Miller theorem applied in this context asserts that financial structure does not matter: households can construct portfolios which offset any position taken by an intermediary and intermediation cannot create value (Fama 1980).

A traditional criticism of this standard market-based theory is that a large number of securities are needed for it to hold except in special cases. However, the development of continuous time techniques for option pricing models and the extension of these ideas to general equilibrium theory have negated this criticism. Dynamic trading strategies allow markets to be effectively complete even though a limited number of securities exist.

Such an extreme view – that financial markets allow an efficient allocation and intermediaries have no role to play – is clearly at odds with what is observed in practice. Historically, banks and insurance companies have played a central role. This appears to be true in virtually all economies except emerging economies, which are at a very early stage. Even here, however, the development of intermediaries tends to lead to the development of financial markets themselves (McKinnon 1973).

In short, banks have existed since ancient times as demonstrated in previous chapters, taking deposits from households and making loans to economic agents requiring capital. Insurance, and in particular marine insurance, also has a very long history. In contrast, financial markets have only been important recently, and then only in a few countries, primarily the UK and the US. Even there, banks and insurance companies have played a major role in the transformation of savings from the household sector into investments in real assets.

Our understanding of the role or roles played by these intermediaries in the financial sector is found in the many and varied models in the area known as intermediation theory. These theories of intermediation have been built on the models of resource allocation based on perfect and complete markets by suggesting that it is frictions such as transaction costs and asymmetric information that are important in understanding intermediation. Gurley and Shaw (1960) and many subsequent authors have stressed the role of transaction costs. For example, fixed costs of asset evaluation mean that intermediaries have an advantage over individuals because they allow such costs to be shared. Similarly, trading costs mean that intermediaries can more easily be diversified than individuals.

Looking for frictions that relate more to investors' information sets, numerous authors have stressed the role of asymmetric information as an alternative rationalisation for the importance of intermediaries. One of the earliest and most cited papers, Leland and Pyle (1977), suggests that an intermediary can signal its informed status by investing its wealth in assets about which it has special knowledge. In another important paper, Diamond (1984) has argued that intermediaries overcome asymmetric information problems by acting as "delegated monitors." Many others followed, expanding on these two contributions and advancing the literature in substantive ways (e.g., see Gale and Hellwig, 1985; Campbell and Kracaw, 1980, and Boyd and Prescott, 1986).

Allen and Santomero (1997) argue that the financial systems in many countries have undergone a dramatic transformation. It is widely acknowledged that there has been an unprecedented amount of financial innovation (Miller, 1986). However, financial innovation has been occurring for many centuries albeit at a slower pace.

Allen and Gale (1994a) offer a detailed historical account of financial innovation. They point out that numerous different types of instruments were developed over time but relatively few survived. By the 1930s what might be named as the traditional financial instruments had been developed and had demonstrated some robustness.

Financial markets such as the stock and bond markets have grown in size using nearly any metric, such as the value of companies listed or any other conceivable measure of their importance. At the same time, there has been extensive financial innovation acceleration in the 1970s and 1980s. This includes the introduction of new financial products, such as various mortgage backed securities and other securitized assets, as well as derivative instruments such as swaps and complex options. These have all had a virtual explosion in volume. At the same time, new exchanges for financial futures, options and other derivative securities have appeared and become major markets.

Starting in the 1960s but primarily in the 1970s and 1980s, markets themselves have changed significantly. Arguably the most successful type of innovation has been the development of various kinds of derivative securities which have been introduced over this period.

Interestingly, this increase in the broadness and depth of financial markets has been the result of increased use of these instruments by financial intermediaries and firms. They have not been used by households to any significant extent. In fact, the increased size of the financial market has coincided with a dramatic shift away from direct participation by individuals in financial markets towards participation through various kinds of intermediaries (Allen and Santomero 1998).

The importance of different types of intermediaries over this same time period has also undergone a significant change. The share of assets held by banks and insurance companies has fallen, while mutual funds and pension funds have dramatically increased in size. New types of intermediary such as non-bank financial firms like GE Capital have emerged which raise money entirely by issuing securities and not at all by taking deposits. In short, traditional intermediaries have declined in importance even as the sector itself has been expanding.

Perhaps in response, but clearly contemporaneously, the activities of traditional institutions such as banks and insurance companies have also changed. Banks which used to take deposits and make loans found that the possibilities for securitising loans meant that they did not need to keep on their balance sheet all the loans they could originate. At the same time, insurance firms realised – assisted by a further liberalisation and deregulation of capital markets - that their actuarial function was but a minor part of their asset management capabilities and these firms too innovated and broadened their products and services.

Allen and Santomero (1998) have suggested that some of these changes in the volume of financial activity, along with the relative importance of some institutions and the changes in others can be explained using traditional theories which are based on transaction costs and asymmetric information. But, others cannot and they suggest that a whole new market between intermediaries was created.

Merton and Bodie (1995) suggest that financial systems should be analysed in terms of a "functional perspective" rather than an "institutional perspective." A functional perspective is one based on the services provided by the financial system, such as providing a way to transfer economic resources through time. In contrast, an institutional perspective is one where the central focus is on the activities of existing institutions such as banks and insurance companies. The argument in favour of focusing on the functional rather than the institutional perspective is that over long periods of time, functions have been much more stable than institutions. This has clearly been a characteristic of the intermediary sector in the recent past. Institutions have come and gone, evolved and changed, but functional needs persist while packaged differently and delivered in substantially different ways.

This constancy of functional needs has led Oldfield and Santomero (1997) to argue that financial services such as origination, distribution, servicing and funding are more stable than either the institutions that provide services or the specific products they offer in order to satisfy customer requirements. The financial services may be packaged differently both across competitive institutions and over time, but the functions are far more stable.

Using this functional approach to the financial sector, the literature that explains its activities can be seen as focusing on one or another function performed by it. The literature on transaction costs can be seen to be rationalising the role of these institutions in the distribution function.

Allen and Santomero (1998) recognised the importance of intermediation theories, but have suggested that these need to reflect and account for the fact that financial systems in many countries have changed substantially over the past 30 years. Over this period many traditional financial markets have expanded and new markets have come into existence. They argued that transaction costs have been relatively reduced in relevance and that information has become cheaper and more available. However, these changes have not coincided with a reduction in intermediation. In fact, quite the reverse has happened. Intermediaries have become more important in traditional markets and account for a very large majority of the trading in new markets, such as those for various types of derivatives. Standard theories of intermediation based on transaction costs and asymmetric information are difficult to reconcile with those specific changes that have taken place. They have argued that participation costs are crucial to understanding the current activities of intermediaries and in particular their focus on risk management. It appears that whilst making these valuable contributions, they could have expanded TCT and have specified the difference of participation costs to TCT, i.e. motivation costs and co-ordination costs. Besides, and in line with the findings of Allen and Gale (1994a), we should question the long-term viability of the new products which are traded on these markets between intermediaries. Recent decline in what banks refer to as investment banking, tends to indicate that yet another bubble has burst. (Economist 2002).

2.1.11. Are banks special?

The speciality of banks has traditionally been traced back to the monetary nature of their (demand deposit) liabilities and to their running the economy's payment system. Since the early experience of the deposit-taking institutions of the 19th century, banks have issued debt instruments that are accepted as means of exchange and payment on the basis of a fiduciary relationship among the agents using them, and between the agents and the issuing banks.

Supplying transaction and portfolio management services is what defines banking according to Fama (1980), while Kareken (1985) emphasises the central role of banks in managing the payment system. Corrigan (1982) adds to these functions the banks' twofold role of backup sources of liquidity for all enterprises in the economy and of transmission mechanism for monetary policy. Others have objected that, with the evolution of financial markets and institutions, none of the above functions is compellingly and exclusively pertinent to banks as such. In advanced economies, transaction account facilities are supplied by non-depository (and even non-financial) institutions with access to payment clearing and settlement systems. Likewise, various other financial and non-financial entities can provide credit to business, while the backup-source-of-liquidity function in times of economic distress is in principle inconsistent with bank regulations aimed to prevent or forestall bank failures. Finally, where monetary policy is mainly conducted via open-market operations, government securities dealers (even more than banks) may act as transmission mechanisms of monetary policy signals to the economy. Research according to Borsonne (2001) has thus looked for other features that may more specifically characterise banks as special financial intermediaries.

2.1.12. The credit function:

Diamond (1984) finds a special feature in banks acting as delegated monitors of borrowers (principals), on behalf of the ultimate lenders (depositors), in the presence of costly monitoring. Essentially, banks produce a net social benefit by exploiting scale economies in processing the information involved in monitoring and enforcing contracts with borrowers. Banks reduce the delegation costs through a sufficient diversification of their loan portfolio. Bossone (2001) argues that even if Diamond's result shows that banks' specialisation in monitoring credits improves social welfare, it does not prove to hold for banks exclusively, since any kind of intermediary equally benefits from portfolio diversification. Also, it does not explain why loan contracts are not replaced by more efficient risk sharing, more complete state-contingent contracts that reduce asymmetric information (such as equities).

What is characteristic of bank loans is that their value is fixed in nominal terms and includes collateral requirement clauses as well as costly bankruptcy provisions. By factoring ex-post information asymmetries and agency cost in the credit-making process, Gale and Hellwig (1985) show that such contract types, which they call standard debt contracts (SDCs), are optimal financial arrangements. These, on the one hand, save on the creditor's costs of monitoring states of nature throughout the life of the loan and, on the other, give borrowers an incentive to minimise the risk of default and discourage them from hiding their true business performance.

The optimality of SDC’s suggests a powerful argument to explain why banks have historically emerged as the first form of financial intermediation virtually everywhere in the world whenever capitalistic production had taken place. However, SDC optimality is not robust against changes in the universal risk-neutrality assumption used by Gale and Hellwig (1985) in their model, and does not hold in the case of ex-ante information asymmetries, where SDC’s become exposed to adverse selection and moral-hazard risks. Besides, as information and contract performance are crucial to the SDC optimality result, one would expect bank speciality to fade with the development of financial infrastructure, since this provides agents with better information and more efficient contract enforcement technologies leading investors to prefer non-SDC contract types (e.g., equity). Bank speciality is therefore a product of history, much like its own disappearance at some point.

Terlizzese (1988) uses the presence of ex-ante asymmetric information as a rationale for the depositors' preference to lend indirectly (writing a SDC with a bank) over direct financing of individual entrepreneurs. As depositors are faced with a "lemon" problem, they generate a demand for delegated screening which banks have a comparative advantage to perform. In a repeated-game situation, the related agency problem is solved through reputation incentives. Interestingly, due to the ex-ante information asymmetry, banks should not find it possible to have depositors agree on deposit contracts contingent on states of nature. This provides an enlightening explanation for the reason why banks commonly use SDC’s to finance their assets.

Through the credit function and the associated access to private information, banks tend to establish long-term relationships with fund users, based on mutual trust and mutually beneficial incentives. Quite correctly, Bossonne (2001) argues that relationships ensure borrowers with a steady and reliable supply of funding, even at times of adverse contingencies, while they generate for the banks safe sources of (quasi-monopolistic) rents. As relationships consolidate over time, it becomes costly for both parties to exit and replace them with different counterparties. Relationships, however, are not necessarily a unique feature of banks and can be replicated by other types of non-bank financial intermediaries; especially those specialised in term lending.

2.1.13. The liquidity function:

The credit view of bank speciality underscores the relevance of banks' informational advantage vis-à-vis the ultimate investors (depositors). Banks specialise in extracting and processing information concerning borrowers in a way that is not replicable by individual investors. In fact, bank information may be very exclusive and made unavailable to others. This is tantamount to saying that loans are illiquid to investors and non-negotiable in the market. In spite of this, banks finance their loans with liquid deposits bearing nominal fixed value and available to their holders on demand. The speciality of banks must thus rest with their capacity to provide liquidity services.

The provision of liquidity services pre-eminently characterises banks in the classical contribution by Diamond and Dybvig (1983). Instead of placing their endowments in an illiquid production technology, individuals deposit them with banks in exchange for (interest-bearing) claims entitling them to withdraw the deposits to finance future, unanticipated consumption needs (with uninsurable risk of occurrence). Depositors gain consumption flexibility. Their requests of withdrawals, however, are served sequentially, on a first-come-first-serve basis, until the bank runs out of (liquid) assets; thus, each depositor faces a positive risk of being unable to exercise his claim if the bank runs out of assets before his request is submitted. The return on deposits, on the other hand, enables depositors to achieve higher future consumption than if they realised the illiquid assets. Banks therefore provide depositors with a liquidity insurance service, and allow money to be transferred from patient holders to impatient consumers. (Bossonne, 2001)

However, any non-deposit type of money (say, cash) would provide at least the same kind of consumption flexibility that the Diamond–Dybvig (1983) deposits provide (although at a different risk–return trade off). The speciality of banks must therefore originate from their being able to transform liquidity into “optimal illiquidity” in the agent portfolios, by efficiently exploiting at the margin the depositors' preferred trade-off between consumption flexibility and inter-temporal consumption. The result is an instrument, which is riskier and higher paying than cash, but which works like cash. This is possible if the banks use deposits to finance illiquid assets that would not be financed by investors directly, and if they extract from these assets enough rents to remunerate the depositors. Banks are therefore pure intermediaries, and their speciality must be traced to their ability of integrating optimal illiquidity creation for depositors with rent-extraction power from borrowers.

In his last testament on money, Sir Hicks (1989) saw the speciality of banks in their acquired ability to make deposits withdrawable at sight and usable in payments. He understood that this allowed both banks and depositors to use deposits as money. He also saw this as enabling banks to hand over money when they make loans without giving up any cash (or third-party liabilities) but, simply, by increasing their liabilities: deposit withdrawability and their use for payments allow banks to create money.

In an innovative contribution, McAndrews and Roberts (1999) emphasize the power of banks to create liquidity through their role as payment intermediaries between buyers and sellers. As long as the agents hold deposits with banks and accept to be paid by book-entry transfers, banks can exploit the offsetting nature of multilateral payments and issue overdrafts on their books (thus creating liquidity) to depositors who demand to make payments in excess of their deposit claims. Bank deposits therefore remain a superior and cheaper means of payment than alternative instruments (e.g., mutual fund shares) which abjure the use of netting credit. In addition to what has been argued before, many depositors are driven to banks because of a combination of transaction costs and the virtue that in most countries – especially OECD – some kind of deposit insurance applies. Furthermore, banks have expanded in their services to clients, such as internet banking, credit card services and insurances, which make them interesting to depositors for a one stop shop. (All-Finanz concept).

2.1.14. Integrated functions:

Fama (1985) points to the speciality of banks as deriving from integrating credit and liquidity provision functions. By having borrowers hold deposits with them, banks can observe cash-flow movements and gain private information on borrowers, which they then feed into the processing of new loans. This gives banks a special role as information providers to capital market participants, who incorporate the information embedded in banks' lending decisions into their own investment evaluations. Though Fama's theory may explain why transaction- and credit-related services have historically been integrated within the same type of institution, it is not hard to imagine these services being increasingly provided by non-bank institutions specialised in extracting information on payment records of individual borrowers.

Goodhart (1987) looks at the peculiar asset and liability structure of banks. Bank assets determine the nature of bank liabilities: holding assets mainly in the form of nominally fixed loans induces banks to issue liabilities largely in the form of deposits with guaranteed nominal capital value. This makes banks particularly vulnerable to perceptions of asset deterioration, to an extent that even requires the setting up of special safety nets. Goodhart (1987) emphasises the effect that the exclusive nature of the information banks have on borrowers as the cause for the opaqueness and non-marketability of loans. It is not clear though, in Goodhart's explanation, why banks should not be able to use more efficient risk-sharing types of contract and stick, instead, to SDC types for lending. If the information inferiority and risk aversion of small depositors justify the banks' use of SDC’s for liabilities, the same does not hold for their assets since banks do have access to information on borrowers. Moreover, if banks diversify their assets sufficiently, there are not compelling reasons why they should not issue SDC's as liabilities and not use non-SDC's for their investment.

Calomeris and Kahn (1991) investigate the specific liability issued by banks in the form of demandable debt to finance illiquid assets. They show that, under costly and asymmetric information, demandable debt provides an incentive-compatible solution to the potential conflict of interest between (informed) bankers and (uninformed) bank depositors: the depositors' right to withdraw their claims from a bank, if they become dissatisfied with their deposit returns, gives them an incentive to monitor the bank. If enough of them agree on a negative assessment of the bank's performance, this can result in a bank's liquidation. As a result, demandable debt induces bankers to pre-commit to a set of agreeable payoffs to depositors. Obviously, the incentive property of demandable debt is less and less peculiar of banks, as claims on any (non-bank) financial intermediary become negotiable in efficient secondary markets and grant to their holders the power to "walk out" of the intermediary at any time.

Integrating information-intensive lending and payment services distinguishes banks from other intermediaries, according to Goodfriend (1991). Systems to evaluate, monitor, and enforce loan agreements are useful both for processing loans and for managing the implicit or explicit lending associated with the provision of payment services. As a result, payment services can be provided at lower costs by entities that also offer credit services.

Diamond and Rajan (1998) introduce banks as superior devices to tie human capital with real (illiquid) assets. Like Diamond and Dybvig (1983), they, too, focus on the liquidity insurance services provided by banks but take the further step of integrating the two sides of the bank balance sheet: banks create liquidity both for the depositors and the entrepreneurs.

Diamond and Rajan (1998) show that the peculiar bank capital structure works as a disciplinarian device: banks possess specific talents to collect the maximal value of loans to entrepreneurs and to attract deposits from individual investors, as they can credibly commit to pass on to them the rents they expect to collect from borrowers. Banks can do so because their capital structure exposes depositors to liquidity and credit risks, and makes depositors prone to run on banks if they perceive banks to become insolvent. Since a run would drive bank rents to zero, the risk of runs provides banks with an incentive to be credible borrowers. In this respect, runs are no longer an undesirable by-product of deposit contracts but an essential inducement to sound banking. This only applies under normal circumstances, mainly OECD countries for the last decades, as this is however not the reality for most non-OECD countries.

2.1.15. The circuit approach:

Integrating bank credit and liquidity functions, as proposed by the theories just reviewed, is necessary to gain an understanding of how banks interact with the real economy. Yet these theories share one limitation: all implicitly assume the pre-existence of some form of outside (commodity or reserve) money that is deposited with banks and is used by banks to extend loans. All these theories therefore take banks as intermediaries of outside money. Almost none of them, with few notable exceptions, point out that banks create money and that money creation makes banks differ from other intermediaries (Bossone 2001).

Like many economists before, Schumpeter (1934) explained this clearly, but his message did not make it through to today's mainstream theory of banking. Schumpeter understood banks as being uniquely capable of adding to the existing stock of money by lending promises to pay, so that the total credit in the system can exceed what is possible if credit has to be fully covered. And he understood that, through money creation, banks generate purchasing power in anticipation of, and for the production of, new output: bank money is made up of claims on output yet to be produced. Schumpeter saw that banks do not confine themselves to transferring existing purchasing power from depositors to borrowers. However, his model was not articulated enough to identify the different roles of banking and non-banking financial intermediation.

Banks are thus special because they, only, create money in the form of claims on their own debt, which they inject in the system by lending. Their speciality lies on their ability to economise on the (costly) use of outside money with their own deposit liabilities. For over four decades, this has been the core idea of the theory of the monetary circuit (Bossonne, 2001a). This theory integrates the real and financial sides of a monetary production economy in a sequential, flow-of-funds, general equilibrium framework. With some structural amendments, the theory sheds light on the different and complementary roles that banking and non-banking intermediation provides in servicing the real economy. Circuit theory is not inconsistent with the theories of banking discussed above that essentially identify the special role of banks with information and liquidity insurance provision, and contributes to understanding the links between the (micro) functions of banks and the macro economy.

2.1.16. Non-bank finance and the relevance of banking:

Bossone (2001) has clearly demonstrated the role of non-bank finance and the continuing relevance of banking, and argues that although in the industrial world, non-bank financial intermediaries have taken away considerable business from commercial banks, increases have been observed in the market share of institutions holding securities instead of loans. At the same time, banks themselves have heavily shifted their activity from traditional banking to other financial intermediation services. Lending to production, in particular, has become less important as more and more firms can directly access the market for short-term funds. Also, following financial liberalisation, domestic banking sectors have undergone large reorganisation, with banks consolidating into fewer and larger units.

An interesting interpretation of the disintermediation problem is the core-deposit theory of Berlin and Mester (1996). Liberalisation has led banks to pay market rates on an increasing portion of their funds, core deposits have shrunk, and relationship lending has become less and less feasible. Accordingly, banks have lost some of their comparative advantage vis-à-vis non-bank intermediaries[3]. Circuit theory suggests an alternative hypothesis to explain disintermediation and consolidation. As liberalisation reduces the demand for core deposits, banks tend to run increasing inter-bank open debit positions associated with their lending. As a result, banks incur in higher reserves holding costs to protect themselves against the risk of defaulting on inter-bank obligations. This puts pressure on banks to reduce lending and/or to expand their scale in an attempt to capture a larger deposit base from competitors. Bossone (2001) suggests that in any case, banks seem bound to become less in number and bigger in size.

Aside from the arguments discussed earlier under the narrow banking rubric, pointing to the real cost of money creation, there are important additional factors to consider in answering this question. In an environment where bank lending to production is less relevant,

[3] The concept of 'core deposits' must be used cautiously. In a circuit process, increases in the interest elasticity of the demand for deposits do not imply destruction of existing deposits, but simply their increasing velocity of circulation. In principle, to the extent that banks extend sufficient credit to each other, and/or that their size allows them to minimise inter-bank exposures, the decline of core deposits should not upset lending.

banks perform their key money creation function through alternative (and more wholesale type of) instruments. These include credit to non-bank intermediaries (including credit card issuers and industrial corporations offering financial intermediation services) and contingent credit.

By lending to non-bank intermediaries, banks indirectly supply the economy with fresh money to absorb production and services. This is typical of bank lending to intermediaries that provide credit for consumption, second-hand asset purchases, and financial services (including for speculation and hedging). This credit is essential as industrial productivity growth requires ways to expand and accelerate consumption of durables and physical capital renewal, and the demand for financial investment and risk- and portfolio-management services increases rapidly. Banks advance short-term loans to the intermediaries with ready and deep access to the capital market. The intermediaries on-lend the loan proceeds (on longer-term conditions) to households and firms planning to buy durables, second-hand assets, or financial services. As sales are executed, selling firms can cash the sale proceeds and invest the income, which generates capital market funds. The intermediaries can refinance their position from the capital market and match their asset–liability maturity and the system overall has more liquidity in it. A new flow of funds takes place wherein the selling firms are the net savers (investors), the buyers of goods and services are net dissevers (fund users and borrowers), and banks remain the suppliers of money.

Banks are thus essential for a growing real and financial economy (Bossone 2001).

Banks create money also through contingent liabilities (such as guarantees and warranties) that they issue to protect financial and non-financial institutions against contingencies that could disrupt their solvency. These liabilities are stand-by commitments to issue money to their holders if and when those contingencies happen. Their diffusion confirms the continuing speciality of banks: first of all, they enable the economy to use the existing liquidity more efficiently by supporting the extension of quasi-money and short-term borrowing instruments to an extent that would not be feasible without banks' stand-by commitment guarantees. Second, through these types of liabilities banks act as backup sources of liquidity for all other institutions in the system (Corrigan, 2000), and are in a position to support circuit closure in the event of payment failures. This underscores the banks' continuing importance in spite of the historical decline of their traditional activities. It also emphasises their key role as market agents specialised to validate the credit-worthiness of issuers of quasi-monies and short-term borrowing instruments.

Through money creation banks complete the economy's financial market structure by transforming liquidity and maturity (at a risk).

2.1.17. Research questions:

Following the above chapter on the question why banks exists, the following hypotheses were formulated:

H.1.1. In general banks seem to be very competent with regard to understanding risks.

H.1.2. Clients of banks would be benefited if banks were rated in terms of client's satisfaction.

H.1.3. The long history in banking and the lack of alternatives means that banks will continue to exist for many more years.

H.1.4. With current supervision and regulation on banks one can be confident about low systemic risks.

H.1.5. Banks play a crucial, mostly constructive role within the world economy.

H.1.6. With increased knowledge and modern techniques in finance the role of relationship in bank-client relations will diminish.

And the sub-hypotheses;

H.1.6.1. Most companies tend to act opportunistically in their bank-relations.

H.1.6.2. Banks are considered by most clients as a necessary evil.

H.16.3. Housebanks play an important and largely positive role in the process of corporate control; and borrowers with a strong bank–borrower relationship receive more competitive credit on average.

2.1.18. Concluding remarks:

In this section 2.1. a thorough explanation has been given as to why banks exist, using a variation of existing economic theories. This was considered to be of importance given that banks are the main channel through which cross border lending takes place. A critical analysis of their role in society has been provided and subsequent hypotheses have been formulated. In the next section of this Chapter 2, credit and credit risk will be further explored and analysed as it is credit and credit risk which represent the core aspects in the field of cross border lending. Also the role of credit rating will be discussed as credit rating will become more important in view of the new Basel II regulations to be implemented by 2006.

Section 2.2 - CREDIT AND CREDIT RISK

2.2.1. Introduction:

In this section of Chapter 2 a literature survey will be provided on the relation between credit and credit risks as well as how credit risk can be measured will be discussed. Obviously the instrument of credit rating comes to mind, as credit rating will become even more important in view of the upcoming Basel II regulations. Also the role of relationship banking comes in play as well as the role of external credit rating agencies, their techniques, the strengths and weaknesses thereof and their added value to markets and companies will be reviewed.

Credit risk measuring and credit risk ratings are not new phenomena. Credit rating agencies are as old as 100 years, whereas credit risk measuring is as old as the origin of financing. What seems to be new in recent years is the increasing application of technology and modelling, whilst measuring credit risk is in large part inspired by market developments, such as derivative market development, globalisation, the liberalisation of financial markets, and, last but not least, the suggestion that with stricter controls, through Central Bank and BIS regulation, credit risk and secondary systemic risks may be better managed, as is shown in the following paragraph quoted from IMF and World Bank:

“Since 1997, financial sector crises in a number of countries, for instance Argentina, Ecuador, Indonesia, Korea, Russia, Thailand, and Turkey, have highlighted linkages between financial sector crises and weak macroeconomic policies, while also showing the adverse effects of poor lending practices, weak corporate governance, inadequate loan provisioning, accounting and auditing practices, and insufficient supervisory independence. In many cases, the preconditions for effective banking supervision, which include sound and sustainable macroeconomic policies, a well-developed public infrastructure, effective market discipline, procedures for effective bank resolution, and systemic protection or a safety net, had not been met sufficiently (IMF and World Bank, 2002).”

This chapter describes key issues related to credit and credit rating as well as supervision, without discussing the technical content of the different models and methodologies. Also, within the context of this field, theories such as intermediation theory and agency theory are relevant, but those aspects will not be addressed here. Reading through the enormous amount of publications on the subject, one observes that there is plenty of discussion on technical aspects and considerations, yet that perhaps there is less discussion on the concept itself and rather few critical considerations. It will be argued that this is somehow due to the dominant epistemology governing the field of finance, where researchers mainly seem to adhere to the functionalist paradigm.

Before credit rating and credit ratings agencies came into play, all financing was either done on a transactional basis, i.e. commodity finances for example, or on the basis of a relationship between borrower and financier. At the beginning of the relationship, as in Stiglitz and Weiss (1981), there is no possibility of selecting borrowers according to their quality. Hence, problems of adverse selection and moral hazard have to be considered. These problems can be solved by charging low interest rates at the beginning. In later stages of the relationship, borrower selection problems are resolved by having monitored former successful projects of surviving borrowers. With these borrowers, higher interest rates can be achieved. These higher interest rates are still low compared to interest rate offers of competing banks with no earlier relationship to these customers. These competing banks have to rely on an assessment of the average default probability of possible new borrowers, which is higher because no pre-selection of borrower quality has taken place.

Stiglitz and Weiss (1981) explain restrictive lending policies of banks as a consequence of asymmetric information on borrower quality. Models such as Bester (1985) and Besanko and Thakor (1987) solve this problem by introducing collateral as a sorting device to identify borrower quality. Petersen and Rajan (1995), and Petersen and Rajan (1994), show theoretically and empirically that another key to overcoming this phenomenon is the possibility of learning about borrower quality through time. As a consequence borrowers with a strong bank–borrower relationship receive more credit on average. This conclusion is sustained by evidence from Japan provided by Hoshi *et al.* (1990) and Hoshi *et al.* (1991).

A growing body of literature, both theoretical and empirical, has focused on the role of relationship lending as a determinant of corporate performance. In an early contribution, Cable (1985), for example, relates the rapid path of industrialisation and economic growth in 19th century Germany to the active role of its banking system. In particular, close connections between industry and their major banks, or housebanks[4], are credited with some of industrialisation success in the late 19th century. Tilly (1989) reports results on the contribution of German universal banks to industrial investment in large corporations. His findings support the view that housebanks play an important, and largely positive, role in the process of corporate control, and of industry-wide merger activities.

In this literature, a housebank is regarded as the premier lender of a firm, being equipped with more relevant and timelier information than any "normal", non-housebank institution. Furthermore, a housebank is more committed to its client, enlarging their role as financier if the firm faces sudden and temporary difficulties. The importance of long-term commitment in the bank–customer relationship is stressed by Mayer (1988) and Hellwig (1989), and Boot and Thakor (1994), just to name a selection of the extant relationship lending literature.

This literature usually makes no distinction between housebank relations and normal bank relations. In this sense, modern banking theory has largely focused on homogeneous banking relations. Firms

[4] Housebank is a term which is known especially in Germany (and surrounding countries) as reported by Tilly (1989) and others. A housebank is regarded as the premier lender of a firm

have an exclusive outside financier, their housebank, and all corporate customers of commercial banks are presumably housebank–clients. However, theoretical as well as empirical arguments suggest that firms have a multitude of banks supplying credit (von Thadden, 1992). Thus, the case of "relationship lending" or "housebank financing" is a specific implicit contractual arrangement among a broader range of financial relations.

2.2.2. A survey on relationship banking:

Various models of the banking firm stress their role in reducing costly information asymmetries between borrowers and lenders (see the surveys by Bhattacharya and Thakor, 1993 and Thakor, 1995). Under certain assumptions, financial intermediaries are able to realise economies of scale and scope concerning production, and use of information. One important line of reasoning focuses on the structure of long-term debt contracts. As complete and state-contingent contracts are not feasible in a world of asymmetric information, intermediaries may restore efficiency through the use of relationship lending. In particular, a bank is able to offer a technology for low cost renegotiations of debt contracts: “...by close and continued interaction, a firm may provide a lender with sufficient information about, and a voice in, the firm's affairs so as to lower the cost of and increase the availability of credit” (Petersen and Rajan, 1995, p. 5). Here, private information helps to establish commitment by the lender vis-à-vis the borrower. The resulting optimal contract allows for intertemporal arrangements, lowering aggregate financing costs and reducing credit rationing (see Greenbaum *et al.*, 1989; Sharpe, 1990; Fischer, 1990; Boot and Thakor, 1994 and Petersen and Rajan, 1995).

Relationship lending with long-term commitment and informational monopoly by the lender has some similarity with the so-called housebanking principle. As pointed out by Edwards and Fischer, housebanks in Germany are said to bear a special responsibility if their customer face financial distress (Edwards and Fischer, 1994, pp. 8–10, 157). The housebank is regarded as the premier lender of a firm, with more intensive and more timely information production than under a comparable normal debt contract.

A large proportion of the literature implies exclusivity as a fundamental characteristic of debt financing, thereby identifying bank loans a priori with relational financing. In Diamond (1984), an intermediary realises economies of scale with respect to monitoring. There is no direct competition from a second intermediary. In the model of Fischer (1990), banks need an exclusive relation with their clients to support an intertemporal trade-off between loan availability and loan pricing. With competition between several banks that cater for the financial needs of a firm, the special long-term relation to clients breaks down. In this sense, modern banking theory has largely focused on homogeneous banking relations. Firms have an exclusive outside financier, their housebank, and all corporate customers of commercial banks are presumably housebank-clients. However, in most papers, competition is indirectly introduced by imposing a zero-profit condition for the banks.

The available evidence suggests that exclusive financing relation between banks and firms are extremely rare. Even in the small firms-sample utilised by Berger and Udell (1993) and Petersen and Rajan (1994), the average number of bank relations at any moment in time is a function of firm size, varying between 1 and 6. Boot and Thakor (1997) analyse a more complete model, where banks engage in both transaction-based and relationship-based banking. The model allows studying the bank's optimal choice of relationship financing. Nevertheless, it is partial in that the borrower does not have a choice between different kinds of bank debt.

The information monopoly of housebanks potentially poses a risk for the borrower, since the former has ex post superior bargaining power. The debtor is informationally captured and might loose future benefits of an enhanced creditworthiness (Mayer, 1988 and Rajan, 1992). These extra-costs of lending may explain why borrowers establish relations with a multitude of lenders. Von Thadden (1992) argues that competition from a second lender ("duplicated monitoring") may reduce the rents from hold-up situations. Bolton and Scharfstein (1996) analyse the process of debt renegotiations with many lenders and the role of collateral therein. Their results are consistent with the assumptions and implications of the relationship lending literature, although the driving forces in their model are differences in property rights on collateral.

In summary, relationship lending is an information-intensive type of debt financing, which can affect credit costs and credit availability in a predictable way. It is based on the idea of an intertemporal implicit contract, which is facilitated by a certain degree of (ex post) bargaining power of the lender. However according to Elsas and Krahnen (1999) housebanking is not necessarily synonymous to exclusive financing. Firms may have a multitude of lenders, but they will have at most a single housebank.

Turning to the relevant empirical literature, one finds it largely concerned with the analysis of bank uniqueness, rather than relationship lending. For example, James, 1987 and Lummer and McConnel, 1989 and Billett *et al.* (1995) provide some evidence on abnormal positive market returns after announcements of new bank debt, or renewal of existing bank debt. These studies do not differentiate between housebank contracts and normal bank contracts and thus do not provide insights into the specific role of relationship lending. Systematic attempts to analyse the implications of relationships can be found in Petersen and Rajan (1994) and Berger and Udell (1995). These papers draw on a data set from the National Survey of Small Business Finance. They examine determinants of loan pricing in a cross-section. Blackwell and Winters (1997) use credit-file data from a number of banks in the U.S. Unlike the data in Elsas and Krahnen (1999), there is no information on internal risk assessments (credit ratings), and there is only one year of observations.

In all these papers, housebanks and normal banks are identified by the duration of the firm's relationship with the bank. It is implicitly assumed that duration of a relationship is a sufficient statistic for information intensity. However, the suitability of duration as a relationship lending proxy may be questioned. Elsas and Krahnen (1999) indicated that they are not aware of a theoretical argument predicting different lengths of time for housebank and normal bank financial relations. Though there are models predicting housebanks to behave differently from normal banks, e.g. in situations of financial distress, they do not predict an early discontinuation of normal bank lending (though they may predict a tightening of credit availability). Note that the duration-proxy captures only the length of a relationship, not its intensity. Second, recent direct empirical evidence disputes the validity of duration as a proxy for relationship lending altogether. In a study on the Norwegian credit market, Ongena and Smith (1997) find no significant influence of contract duration on the likelihood of relationship termination. The authors argue that this finding is inconsistent with duration being a good measure of relationship intensity. For Elsas and Krahnen (1999) they found no significant difference of mean contract duration between the sub-samples of housebanks and normal banks.

One recent attempt to control for the dynamic aspects of relationship lending is the analysis of Berlin and Mester (1997a). Based on a data set of 600.000 small business loans and an observation period of 12 years, the authors try to examine the idea of an intertemporal compensating scheme. Their results do not provide evidence in support of the existence of relationship lending (Berlin and Mester, 1997a, pp. 15, 16). However, the analysis does not directly compare relationship-based and normal bank debt. Berlin and Mester estimate cost functions and profit functions for each bank in their sample. The link to relationship lending is provided by the idea that relationship lending is reflected by loan rate smoothing, leading to higher costs and higher profitability simultaneously. Moreover, by relying on bank loans with contractual interest rates above the prime rate, the authors in fact use a censored sample. As argued by Gorton and Kahn (1996), banks may, under certain circumstances, charge below-prime rates under an optimal arrangement.

Preece and Mullineaux (1996) address the issue of multi-lender relations empirically. They examine the market response to announcements of private financing with different numbers of lenders. Abnormal returns are observed only if the number of lenders is sufficiently low, i.e. smaller than 4. This is consistent with the idea that a small number of lenders have stronger incentives for a close monitoring over time, and that they have lower costs of renegotiation. Once again, their analysis does not differentiate between housebanks and normal banks.

The relationship between the number of lenders and a firm's sensitivity to cash flow variations is analysed by Houston and James

(1996). The authors find that firms relying on a single bank are more cash flow constrained and appear to hold larger stocks of liquid assets as a means of liquidity insurance than firms with several banks. This finding casts doubt on the insurance hypothesis as implied by relationship lending. However, one cannot conclude immediately that firms with a single lending bank are better off by employing additional lenders. The observed financing structure could well reflect equilibrium and, thus, by increasing the number of lenders, the firm's situation might deteriorate (Houston and James, 1996, p. 21).

Overall, the empirical evidence for the existence of relationship lending appears to be mixed. Due to the utilisation of duration as a proxy for relationship intensity, most studies to date have to be evaluated carefully. Only few papers control directly the dynamic character of the bank–borrower relationship or the number of lenders a given borrower contracts with simultaneously.

2.2.3. Introduction to credit rating:

The rating of borrowers is a widespread practice in capital markets. It is meant to summarise the quality of a debtor and, in particular, to inform the market about repayment prospects. Apart from so-called external ratings by agencies, there are also internal ratings by banks and other financial intermediaries providing debt finance to corporations. While external ratings by agencies have been available for many years, in fact since 1910 in the case of Moody's, the oldest agency, internal ratings by commercial banks are a more recent development. Their history in most cases does not exceed 5–10 years.

Rating categories, typically letter labelled (AAA or Aaa for prime quality), or simply numbered (1 to 10, say), are a shorthand to quantify credit risk. On the basis of historical data, ratings can be related to the relative frequency of defaults (default-mode paradigm), or they become the basis for the valuation of an asset (mark-to-model paradigm). The most prominent application relates to corporate asset-liability management, where risk-adjusted return on capital (RAROC) numbers is used to benchmark divisional performance. Ratings allow to measure credit risk, and to manage consistently a bank's credit portfolio, i.e. to alter the banks' exposure with respect to type of risk. In particular, ratings are useful for the pricing of a bond or a loan, reflecting an intended positive relation between expected credit risk and nominal return.

For all these reasons, the quality of a financial institution's rating system has attracted attention from many parties. Auditing firms discuss the risk reporting systems of a corporation in the annual report, rating agencies evaluate the risk assessment system of a borrower who wants to issue asset backed securities, and supervisory authorities (under the guidance of the BIS) are expected to start soon to certify institutional rating systems and credit risk models.

A final remark is in order about the differences between two types of ratings: internal and external. Rating agencies generate external ratings. These agencies specialise in the production of rating information about corporate or sovereign borrowers, they do not engage in the underwriting of these risks. The rating information is made public, while the rating process itself remains non-disclosed. Internal ratings, in contrast, are produced by financial intermediaries (notably banks) to evaluate the risks they take into their own books. The rating information is seen as a source of competitive advantage, because it is believed to contain proprietary information, and is therefore not made public. Even the firm being rated is typically not informed about its current internal rating.

While there is a growing empirical literature on the validity and the reliability of external ratings (see notably Ederington *et al.*,1987 and Blume *et al.*, 1998), and on the informational content of external rating changes (see Hand., 1992 and Liu *et al.*, 1999), there is still very little published work on the methodology and the empiricism of internal ratings. A notable exception that relies on data from the US is Treacy and Carey (1998) and Carey (1998).

2.2.4. Rating agencies:

2.2.4.1. The external agency rating process:

The issuance of bonds by corporations is a 20th-century phenomenon. It started at the beginning of the century, at approximately the same time that the first papers and articles were published on the analysis of accounting ratios, as a means of diagnosing the financial strength of a company. By the 1920s, this approach had been commercialised and specialised firms were offering their services, and promoting the merits of ratio analysis. This was also the period when Moody's (1909), S&P (1916), and other agencies started to rate public debt issues. Over the last 30 years, the introduction of new financial products has led to the development of new methodologies and criteria for credit rating: S&P was the first rating company to rate mortgage-backed bonds (1975), mutual funds (1983) and asset-backed securities (1985).

A credit rating is not, in general, an investment recommendation concerning a given security. In the words of S&P, "A credit rating is S&P's opinion of the general creditworthiness of an obligor, or the creditworthiness of an obligor with respect to a particular debt security or other financial obligation, based on relevant risk factors." A rating in Moody's words is "...an opinion on the future ability and legal obligation of an issuer to make timely payments of principal and interest on a specific fixed income security." "Moody's ratings of industrial and financial companies have primarily reflected default probability, while expected severity of loss in the event of default has played an important secondary role. In the speculative-grade portion of the market, which has been developing into a distinct sector, Moody's ratings place more emphasis on expected loss than on relative default risk." Since S&P and Moody's are considered to have expertise in credit rating and are regarded as unbiased evaluators, their ratings are widely accepted by market participants and regulatory agencies. Financial institutions, when required to hold investment-grade bonds by their regulators, use the ratings of credit agencies such as S&P and Moody's to determine which bonds are of investment grade.

The subject of a credit rating might be a company issuing debt obligations. In the case of such "issuer credit ratings", the rating is an opinion on the obligor's overall capacity to meet its financial obligations. The opinion is not specific to any particular liability of the company, nor does it consider the merits of having guarantors for some of the obligations. In the issuer credit rating category there are counterparty ratings, corporate credit ratings, and sovereign credit ratings.

Another class of rating is "issue-specific credit ratings". In this case, the rating agency makes a distinction, in its rating system and symbols, between long-term and short-term credits. The short-term ratings apply to commercial paper (CP), certificates of deposits (CD) and put bonds. In rating a specific issue the attributes of the issuer, as well as the specific terms of the issue, the quality of the collateral and the creditworthiness of the guarantors, are taken into account.

The rating process includes quantitative, qualitative and legal analyses. The quantitative analysis is mainly financial analysis and is based on the firm's financial reports. The qualitative analysis is concerned with the quality of management, and includes a thorough review of the firm's competitiveness within its industry as well as the expected growth of the industry and its vulnerability to technological changes, regulatory changes and labour relations.

When rating a company, the nature of competition within its industry is a very important consideration. In trying to illustrate its evaluation process, S&P uses an example of a firm from the airline industry. For such a firm, the analysis concentrates on issues such as market position in specific markets locally and internationally, including barriers to entry, revenue generation (including pricing, utilisation of capacity, service reputation, and productivity), cost control (for labour, fuel, commissions) and the quality of the aircraft fleet.

The assessment of management, although subjective in nature, investigates how likely it is that it will achieve operational success, and its risk tolerance. The rating process includes meetings with the management of the issuer to review operating and financial plans, policies and strategies. All the information is reviewed and discussed by a rating committee with appropriate expertise in the relevant industry, which then votes on the recommendation. The issuer can appeal against the rating before it is made public by supplying new information. The rating decision is usually issued four to six weeks after the agency is asked to rate a debt issue.

Usually the ratings are reviewed once a year based on new financial reports, new business information and review meetings with management. A "credit watch" or "rating review" notice is issued if there is reason to believe that the review may lead to a credit rating change. A change of rating has to be approved by the rating committee.

2.2.5. The differences in ratings:

While the rating agencies use similar methods and approaches to rate debt, they sometimes come up with different ratings of the same debt investment. In their studies of the credit rating industry, Cantor and Packer (1996) show that for 1.168 firms rated by both Moody's and S&P at the end of 1993, only 53% of the firms rated AA or Aa and AAA or Aaa were rated the same by both agencies. For other investment-grade issues, only 36% were rated in the same way, while 41% of those rated below investment grade had been awarded the same ratings.

This issue of ratings' differences is an important one. It raises two questions: First, to what extent is the rating quantitatively based and what is the role of judgement? The second question concerns the independence of the rating agencies. Since the rated companies pay to be rated, there is a perceived danger that business pressures will affect the process.

Cantor and Packer (1996) studied differences of opinion in the credit ratings industry and suggest that often ignored in the debate has been the fact that observed rating differences need not imply different credit standards, but rather could be the result of sample selection bias. While for decades Moody’s and S&P have automatically assigned ratings to all corporations issuing in the U.S. public bond markets, Fitch and Duff & Phelps-the two other major agencies-have issued ratings only upon request. These “third” agencies have argued that their ratings have often been sought when there is a strong expectation by issuers of improving upon Moody’s and S&P’s ratings. However, whenever Fitch and Duff & Phelps would have rated lower, their ratings would not have been purchased. Certainly, the mechanism of reputation should serve as a powerful incentive to maintain ratings that are not too out-of-line with established standards. The rationale for obtaining credit ratings has traditionally been viewed in the finance literature to be the economies of scale in information collection and the reduction of agency costs in the issuance of debt (Wakeman 1984, Ramakrishnan and Thakor 1984, Millon and Thakor 1985). If investors were to lose confidence in an agency's ratings, issuers would no longer believe they could lower their funding costs by obtaining its ratings. To this extent, we might expect the credit rating agency's reputation in the bond market to play a role similar to that of the underwriter's in the initial public offering (lP0) market, where reputation checks the degree to which low-quality issues are brought to the market (Beatty and Ritter 1986; Carter and Manaster 1990).

Cantor and Packer (1996) found that third agencies, such as Fitch and Duff & Phelps, on average assign higher ratings than Moody's and Standard and Poor's. This pattern may result because the third agencies have more lenient standards or because their policy of rating only on request induces selection bias. Their results suggest that although there is evidence of sample selection in the data, the majority of the observed differences in average ratings appear to reflect differences in standards. Considerations about reputation apparently do not ensure equivalence across agency scales, and financial industry regulations that assume such equivalence may be misconceived (Cantor and Packer, 1996).

The rating agency business already constitutes an oligopoly. The issue of who rates the rating agencies has been debated since the industry was first established. Linnell (2001) believes that the proposed changes to the Capital Accord will further fuel this debate given the perception of increased power for the industry. However, it is unlikely that the Accord will add to the formal regulatory burden of rating agencies. Credit Rating agencies are already regulated at the point of entry, i.e. in order to establish a presence in a local market; virtually every country operates a formal approval process from the local securities authorities. Once this has been received, whilst the ongoing burden of regulation is negligible, agencies are still responsible to the local authorities and may be expelled from a market if found to be acting in an inappropriate or irresponsible manner. In addition, any increased formal regulation would have to overcome formidable practical obstacles, not least how can opinions be regulated?

Whilst formal regulation of the industry is minimal, informal regulation is ever present. Specifically, market forces, confidence and judgement are by far the most significant regulatory influences affecting the ratings industry. No rating agency can afford to lose its market credibility since; ultimately, it is merely a formal mechanism for expressing credit opinions. Without its reputation, therefore, those opinions become worthless and its franchise eroded. Consequently, a ratings agency has to behave responsibly and clearly articulate its policies and decisions; otherwise the market will judge it harshly and quickly marginalise its activities.

Cantor (2001), now employed by Moody’s, confirms that the credit rating agency industry is subject to moral hazard. Every rating agency has a business incentive to assign high ratings to issuers, who are free to choose among the agencies. This incentive is offset by a rating agency's need to maintain its reputation in the market with investors, who drive the issuers' demand for credit ratings. Pressure on issuers to "shop" for the highest rating is increased by their use in regulation. Such practices could undermine the reliability of ratings over time.

2.2.6. Rating through the cycle versus current condition rating:

Rating agencies such as Fitch, Moody's or Standard & Poor's play an important role for the functioning of credit markets. Their ratings are used to price risky debt, to compute economic and regulatory capital, or to calibrate internal ratings of banks and other financial institutions (for the latter see Carey and Hrycay, 2001). When using agency ratings for such purposes, two main requirements should be met. The nature of a rating should be properly understood, i.e., it should be clear what kind of information rating agencies intend to summarise. Secondly, ratings should efficiently aggregate this information.

As for informational efficiency, there is plenty of academic and anecdotal evidence, which suggests that agency ratings do not fully reflect available information. Altman and Kao (1992) and Lando and Skødeberg (2002) document serial dependence in rating changes, while Delianedis and Geske (1999) conclude that borrower fundamentals predict future rating changes. Other evidence which points to inefficiencies is the high stability of agency ratings (Kealhofer *et al.*, 1998), or the agencies' performance in the Asian crises (IMF, 1999).

The peculiarities of the agencies' rating method, on the other hand, have received little attention in the literature. It is commonplace to note that agency ratings are not estimates of short-term default risk, but should rather be characterised as looking through the cycle (Basel Committee on Banking Supervision, 2000). Carey and Hrycay (2001), however, are the first to study the nature and consequences of the agencies' rating architecture. They examine problems that arise if the default history of through-the-cycle ratings is used to map internal bank ratings into default probabilities. Contrary to agency ratings, bank ratings are usually based on the actual default probability over a specific horizon. In the literature, such ratings are labelled current-condition or point-in-time ratings. The category also comprises ratings based on quantitative forecasts of bankruptcy.

Löffler (2002) suggests that the empirical evidence on ratings has to be interpreted with care. Apparent violations of informational efficiency could well result from the agencies' rating method. It is important to evaluate ratings against an appropriate benchmark and to take their particularities into account when using them as inputs to other models. Depending on the purpose, agency ratings and current-condition ratings may not be interchangeable.

Among the related literature are Carey and Hrycay (2001), whose paper contains an empirical investigation into rating dynamics. They find that agency ratings exhibit less cyclical variation and are more stable than current-condition ratings, which is consistent with agencies following the through-the-cycle approach. Löffler (2002) examines the consequences of the agencies' tendency to reduce rating volatility by taking a rating action only when it is unlikely to be reversed shortly afterwards. Such a policy affects rating dynamics in a similar way as following a through-the-cycle approach. It appears that rating through-the-cycle can have stronger effects on rating stability, whereas avoidance of rating reversals can explain predictability of rating changes unaccounted-for by the through-the-cycle approach. Even though their effects are similar, the two rating policies are conceptually different. Avoiding rating reversals by suppressing rating changes works like a filter that leads to a loss of information. Through-the-cycle ratings, too, neglect information, but only in order to convey other information not contained in current-condition ratings.

Löffler's (2002) analysis of cyclical components in default risk partly builds on the literature on mean reversion in asset prices (Fama and French, 1988; Poterba and Summers, 1988). The consequences of mean-reverting default risk for the prices of risky debt are studied in Collin-Dufresne and Goldstein (2001). Dangl and Zechner (2001) investigate dynamic capital structure choice and its impact on credit spreads and default risk. Recent papers on the fundamental determinants of ratings and their informational content are Blume *et al.* (1998) and Ederington and Goh (1998), respectively.

Agency ratings are often used to infer individual obligor default probabilities. Examples are portfolio credit risk models such as

CreditMetrics (Gupton *et al.*, 1997) or the recent proposal of the Basel Committee on Banking Supervision (2001). Proponents of alternative rating methods point out that the predictive quality of agency ratings can be substantially improved (Kealhofer *et al.*, 1998). The fact that Moody's has developed a statistical model for predicting short-term default risk, which complements the traditional through-the-cycle rating, indicates that even the rating agencies share this view (Sobehart *et al.*, 2000).

Kealhofer *et al.* (1998) and Carey and Hrycay (2001) find that agency ratings exhibit a much larger stability than current-condition ratings. Kealhofer *et al* (1998) derive current-condition ratings from an application of the Merton (1974) model and compare their stability with that of S&P ratings. Carey and Hrycay (2001) use a logic model to categorise issuers rated by Moody's. Typically, 40–50% of current-condition ratings remain stable over a one-year horizon, compared to 80–90% in the case of agency ratings. Carey and Hrycay (2001) attribute this discrepancy to the agencies' rating methodology, but they do not examine whether the potential effects of rating through the cycle are large enough to account for the evidence. An alternative explanation could be that agencies consistently under-react to new information.

Empirical studies of rating changes have documented a significant positive autocorrelation (Altman and Kao, 1992; Lando and Skødeberg, 2002). A partial explanation for this phenomenon could be that rating agencies "dole out the bad news in small doses rather than savaging the bond issuer – who is, after all, their customer – all in one go" (Economist, December 13, 1997, p. 70). Serial correlation might also be due to horizon effects. Consider a firm which gradually expands into a new, risky business segment, repeatedly issuing new debt to finance necessary investments. Over time, the default probability will rise. Even if the rating analyst perfectly predicts this development, she will not completely incorporate it in the current rating if the rating horizon is shorter than the time span in which the firm's restructuring is completed. Rating changes will then exhibit positive autocorrelation.

Löffler (2002) showed that empirical irregularities of agency ratings could be a consequence of the through-the-cycle method. Rating stability is significantly higher than with a current-condition approach. Ratings are not perfectly correlated with actual default risk, and they are correlated with past rating changes provided contemporaneous information is controlled for. Predictability in the usual sense can stem from errors in assessing the degree of cyclicality. The empirical evidence on ratings should therefore be interpreted with care. Apparent shortcomings of agency ratings might well be inherent to the rating method. Rating through-the-cycle does not per se lead to predictability of the type tested by Altman and Kao (1992), Lando and Skødeberg (2002), and Delianedis and Geske (1999).

The Basel Committee on Banking Supervision (2001) has proposed to tie bank capital requirements closer to default risk. Löffler (2002) poses the question of whether banks should measure individual credit risk with a through-the-cycle or a current-condition approach. Even though through-the-cycle ratings are incomplete measures of short-term default term risk, they need not be inferior for the purpose of bank regulation. Among others, Estrella (2001) and Catarineu-Rabell *et al.* (2002) argue that regulators should avoid procyclicality in capital requirements. Löffler (2002) suggests that relying on through-the-cycle ratings would be one way of achieving this objective.

2.2.7. Rating requirements: What should a good rating system be like?

Inspired by changing regulation, especially from the BIS, banks have in the last 5-10 years developed their own international credit rating systems. Krahnen and Weber (2001) came up with 14 requirements, some of which are formally derived, some of which are empirically founded, some of which are inspired by the recent publication of the Basel Committee on Banking Supervision, and some of which they derived at by talking to high level practitioners.

Rating systems are what is mathematically called a function:

$$R: \{\text{companies}\} \longrightarrow \{\text{Rating-values}\},$$

meaning that the rating system R is a function which assigns each element of the set of companies to a rating value. These rating values, or short ratings, can be categories, i.e. {A,B+,B,B-,...}, or values of an interval $[r_{\min}, r_{\max}]$. R(company X)=0.67 means that the rating system R assigns the rating value of 0.67 to company X. We will assume that rating categories and values can be ranked, i.e., A B means, that rating category A is better, in the sense of a lower default probability, than rating category B. The symbol "~" means that both ratings are identical. This simple mathematical definition of rating systems as functions allows to define the first requirements without specifying at this point, what rating really means.

Requirement 1 (Comprehensiveness). A bank's rating system should be able to rate all past, current and future clients. This requirement defines the potential set of companies to be rated. A bank's rating system should be able to cope with all clients possible. Of course, this requirement is quite general, and hard to meet. There may be future clients, and risk criteria, a given bank may not even imagine. There may be past clients who do not exist any more. However, a bank should make any effort possible to ensure that its rating system is flexible enough to cope with all foreseeable types of risk. It should not happen, e.g., that foreign companies cannot be rated or that the rating system is not able to handle certain industries.

Requirement 2 (Completeness). A bank should rate all current clients and keep on rating its past clients. The requirement states that a bank should rate all its current clients. This is rather trivial and will in most cases be current management practice. In addition, Krahnen and Weber (2001) suggest that a bank should keep on rating its past clients. This might not be easy and in certain cases it might not even be possible. Accounting data as well as qualitative data from talking to the companies' management might not be available for past clients. Nevertheless, we think that a bank should put effort in maintaining its rating database. It is of central importance for any type of back-testing and further development of the bank's rating that the bank has an ongoing set of rating data. If the bank stops rating clients who, e.g., defaulted, the set of companies which are in the rating database can be biased. Such a bank would know nothing about the probabilities of events that happen after default: how likely is the success of restructuring, etc. The survivorship bias (to consider "surviving companies" only) is well known from empirical work in capital markets.

Requirement 3 (Complexity). A bank should have as many different rating systems as necessary and as few as possible. The reasons for choosing the number of rating systems should be made transparent.

Requirement 4 (POD-definition). Probabilities of default have to be well defined.

This requirement states that a bank has to have a proper definition of what its PODs mean. The bank has to define what it considers to be a default event. Krahnen and Weber (2001) found that financial institutions rely on a variety of definitions of a default event, e.g. loan loss provision, or failure to pay interest, or principal, over a specified time span. Note that without a harmonisation of default definitions, it will prove difficult to pool POD-data across banks[5]

2.2.8. Basel II and banks:

In June 2004 the Basel Committee on Banking Supervision reached agreement on a New Basel Capital Accord that will replace the current 1988 Capital Accord. The accord is based on three mutually reinforcing pillars that allow banks and supervisors to evaluate properly the various risks that banks face.

[5] For remaining requirements (5 to 14) kindly refer to Krahnen and Weber (2001)

The New Basel Capital Accord focuses on:

- minimum capital requirements, which seek to refine the measurement framework set out in the 1988 Accord
- supervisory review of an institution's capital adequacy and internal assessment process
- market discipline through effective disclosure to encourage safe and sound banking practices

The Basel Committee received more than 250 comments on its January 2001 proposals. In April 2001 the Committee initiated a Quantitative Impact Study (QIS) of banks to gather the data necessary to allow the Committee to gauge the impact of the proposals for capital requirements. A further study was undertaken in November 2001 to gain industry feedback about potential modifications to the Committee's proposals. In December 2001 the Basel Committee announced a revised approach to finalising the New Basel Capital Accord and the establishment of an Accord Implementation Group. Previously, in June 2001 the Committee released an update on its progress and highlighted several important ways in which it had agreed to modify some of its earlier proposals based, in part, on industry comments.

During its 10 July 2002 meeting, members of the Basel Committee reached agreement on a number of important issues related to the New Basel Capital Accord that the Committee had been exploring since releasing its January 2001 consultative paper. In April 2003 the Basel Committee on Banking Supervision issued a third consultative paper on the New Basel Capital Accord. The goal of the Committee continues for the accord to take effect in member countries by year-end 2006. To that end, work already has begun in a number of countries on draft rules that would integrate Basel capital standards with national capital regimes.

The internal ratings-based approach recently proposed by the Basel Committee on Banking Supervision seeks to make bank regulatory capital requirements for credit risk approximate economic capital requirements (Basel Committee on Banking Supervision, 2001). That is, under certain assumptions (Gordy, 2000), IRB capital requirements would vary across banks according to the riskiness of their portfolios in a manner that would make the estimated likelihood of insolvency due to credit losses approximately the same for all banks that are at the regulatory minimum. Required capital would be larger for banks with portfolios posing greater risks of large losses and vice versa.

The IRB capital formula for credit risk takes as inputs loan and portfolio characteristics and produces capital requirements. Designing such a formula involves decisions about (1) the dimensions of credit risk to be included, that is, which loan and portfolio characteristics should appear as variables in the formula; (2) the relative variations in capital requirements as loan and portfolio characteristics vary from those of a reference or numeraire loan or portfolio; and (3) the absolute level of capital required for the numeraire portfolio. What is being achieved is that with the new BIS is to come from a much generalised capital adequacy ratio of 8% on all assets of the bank, to come to a more refined system of solvency requirements, depending on the quality of the underlying assets.

2.2.9 Key factors motivating improved regulation:

According to The Banker's (2003) database, Tier 1 capital ratio, the measure of a bank's strength, for countries in the Organisation for Economic Co-operation and Development (OECD), excluding Japan, is a healthy 13.48% and aggregate Tier 1 capital is $1360bn. However, in a possible vicious circle, banks' capital could come under serious pressure if the bear market were to continue for 10 years, which in turn would lead to further downward pressure on share prices. Raising capital in a bear market is both difficult and unappealing, yet a number of banks would need to do so. The Japanese banks are a known worry. What is a newer and potentially bigger concern is the state of the German banks: in a private meeting, Deutsche Bank chief executive Josef Ackerman floated the idea of the state taking over some banks. The average Tier 1 capital ratio for German banks is 6.8%, which is less than half the 13.4% of OECD banks excluding Japan, according to The Banker (2003). Their average non-performing loans are double that of OECD banks excluding Japan. Even more worrying, only six banks out of a total of 287 declare their non-performing loans.

The cost of equity is generally perceived to be much greater than the cost of debt, owing to tax considerations, asymmetric information, agency costs, and the bank safety net (e.g., direct access to government deposit insurance, the discount window, and the payments system). For this reason, when regulatory capital standards require banks to maintain equity cushions exceeding what they would otherwise choose based on market discipline alone, banks may view these standards as a form of regulatory taxation (Donahoo and Shaffer, 1991). As with other forms of taxation, regulatory taxes encourage banks to develop methods for serving customers that avoid or minimise these taxes. Several studies, using mainly pre-Accord data, report findings broadly consistent with the view that bank behaviour is influenced by regulatory taxation, defined to encompass minimum capital requirements, reserve requirements and any deposit insurance premiums (Cumming, 1987; Baer and Pavel, 1988; Pavel, 1987; Koppenhaver, 1989; Berger and Udell, 1993 and Jagtiani *et al.*, 1995).

Many banks perceive that through regulatory capital arbitrage they can enhance shareholder value by replacing equity with debt in their capital structures. The "freed up" equity is then either returned to shareholders as increased dividends or share repurchases, or redeployed within the firm. The institutionalisation of equity holdings in the hands of mutual funds and other professional portfolio managers appears to have increased pressures on banks to maximise equity values and to rationalise their equity retention policies. Heightened domestic and international competition in the financial services industry probably has reinforced incentives for banks to keep their production costs, including the overall cost-of-capital (debt + equity), as low as possible.

Regulatory capital arbitrage – like traditional tax arbitrage – represents a bank's willingness to incur various "structuring costs" in order to reduce the regulatory tax consequences of formal capital requirements. A bank's decision about whether to engage in regulatory capital arbitrage, and on what scale, reflects a cost-benefit analysis in which the expected structuring costs are weighed against both the expected reduction in the bank's overall funding costs and any other benefits (Pennacchi, 1988; Cumming, 1987; James, 1988; Passmore, 1992 and Chhikara and Hanson, 1993). For a given perceived differential between the cost of equity and the cost of debt financing, incentives to undertake regulatory capital arbitrage, therefore, are related negatively to the associated structuring costs, and positively to the extent to which RCA permits debt to be substituted for equity (i.e., the amount of "freed up" regulatory capital).

As suggested in Merton (1995), the basic insight behind regulatory capital arbitrage follows from the observation that, when capital standards are not based on any consistent economic soundness standard (e.g., probability of default), through securitization and other techniques, it is often possible to restructure portfolios to have basically similar risks, but much lower regulatory capital requirements. Importantly, as emphasised by Cumming (1987), the process of unbundling and repackaging risks incurs costs, which are a key determinant of a bank's willingness to engage in regulatory capital arbitrage. The lower these structuring costs the greater the incentives to undertake regulatory capital arbitrage.

In the broad sense, structuring costs may be external or internal. The former include all out-of-pocket expenses to third-parties (e.g., fees to underwriters, lawyers, credit rating agencies, etc.) as well as any increase in the bank's net interest costs associated with the use of off-balance sheet funding sources, in lieu of on-balance sheet funding, such as deposits. Examples of internal structuring costs include any required modifications to loan administration and management information systems to support securitization.

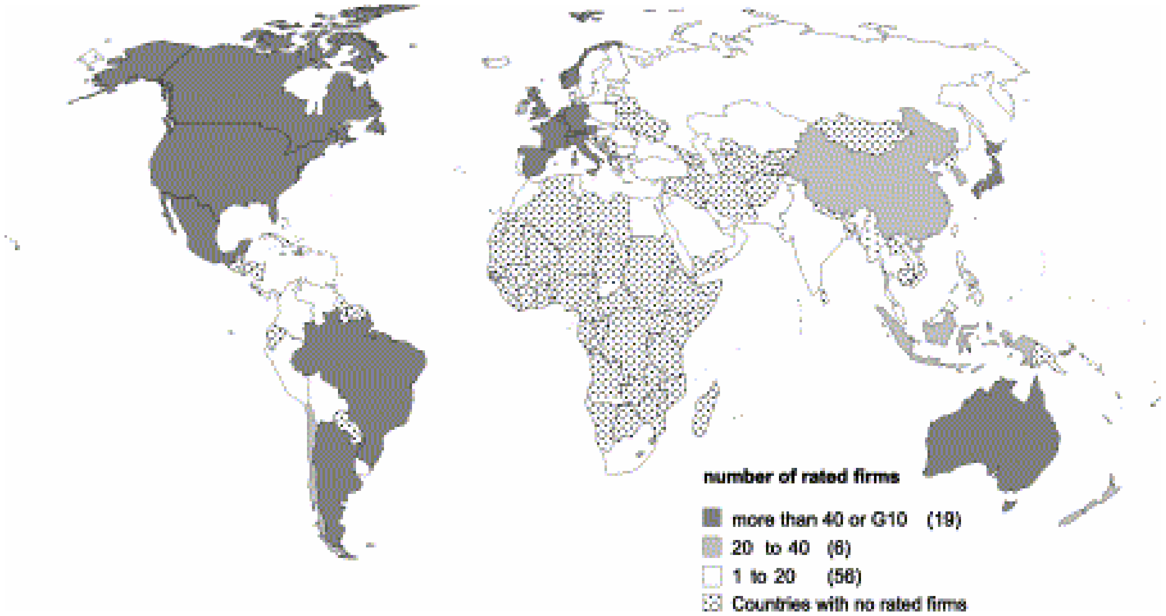
There appear to be no published studies tabulating structuring costs for different types of regulatory capital arbitrage. Anecdotal evidence suggests that such costs display substantial economies of scale, and depend on many factors including the nature and riskiness of the underlying assets, legal complexities and uncertainties, and investors' familiarity with transactions of that type. Ongoing financial innovations, technological advances, and increased competition in the financial services sector have been working to reduce structuring costs over time. The upcoming new BIS regulations intend to deal with these issues more appropriately.

2.2.10. BIS, Ratings and non-OECD countries:

The geographical coverage of rated firms has greatly increased in the last two decades together with the progressive globalisation of goods and financial markets. This development is the consequence of both the greater scope of coverage of the larger international rating agencies (S&P, Moody's, Fitch-IBCA) and of a more active presence of nationally based rating agencies (Ferri *et al* 2001). An example of the development in the scope of coverage by large international rating agencies is provided by the increase in the number of foreign currency sovereign ratings provided by Standard and Poor's, which has gone from only 11 countries 20 years ago to 25 in 1989 and to 80 in 1999. The expansion of the number of rated firms has followed that of the sovereign ratings. By the end of 1999, only six countries, among those who had an S&P sovereign rating, did not have any individual firm ratings.

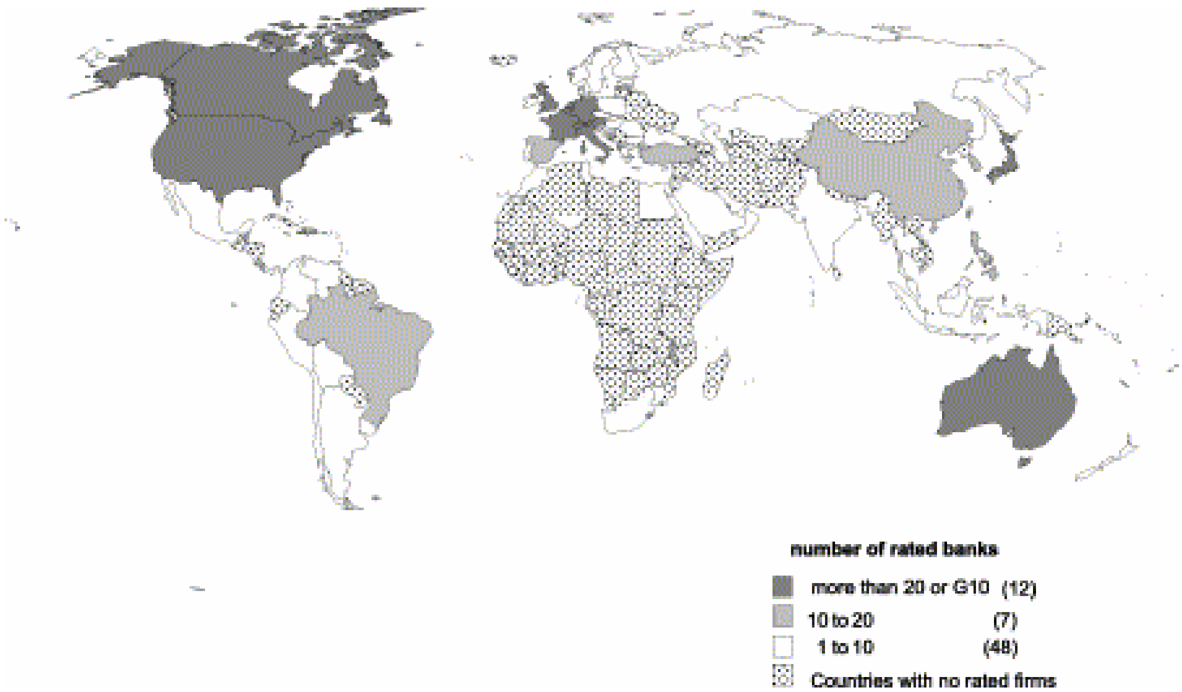
The world-wide distribution of firms rated by the two largest US-based rating agencies (Moody's and S&P) is shown below. The country density of rated banks and of non-bank corporations is also illustrated. The number of rated firms per country has been computed as the average number of firms that held a foreign or domestic currency rating from S&P and Moody's in the second half of 1999. From the maps, it appears that the scope of coverage for banks is substantially similar to that of the total of rated firms. In both cases, Africa, Central America, Central Asia and the Middle East show the lowest density of coverage. Most developing countries show the lowest degree of concentration of rated firms, exception made for fast growing economies as Korea and Indonesia and for large countries as China, Brazil, Argentina and Chile.

Figure 6 Geographical distribution of non bank ratings



Note: Geographical distribution of Moody's and S&P's non-banking firm ratings. (Ferri *et al*, 2001)

Figure 7 Geographical distribution of bank ratings



Note: Geographical distribution of Moody's and S&P's bank ratings (Ferri *et al*, 2001)

Ferri *et al* (2001) show that US-based rating agencies, in spite of the very rapid growth of their international activities in the last decade, have devoted most of their efforts to relatively more developed economies, where marginal and fixed costs associated to the coverage of additional firms are lower and/or where the demand for ratings is higher. Second, the attainment of a world-wide scope of coverage is a very recent phenomenon, providing rating agencies with too limited a sample for comprehensive assessments of their accuracy in non-G10 countries. Third, rating agencies tend to concentrate initially on the banking sector and only subsequently move to the non-bank sector of the economy. Finally, firms' ratings follow more closely sovereign ratings as the income level decreases. While these outcomes may be fully consistent with rational assessments of credit risk in economies with large information costs and unstable institutional structures, they also point to potential shortcomings in the use of ratings for regulatory purposes.

A temporary worsening in their access to bank credit could have a negative impact on corporate sectors in emerging economies – e.g. amplifying corporate bankruptcies and holding corporate production constrained below potential. This would provoke a depletion of organisational capacity in emerging economies' corporate sectors with potential long-lasting detrimental consequences for these economies' recovery, as stressed by Greenwald and Stiglitz (1993).

Ferri *et al* (2001) suggested that the Basel proposal would increase the volatility of capital needs of banks in non-high-income countries vs. high-income countries' banks. In fact, bank and corporate ratings in non-high-income countries appear to be strongly related – and in an asymmetric way – to changes in sovereign ratings. A sovereign downgrading would, for instance, imply larger changes in capital allocations than an upgrading and would call for larger capital requirements at the very time in which access to capital markets is more difficult. In addition, the lack of a widespread use of ratings for banks and corporations in non-high-income countries would not provide an effective incentive to adopt more sound risk assessments on the part of banks. In fact, while good banks in non-high-income countries would see their capital requirements reduced as a consequence of a prudent lending behaviour, their peers in non-high-income countries would not draw an equivalent benefit from an analogous attitude. In fact since publication of the findings of Ferri *et al* (2001) we have already witnessed some of these consequences, as markets in anticipation of Basel II, are already in the process of getting ready. In consequence, we have seen financial sectors in emerging markets being severely affected, despite above Basel II capital adequacy, where – for example – the German financial sector, continues operating without there seeming to be a sense of urgency, with an average Tier 1 capital ratio of 6.8%, which is less than half the 13.4% of OECD banks excluding Japan, according to The Banker (2003). What this would indicate is that Basel II may further enhance the gap between OECD and non-OECD countries.

Yet the following discourse seems to be illustrative for the dominant paradigm, outlining in which direction improvement and solutions are to be found. Since 1997 (IMF and World Bank, 2002), financial sector crises in a number of countries, for instance Argentina, Ecuador, Indonesia, Korea, Russia, Thailand, and Turkey, have highlighted linkages between financial sector crises and weak macroeconomic policies, while also showing the adverse effects of poor lending practices, weak corporate governance, inadequate loan provisioning, accounting and auditing practices, and insufficient supervisory independence. In many cases, the preconditions for effective banking supervision, which include sound and sustainable macroeconomic policies, a well-developed public infrastructure, effective market discipline, procedures for effective bank resolution, and systemic protection or a safety net, had not been met sufficiently.

2.2.11. The mathematical language of academic finance: A paradigmatic look

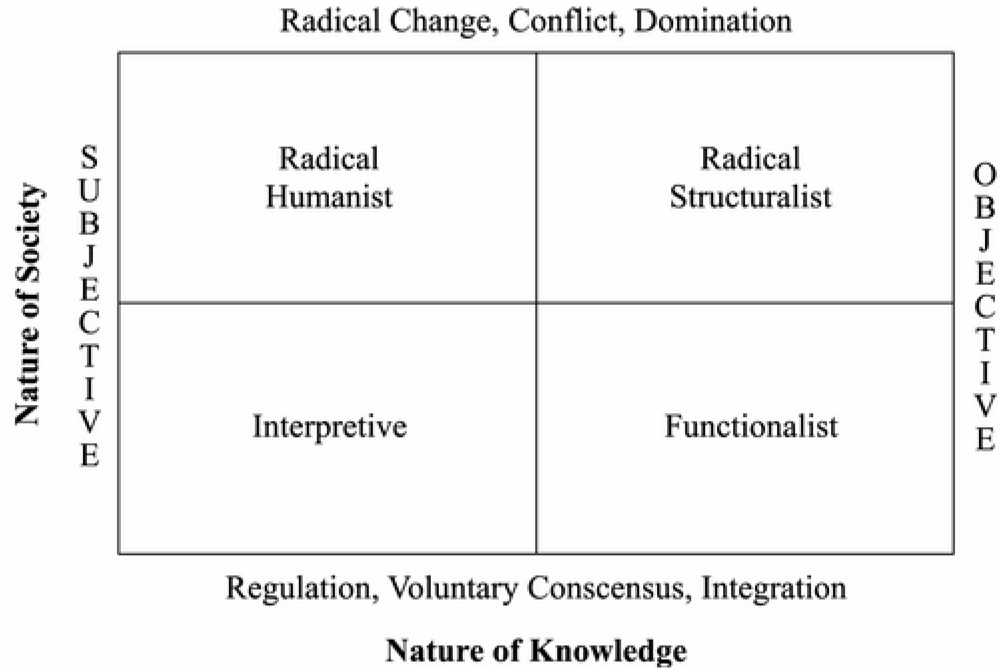
Any adequate analysis of the nature and role of the mathematical language in finance necessarily requires fundamental understanding of the worldviews underlying the views expressed with respect to the nature and role of language (Ardalan, 2002). A worldview can be positioned on a continuum formed by four basic paradigms: functionalist, interpretive, radical humanist, and radical structuralist.

Ardalan (2002) looked at the current state of mainstream academic finance and noted that it is founded on the functionalist paradigm.

It is generally accepted that neo-classical economists develop and refine their theory using the language of mathematics. The defence of the use of mathematics as a neutral language means that the debates within literary criticism about the non-neutrality of language have an important contribution to make in reconsidering the use of mathematics. Any adequate analysis of the role of paradigms, in social theory, must recognise the assumptions that underwrite that paradigm or worldview. Social theory can usefully be conceived in terms of four key paradigms: functionalist, interpretative, radical humanist and radical structuralist, according to Burrell and Morgan (1979). The four paradigms are founded upon different views of the social world. Each generates theories, concepts and analytical tools, which are different from those of other paradigms.

The four paradigms are based on different assumptions about the nature of social science (i.e. the subjective-objective dimension) and the nature of society (i.e. the dimension of regulation-radical change) Burrell and Morgan (1979).

Figure 8 Paradigms in social science



Source: Burrell and Morgan (1979). This can be used as both a classificatory device or, more importantly, as an analytical tool.

The functionalist paradigm occupies the south-east quadrant. Schools of thought within this paradigm can be located on the objective-subjective continuum. From right to left they are: objectivism, social system theory, integrative theory, interactionism and social action theory.

The functionalist paradigm assumes that society has a concrete existence and follows a certain order. These assumptions lead to the existence of an objective and value-free social science which can produce true explanatory and predictive knowledge of the reality out there. It assumes that scientific theories can be assessed objectively by reference to empirical evidence. Scientists do not see any roles for themselves within the phenomenon, which they analyse through the rigor and technique of the scientific method. It attributes independence to the observer from the observed. That is, an ability to observe what is without affecting it. It assumes there are universal standards of science, which determine what constitutes an adequate explanation of what is observed. It assumes there are external rules and regulations governing the external world. The goal of scientists is to find the orders that prevail within that phenomenon.

The functionalist paradigm seeks to provide rational explanations of social affairs and generate regulative sociology. It emphasises the importance of understanding order, equilibrium and stability in society and the way in which these can be maintained. Science provides the basis for structuring and ordering the social world, similar to the structure and order in the natural world. The methods of natural science are used to generate explanations of the social world. Their approach to social science is rooted in the tradition of positivism. Functionalists are individualists. That is, the properties of the aggregate are determined by the properties of its units. The functionalist paradigm has become dominant in academic sociology and mainstream academic finance. The world of finance is treated as a place of concrete reality and the individual is regarded as taking on a passive role; the economic environment determines his or her behaviour.

Based on Smith (1990), Brennan (1995) and Weston (1994), theories and policies in current mainstream academic finance may be listed as follows:

- efficient market theory;
- portfolio theory;

- capital asset pricing theory;
- option pricing theory;
- agency theory;
- arbitrage pricing theory;
- capital budgeting policy;
- capital structure policy;
- dividend policy.

Bettner *et al*. (1994) notes that the common threads among theories in mainstream academic finance are:

- there is a cause- and effect- mechanism underlying all nature and human activity (ontology);
- it is known through the set of homological connections between initial conditions and final outcomes (epistemology);
- human beings interact with each other and their society in accordance with this mechanism (human nature); and
- information regarding all natural and human activity can be acquired through observations and measurements unaffected by individual perceptual differences (methodology) (Bettner *et al*., 1994, p. 3).

This leads to the conclusion that the current theories in finance are clearly based on the functionalist paradigm. Bettner *et al*. (1994) and McGoun (1992) provide more complete treatments of this point. A sign does not stand in a projective relation with the meaning that it represents. The various phenomena of language must not necessarily have a unity. The uniform appearance of a word or sentence (e.g. in speaking, spelling, etc.) assures us of no uniformity or generality pervading many and various ways of using it, which are dependent upon spatial and temporal factors or what might be called context. Language consists ultimately of nothing more than the multiplicity of "family resemblances" among linguistic phenomena (concepts), each bearing the same signifier. There are similarities among phenomena bearing the same signifier, but it is in the differences among uses that meaning can be grasped.

Ardalan (2002) recommends a serious conscious thinking about the social philosophy upon which finance is based and of the alternative avenues for development. The knowledge of the four paradigms is of paramount importance to any scientist, because the process of learning about a favoured paradigm is also the process of learning what that paradigm is not. The knowledge of paradigms makes scientists aware of the boundaries within which they approach their subject. Each of the four paradigms implies a different way of social theorising in general, and finance in particular.

Academic finance can gain much by exploiting the new perspectives coming from other paradigms. An understanding of different paradigms leads to a better understanding of the multi-faceted nature of finance. Although a researcher may decide to conduct research from the point of view of a certain paradigm, an understanding of the nature of other paradigms leads to a better understanding of what one is doing. Knowledge of finance is ultimately a product of the researcher's paradigmatic approach to this multifaceted phenomenon. Viewed from this angle, the pursuit of financial knowledge is seen as being as much an ethical, moral, ideological and political activity as it is a technical one.

2.2.12. The following hypothesis and sub-hypotheses were formulated:

The role of rating agencies such as Standard and Poor's, Moody's and Fitch-IBCA has increased during the last decades. Both country credit ratings as well as company credit ratings have become indispensable tools in today' s finance. The new Basel II regulations will, through the requirement of internal ratings systems to be development by bank, cause for more emphasis on credit rating.

H.2.1. The role of credit rating agencies generally can be described as constructive and a valuable complementary tool.

H.2.2. Credit rating agencies, despite their long history and expertise, do not really possess competencies which may prevent default risk.

H.2.3. The role of credit rating agencies should be more critically assessed and their influence (oligopoly) in finance should be reduced.

H.2.4. The credit analysis process of a credit rating agency and those of a housebank are comparable in terms of depth and quality.

H.2.5. The new Basel II regulations, to be implemented in 2006, will further contribute to a better risk management and control of financial institutions and markets.

H.2.6. The new Basel II regulations carry the risk of a further widening of the gap between high income and low income countries.

2.2.13. Concluding remarks:

Credit risk, or the risk of default, has always been a major topic of concern for banks and other financial intermediaries, and any agent committed to a financial contract for that matter. While concern for the possible default of counterparty on an agreed-upon financial contract is centuries old, modern techniques and models have arisen in the last decades that help master the problem. An outline of the differences between external and internal rating systems and the influence of Basel II accords (Bank of International Settlements) has been provided in this section 2.2, in order to stress the relevance and the connections between both.

While the rating agencies use similar methods and approaches to rate debt, they sometimes come up with different ratings of the same debt investment. In their studies of the credit rating industry Cantor and Packer (1994) have illustrated this. This issue of ratings differences is an important one. It raises two questions. First, to what extent is the rating quantitatively based and what is the role of judgement? The second question concerns the independence of the rating agencies.

The dominant paradigm seems to suggest that by increasing application of technology and modelling, whilst measuring credit risk, and, last but not least, that by applying stricter controls, through Central Bank and Basel II regulation, credit risk and secondary systemic risks may be better managed.

Within this approach over emphasize is being given to the rating of predominantly hard factors and due consideration of the context in which credit risks need to be assessed is neglected. This holds particularly true for the valuation of cultural differences, which according to the key argument of this thesis, hinders bankers to adequately understand and evaluate the various risks involved with cross border lending. This is why in the next section of chapter 2 cross cultural studies and its relevance to the field of cross border lending will be discussed and reviewed.

Section 2.3 - Culture's Consequences

2.3.1. Introduction:

This section 2.3. reviews some of the more prominent publications in cross cultural studies and deals with the relative strengths and weaknesses of the different methodologies in its research. Hall (1976) describes his views on low- and high context and suggests that if one could get behind the scenes one would find context dependant results in the majority of research projects. Western science, according to Hall (1976) is striving for replicability and rigor in methods and is conducted with a view to eliminating context. This is to some extent what Basel II does as well with its aim of striving for rigor in the methods of measuring and quantifying credit risks, whereas particularly with cross border lending, context and therefore cultural differences are supposed to be relevant, in order to appropriately understand the associated risks of a particular credit in a particular country.

Culture has been defined in many ways. In the English language, "culture" is derived from its original Latin meaning; the cultivation of soil (the same applies in French and German). The other meaning which leads to most confusion, especially in communication with the French is: the training and refinement of the mind, manners, taste, etc. or the result of this. "He/she has no culture" is almost as bad as "he/she has no personality". The world "culture" is usually reserved for societies or for ethnic or regional groups, but it can be applied equally to other human collectivities or categories: an organization, a profession, or a family. Very often practitioners mix what is understood to be the culture of the specific organization, with the way in which culture is being referred to in cross-cultural literature. In this thesis the word ‘culture’ is used to refer to societies, within nations or, as the case may be, within regions.

Kluckhohn (1961) quoted a consensus of anthropological definitions on culture:

Culture consists in patterned ways of thinking, feeling and reacting, acquired and transmitted mainly by symbols, constituting the distinctive achievements of human groups, including their embodiments in artefacts; the essential core of culture consists of traditional (i.e. historically derived and selected) ideas and especially their attached values.

Hofstede (1980) treats culture as “the collective programming of the mind which distinguishes the members of one human group from another. Culture in this sense includes systems of values; and values are among the building blocks of culture.”

2.3.2. Cross-cultural and intercultural research:

As a precursor to the discussion, we need to understand what is meant by “intercultural” as distinct from “cross-cultural” research. People who are identified as “intercultural” researchers (e.g., Triandis, Brislin, Gudykunst, Landis, Ting-Toomey, etc.) publish not only in journals dedicated to the “intercultural” (e.g., The International Journal of Intercultural Relations, IJIR) but also in “cross-cultural” venues (e.g., Journal of Cross-cultural Psychology). Sometimes it is quite difficult to see the substantive differences between papers published in the two types of outlets (Landis and Wasilewski, 1999). There are, nonetheless, distinctions that can be made. Cross-cultural research deals primarily with the similarities and differences between cultures. The best research of this kind is multicultural (e.g., more than three cultures), in focus, and more than likely deals with fairly basic psychological processes. Intercultural research tends to focus on the penetration by a member of one culture into another culture. It is therefore more dynamic than cross-cultural research. So, while cross-cultural research has a fairly long history in psychology (Klineberg, 1980), intercultural studies are fairly recent. This paper deals mainly with cross-cultural research.

In most Western languages “culture” commonly means “civilisation” or “refinement of the mind” and in particular the results of such refinement, like education, art, and literature. Hofstede (1991) describes this as culture in the narrow sense, sometimes referred to as "culture one". Cultural as mental software, however correspondents to a much broader use of the world which is common among social anthropologists: this Hofstede (1991) describes as "culture two" and is the concept being used in this thesis. Culture two is the catchword for all the patterns of thinking, feeling and acting. It includes not only those activities supposed to refine the mind, but also the ordinary and menial things in life: greetings, eating, showing or not showing feelings, keeping a certain physical distance from others, making love, or maintaining body hygiene. Culture understood in this way deals with much more fundamental human processes than culture one: it deals with the things that hurt.

Hofstede (1991) warns of the risk of stereotyping, which occurs when assumptions about collective properties of a group are applied to a particular individual from that group and quotes the grand old man of French anthropology, Claude Lévi-Strauss (1988), by giving his definition of cultural relativism affirming that one culture has no absolute criteria for judging the activities of another culture as "low" or "noble". However, every culture can and should apply such judgment to its own activities, because its members are actors as well as observers.

Everybody looks at the world from behind the windows of a cultural home and everybody prefers to act as if people from other countries (cultures) have something special about them, but that home is normal. Unfortunately, there is no "normal" position in cultural matters. This is an uncomfortable message, as uncomfortable as Galileo Galilee's claim in the seventeenth century that the earth was not the centre of the Universe. "Possibly one of the many reasons why the culture concept has been resisted", Hall (1960), writes, "is that it throws doubt on many established beliefs. Fundamental beliefs..... are shown to vary widely from one culture to the next. It is easier to avoid the idea of the culture concept than to face up to it". In addition, "the concepts of culture ... touch upon such intimate matters that they are often brushed aside at the very point where people begin to comprehend their implications" (Hall, 1960).

Sex was the great taboo of the Victorian age. At least in the organisation literature, power was the great taboo until the 1960s. Both taboos have been more or less lifted since that time, although in the literature on finance one seldom comes across the term power. Culture in the organisation literature may be the great taboo of today. In all three cases, the taboo is on something we are all involved in but not supposed to speak about. (Hofstede, 1980).

2.3.3. Culture's consequences:

In 1980 Geert Hofstede published *Culture's Consequences* (Beverly Hills, CA: Sage Publications). This influential study soon became a major source of reference about value differences around the world and has been translated in numerous languages. The four (later five) fundamental dimensions of culture with a high-level cross-cultural impact on human behaviour that Hofstede discovered (argued by Trompenaars *et al* 1997) and reported in this study still serve today as basic criteria in most interdisciplinary, cross-culturally comparative research. Based on this work Hofstede is one of the most cited social scientists world-wide. The survey on which *Culture's Consequences* builds was held twice, around 1968 and around 1972, generating data drawn from 40 countries, 116.000 questionnaires, and about 50,000 respondents who all work for the multinational computer corporation

IBM (called HERMES, after the Greek God of commerce, in Hofstede's book).

Attitudes, orientations, emotions, and expressions differ strongly among people from one nation or the other. These differences are fundamentally cultural. There are countless examples of difficulties and conflicts between people, whether they are policy decision-makers, managers of multinational corporations, aeroplane pilots, or common tourists, trying to communicate or co-operate with people from other cultures. Understanding and overcoming these difficulties require a cultural analysis, an analysis with a high receptiveness for the cultural factor: the factor summarising the influence of deeply rooted values or shared normative, moral, or aesthetic principles that guide action and serve as standards to evaluate (one's own and other people's) behaviour. Cultural distinctions are based in these deeply rooted values which, in turn, according to Hofstede's theory (1980), can be delineated along five fundamental dimensions, some of which will be elaborated on later in more detail:

- Power Distance
- Individualism versus Collectivism
- Femininity versus Masculinity
- Uncertainty Avoidance and
- Long-Term Orientation.

National cultures, Hofstede (1980) points out, represent a nation's unique score on how to deal with social inequality (Power Distance), the degree of integration of individuals within groups (Individualism-Collectivism), the division of social roles between women and men (Femininity – Masculinity), the tolerance for the unknown (Uncertainty Avoidance), and the trade-off between long-term and short-term gratification of needs (Long-Term Orientation).

2.3.4. The concept of power distance:

As it is felt that this dimension highly relates to the research subject, this concept is further outlined below. Hofstede (1980) introduces the term power distance as a measure of the interpersonal power of influence between bosses and subordinates as perceived by the less powerful of the two, being the subordinate. The term power distance is taken from the work of Mulder (1976, 1977); Mulder's theory is based on a long series of laboratory and field experiments with simple social structures. Mulder defines power as the potential to determinate or direct (to a certain extent) the behaviour of another person/other persons more so than the other way around; and power distance as the degree of inequality in power between a less powerful individual (I) and a more powerful one (O), in which I and O belong to the same (loosely or tightly knit) social system (Mulder, 1977:90). He proved about 20 hypotheses, of which the most relevant to Hofstede's (1980) study are the following:

- The mere exercise of power will give satisfaction
- The more powerful individual will strive to maintain or to increase the power distance to the less powerful person

- The greater this distance from the less powerful person, the stronger the striving to increase it
- Individuals will strive to reduce the power distance between themselves and more powerful person
- The smaller this distance from the more powerful person, the stronger the tendency to reduce it
- The downward tendencies of the powerful to maintain the power distance, and the upward power distance reduction of the less powerful reinforce each other.

Power has typically been seen as the ability to get others to do what you want them to do, if necessary against their will (Weber, 1978), or to get them to do something they otherwise would not (Dahl, 1957).

In world history some philosophers have dealt very explicitly with questions of power and inequality. In China, around 500 BC, Kong Ze, whom the Jesuit missionaries 2000 years later Latinised as Confucius (from the older name Kong Fu Ze), maintained that that the stability of society is based on unequal relationships between people. He distinguished the wu lun, the five basic relationships: ruler-subject, father-son, older brother-younger brother, husband-wife, and senior friend-junior friend. These relationships contain mutual and complementary obligations: the junior partner owes the senior respect and obedience: the senior owes the junior partner protection and consideration. Confucius ideas have survived, according to Hofstede (1980) as guidelines for proper behaviour for Chinese people to this day. Hofstede (1980) argues that people in countries which have undergone

Chinese cultural influences, accept and appreciate inequality, but feel that the use of power should be moderated by a sense of obligation.

Culture is learned, not inherited. It derives from one's social environment, not from one's genes. Culture should be distinguished from the human nature on one side and from an individual's personality on the other side (Hofstede, 1991), although exactly where the border lies between human nature and culture, and between culture and personality, is a matter of discussion among social scientists. Please find below a reflection on how Hofstede understands mental programming to be formed.

Figure 9 Human mental programming.

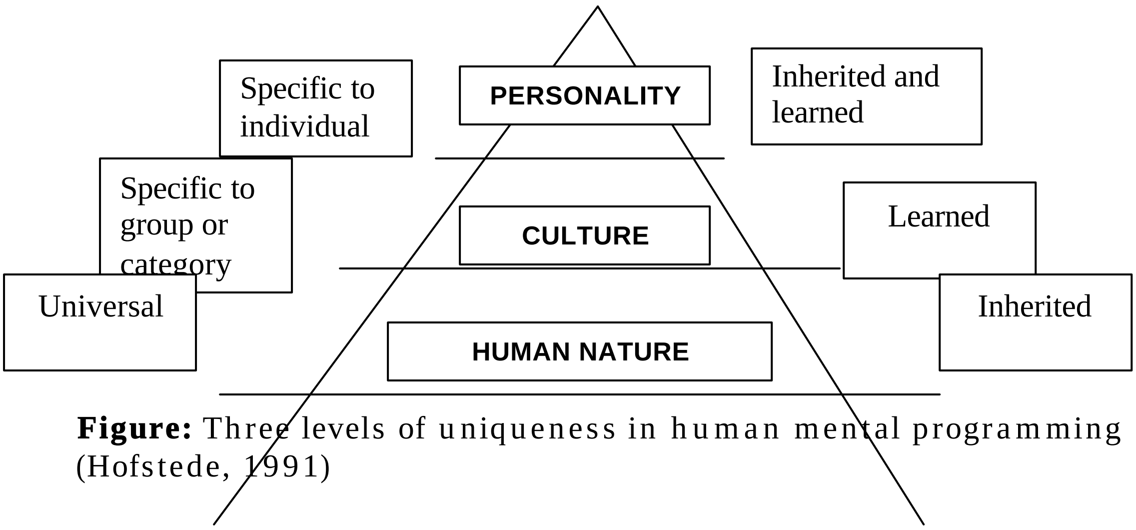


Figure: Three levels of uniqueness in human mental programming (Hofstede, 1991)

2.3.5. The role of symbols, heroes, rituals and values:

Cultural differences manifest themselves in several ways. From the many terms used to describe manifestations of culture these four together cover the total concept rather neatly: symbols, heroes, rituals and values. Symbols are words, gestures, pictures or objects that carry a particular meaning, which is only recognised by those who share the culture. The words in a language or jargon belong to this category, how to dress, hairstyle, Coca-Cola, flags, and status symbols. New symbols are easily developed and old ones disappear: symbols from one cultural group are regularly copied by others. This is why Hofstede (1991) has put symbols into the outer, most superficial layer of the next figure:

Figure 10 Manifestations of culture

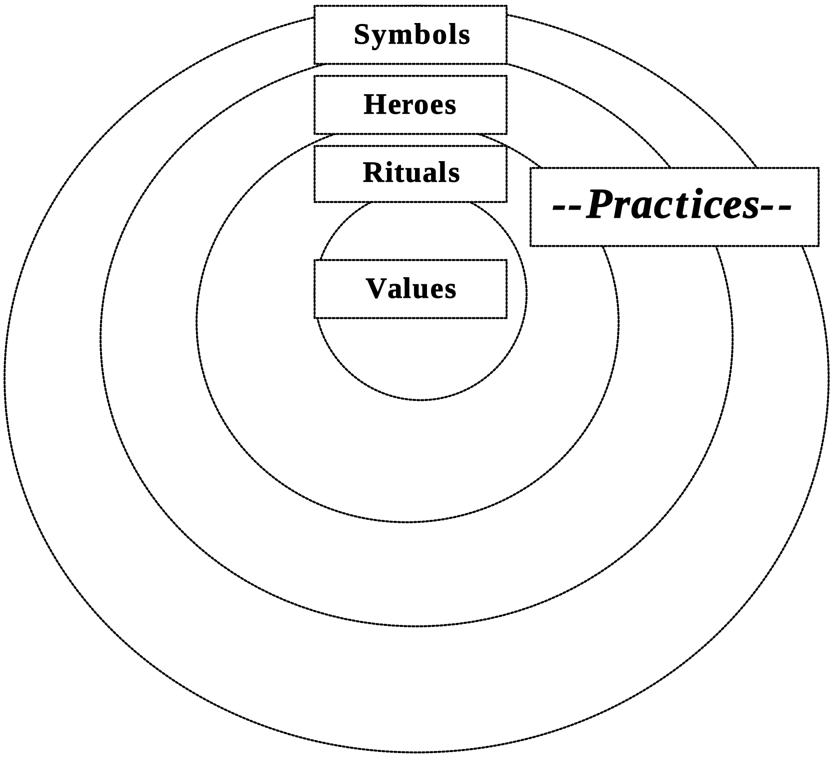


Figure: The union diagram: manifestations of culture at different levels of depth (Hofstede 1991)

Heroes are persons, alive or dead, real or imaginary, who posse characteristics which are highly prized in a culture and who thus serve as models for behaviour. Rituals are collective activities, technically superfluous in reaching desired ends, but which within a culture, are considered as socially essential: they are therefore carried out for their own sake. Ways of greeting and paying respect to others, social and religious ceremonies are examples. These three together are then submitted under the term's practices, as they are visible to an outside observer: their cultural meaning however is invisible and lies precisely and only in the way the insiders interpret these practices. In cross border lending one could consider the differences between one culture and the other when filling for bankruptcy. In the USA, for example, this means something completely different than from Japan. It is unthinkable to have a Donald Trump in Japan, who after several bankruptcies (and counting with substantial personal wealth) continues to be celebrated as a hero, whereas in Japan one looses face and we have seen several CEO's bursting out in tears before TV cameras begging stakeholders and apologizing for their failures. This is confirmed by Trompenaars and Hampden Turner (2000) who argue that the ways Americans resolve dilemmas are often the mirror image of the ways East Asians resolve theirs, leading to considerable misunderstandings and culture shocks. Whilst lending across borders into other cultures, one could perhaps consider the consequences of these different attitudes.

The core of culture is formed by values. Values are broad tendencies to prefer certain states of affairs over others. Values are feelings with an arrow between them: they have a plus and a minus side. They typically deal with:

Evil vs. Good

Dirty vs. Clean

Ugly vs. Beautiful

Unnatural vs. Natural

Abnormal vs. Normal

Paradoxical vs. Logical

Irrational vs. Rational

Values are among the first things children learn – not consciously, but implicitly. Development psychologists believe that by the age of 10, most children have their basic value system firmly in place, and after that age, changes are difficult to make. Because they are acquired so early in our lives, many values remain unconscious to those who hold them. Therefore they cannot be discussed, nor can they be directly observed by outsiders. They can only be inferred from the way people act under various circumstances.

In interpreting people's statements about their values it is important to distinguish between the desirable and the desired: how people think the world ought to be versus what people want for themselves. Questions about the "desirable" refer to people in general and are worded in terms of right/wrong, agree/disagree or something similar. In the abstract, everybody is in favour of virtue and opposed to sin, and answers about the "desirable" express people's views about what represents virtue and what correspondents to sin. The "desired", on the contrary, is worded in terms of "you" or "me" and what we consider important, what we want for ourselves, including our less virtuous desires. The 'desirable' bears only a faint resemblance to actual behaviours but even statements about the "desired", although closer to the actual behaviours should not necessarily correspond to the way people really behave when they have to choose. (Hofstede, 1991)

Trompenaars (1998) approaches the differences in layers somehow differently, describing them as explicit and implicit products. Explicit products coincide with what Hofstede (1991) refers to as "the observed". It is according to Trompenaars (1998) that explicit cultures are symbols of a deeper level of culture. Prejudice starts on this symbolic and observable level. In the literature, one rarely finds an author that combines the understanding of values with norms. Trompenaars (1998) however is one of the few who does so when he explains that explicit culture reflects deeper layers of culture, the norms and the values of an individual group. Norms are the mutual sense a group has of what is "right" and "wrong". Norms can develop on a formal level as written laws, and on an informal level as social control. Values, on the other hand, determine the definition of "good and bad" and are therefore closely related to the ideals shared by a group. A culture is relatively stable when the norms reflect the values of the group. When this is not the case, there will most likely be a destabilising tension. While the norms consciously or subconsciously give us a feeling of "how I normally should behave", values, on the other hand, give us a feeling of – "how I aspire or desire to behave" (Trompenaars 1998). A value serves as a criterion to determine a choice from existing alternatives: it is the concept an individual or group has regarding the desirable (Trompenaars 1998). Here, too, we find resemblance between Hofstede and Trompenaars, where the former refers to the desired and the desirable.

Hofstede's concepts have been helpful in the analysis of national variations in income distribution, defence spending, legal systems, social security policies, outbursts of violence and conflict, military and police co-operation, administrative cultures, safety of national aircraft companies, religious values and behaviours, state and corporate economic governance, etc. Many researchers have provided examples of correlation of (one or two of) Hofstede's five dimensions of culture and different sets of geographic, economic, demographic, and political indicators.

Despite proof of its relevance, the study has met with criticisms, which in part fix on problems related to the distant past in which the data were collected. Hofstede, through his research institute IRIC, argues that this argument alone calls for the replication of the main elements of his IBM Study as it would generate powerful opportunities to address the claim that the assessment of the five fundamental dimensions is outdated. Surely, the world has changed since the early 1970s. Notions on globalisation suggest cultures may converge, undermine the very concept of "national" cultures and redefine cultures on a global, and perhaps simultaneously, on a mere regional scale. Repeating Hofstede's IBM Study, almost 30 years later, would provide the chance to empirically verify these notions and Hofstede's fundamental argument that the five dimensions are stable over time.

More radical perceptions suggest that cultures have no clear dimensions anymore, populated as these cultures are by hyper-individualists shopping for seemingly contradictory values at their own convenience.

2.3.6. Another classic: Riding the waves of culture

According to Keaney (1999) a common and justified complaint of many in academia and elsewhere concerns the poverty of substance of much of what passes for management "literature". The style adopted by Trompenaars and Hampden-Turner (1998) is one which will equally enthuse and infuriate. Most non-business school academics will not be impressed with the rather diluted nature of the subject matter.

Trompenaars and Hampden-Turner (1998) have eschewed the universalism of neoclassical economics, arguing instead for a more appreciative treatment of culture (contested claims). As such, their work is unlikely to garner the appreciation of mainstream economists and the like, who will most likely decry the lack of "rigour" as evidence of their fundamentally flawed reasoning. This was illustrated in Hofstede's critique (1996), where he questions the scientific method and argues that no evidence for the theory of the book is provided by the data. Institutional economists, on the other hand, are encouraged by the attention to details most often ignored by their mainstream colleagues. Much of the empirical material used in the book originates from the "Trompenaars database", "one of the largest and richest sources of social constructs". Their reluctance to make definite pronouncements, according to Keaney (1999) is understandable given the undoubted controversy which would attend their statistical methodology. This again is affirmed by Hofstede (1996) in his vigorous critique arguing that the shortcoming of Trompenaars' database is its evident lack of content validity. In the same critique, Hofstede confirms his own views regarding the sole purpose of research being to replace preconceived notions with empirical findings. The result of Trompenaars' works being a fast food approach to intercultural diversity, according to Hofstede. Trompenaars and Hampden Turner (2000) are taking a rather different view to measure cultural diversity and describe six different dimensions:

Table 3 Dimensions of culture according to Trompenaars *et al*

1. Universalism (rules, codes, laws, and generalisations)	Particularism (exceptions, special circumstances, unique relations)
2. Individualism (personal freedom, human rights, competitiveness)	Communitarianism (social responsibility, harmonious relations, co-operation)
3. Specificity (atomistic, reductive analytic, objective)	Diffusion (holistic, elaborative synthetic, relational)
4. Achieved status (what you have done, your track record)	Ascribed status (who you are, your potential and connections)
5. Inner direction (conscience and convictions are located inside)	Outer direction (examples and influences are located outside)
6. Sequential time (time is a race along a set course)	Synchronous time (time is a dance of fine co-ordinations)

Trompenaars and Hampden Turner (2000) take the view that all values take the form of dilemmas and argue that they would not even know what a universal rule was unless they could contrast it with an exception, a “not-rule”. Evaluative terms are different on a (usually) tacit continuum. You can either search for two objects /or people who are the same or you can search for the many respects in which these are different. For example, one can insist that men and woman are both human and should be treated the same, thereby upholding the universal rights of both genders. Alternatively, one can insist that men and women are different and should be treated differently. Each approach has advantages, but also serious disadvantages.

Regarding comparison between the dimensions used by Hofstede (1991) and the ones used by Trompenaars and Hampden-Turner (2000), it seems that there are more comparisons than both would accept. Both have a strong reference and based their work on findings of Kluckhohn and Strodtbeck (1961).

In every culture a limited number of general, universal shared human problems need to be solved. One culture can be distinguished from another by the specific solution it chooses for those problems. The anthropologists F. Kluckhohn and F.L. Strodtbeck (1961) identify five categories of problems, arguing that all societies are aware of all possible kinds of solution but prefer them in different order. Hence in any culture there is a set of dominant, or preferred, value orientations. The five basic problems mankind faces, according to this scheme, are as follows:

1) What is the relationship of the individual to others?

(relational orientation)

2) What is the temporal focus of human life?

(time orientation)

3) What is the modality of human activity?

(activity orientation)

4) What is a human being's relation to nature?

(man-nature orientation)

5) What is the character of innate human nature?

(human nature orientation)

In short Kluckhohn and Strodtbeck (1961) argue that mankind is confronted with universally shared problems emerging from relationships with fellow beings, time, activities and nature.

Perhaps Hall (1976) is helpful understanding what separates men. The widely divergent but interrelated experiences, which he has drawn from the field of psychoanalysis and his work as anthropologist, have led Hall (1976) to believe that in his strivings for order, Western man has created chaos by denying that part of his self that integrates while enshrining the parts that fragment experience. These examinations of man's psyche have also convinced Hall (1976) that: the natural act of thinking is greatly modified by culture; Western man uses only a small fraction of his mental capabilities; there are many different and legitimate ways of thinking; we in the West value one of these ways above all others – the one we call "logic", a linear system that has been with us since Socrates. Western man sees his system of logic as synonymous with the truth. For him it is the only road to reality.

Hall (1976) takes a firm position towards Western science when he argues that, men have fought and died in the name of different models of nature. All theoretical models are incomplete. By definition they are abstractions and therefore they leave things out. What they leave out is as important as, if not more important than, what they do not, because it is what is left out that gives structure and form to the system. Models have a half-life – some are ephemeral, others last for centuries. There are highly explicit models, while others are so much part of life as to be unavailable for analysis except under very special circumstances. In constructing their models of culture, most anthropologists take into account that there are different levels of behaviour: overt and covert, implicit and explicit, things you talk about and things you do not. Also there is such a thing as the unconscious, although few are in agreement as to the degree to which the unconscious is influenced by culture. Paradoxically, studying the models that men create to explain nature tells us more about the men than about the part of nature being studied (Hall, 1976).

This could bring us back to Trompenaars and Hampden-Turner which provide for the basis upon which they built their theory, avoiding the use of specific models. In their approach, taking the view that all values take the form of dilemmas, it may be helpful to demonstrate their theory. Although the training in cross culture is fairly limited still, this approach is relevant to practitioners and very receptive given the practical way it is being communicated and explained. During the conference,[6] references to these kinds of training have been made (see Annex 1: Kleiterp on FMO (Netherlands)-DEG (Germany) and Hanegraaf touched on the subject of the merger of Fortis (Netherlands) with Generale Bank (Belgium)). Dilemmas are a very appropriate form of testing values, as it is confirmed by the works of Hofstede as well as Trompenaars *et al.*

2.3.7. Dilemma theory (Trompenaars **et al***, 2000):*

Please find below the basis upon which Trompenaars and Hampden-Turner (2000) built their theory. In their approach, all values take the form of dilemmas, and this is helpful to demonstrate their theory.

Values deemed virtuous, god-like, and personified by heroes inevitably conflict and must achieve harmony if protagonists are not to clash tragically (derived from classic Greek tragedy).

Among conflicting values, one is often consciously and culturally preferred to the other which is buried and repressed (derived from Freud, Jung, Adler, Reich, Rank and Fromm).

The personality constantly struggles for consistency and may successfully integrate opposing values or repress and deny one side (derived from cognitive consistency theorist, especially George Kelly, Prescott Lecky and Leon Festinger).

[6] Conference sponsored by FMO, DEG and DBA March 21st -24, 2004 to be discussed in Chapters, 3,4 and 5

These values, properly conceived, are differences on an often tacit continuum and thereby structure the patterns of a culture and the minds of its members (derived from structural anthropologists, such as Frances Densmore, Clyde Kluckhohn, Ruth Benedict, Gregory Bateson, Claude Levi-Strauss and Edmund Leach).

These combinations of values may grow synergistically and humanistically, or regress with catastrophic consequences (from humanistic psychologists, especially Abraham Maslow, Rollo May and Carl Rogers).

Much of this inherent opposition and unity has been found in contrasting brain functions (from brain researchers, such as Roger Sperry, Michael Gazzaniga and John E. Bogen).

Values form open systems which spontaneously self-organise and steer by getting feedback from their environment (from systems theorists, such as Ludwig von Bertalanffy, Geofrey Vickers, West Churchman and others).

Many of the tensions within living systems have been found in organisational behaviour. Industries and workplaces confront dilemmas which they must resolve to generate wealth (from the field of organizational behaviour, Fritz Roethlisberger, Douglas Mc.Gregor, Robert Blake and Angyris and Schon, Michael Porter, Henry Mintzberg and others).

Similar dilemmas pattern the politics and sociology of American and other societies and must be resolved if those societies are to continue developing (from political science, sociology and cultural studies, Talcott Parsons, Daniel Bell, Chrispher Jencks and others).

The ways Americans resolve dilemmas are often the mirror image of the ways East Asians resolve theirs, leading to considerable misunderstandings and culture shock (from East Asian studies, Ezra Volgel, James Abegglen and Jorge Stalk).

Searching into and resolving dilemmas is a form of human and organisational learning (from epistemology and the philosophy of science, Floyd Matton, T.S. Kuhn a.o.).

It requires creativity and innovation (from studies in creativity, Arthur Koestler, Frank Barron and Liam Hudson a.o.).

It may involve moral development (from moral development studies, Jean Piaget, Lawrence Kohlberg, Richard Crutchfield and Stanley Milgram).

It is reflected in architecture and design (from architecture and design, Buckminster Fuller and Kisho Kurokawa).

And it enables us to bring order in chaotic events and manage the fractal patterns which arise (from Chaos theory and patterns of fractals, James Gleick, and John Briggs and many others).

Whereas the publications of findings by Trompenaars and Hampden Turner (1998, 2000) provide very rich sources of information, research data and opinions, it remains somehow vague as to how their theory (approach) can be applied by others. There is no generalization of their theory, neither do they provide for a specific model. The main findings are that foreign cultures are not arbitrarily or randomly different from one another. They are instead mirror images of ones another's values, reversals of order and sequence of looking and learning (Trompenaars and Hampden-Turner, 2000). They argue that what the foreign culture sees so clearly, most of us miss and vice versa. The ideal, they argue, is to perceive and think in both directions, in order words that we must learn to think in circles.

Above argument is illustrated by Trompenaars and Hampden-Turner (2000), starting with the ubiquity of dilemma.

"We all know the old dilemma of the chicken and the egg. Which came first? And they argue that all their six value dimensions can be investigated, representing similar dilemmas. Which came first the universal rule or the exceptional event? There is no final answer to these dilemmas. This is where cultures come in. The resourceful individual comes first, says the American culture. The rice-growing village comes first, says the Chinese culture. Consider the famous dictum of Adam Smith, that self-interest leads as of by an "invisible hand" to social and public benefit. Is there truth to this proposition? Certainly! Do individuals competing with one another in serving customers thereby improve service to those customers? Yes. Is this a truth upon which the science of economics can be squarely based? Perhaps not."

2.3.8. Different schools of thought: Positivist versus realist

It is rather subjective to qualify a researcher as part of a specific school of thought. Different this is, if and when a researcher acknowledges him or herself as part of a specific school.

Trompenaars *et al* (1997), contrasting Hofstede with Trompenaars, provides for the following differences:

Table 4 Contrasting Hofstede and Trompenaars *et al*.

Hofstede assumes	**Trompenaars assumes**
Cultures are static points on dual axis maps	Cultures dance from one preferred end t its opposite and back.
One cultural category excludes its opposite	One cultural category seeks to "manage" i opposite.
"Independent" factors account for "dependent" variables.	Value dimensions self-organize in system to generate new meanings.
Established statistical procedures are culture neutral and value free.	Established statistical procedures ar culturally biased and value full.
Cultures are linear with "more" or "less" of a fixed quality	Cultures are circles with preferred arc joined together
Data derived from IBM is superior to ideas drawn from academic research and reflects managements' convictions.	Data derived from IBM are but pa imitations of academic research and refle managements' compliance.
Hofstede by thinking inductively derived his categories from IBM data and originated his own scales.	Hofstede by thinking inductively reinvente the scales from which IBM had plagiarise their questions.
NO better place to be on a quadrant pas and no answer to the questions "so what?" and "where should we move?"	No better place to start on the seve dimensions but moves to integrate ar reconcile values lend to superi performance.
A priori concepts like "dilemma" are metaphysical constructs with no basis in empirical research and with no testable	Dilemma has been part of culture fro Classic Greek Tragedy, from the Primordi Opposites of the Tao, through Shakespea

validity or means of verification.	to the binary codes of anthropologis today.
All cultures are different although those differences can be expressed as positions of relative salience on four variables.	All cultures are similar in the dilemmas the confront, yet different in the solutions the find, which transcend the oppositior creatively.

2.3.9. Hofstede and positivism:

Clearly Hofstede qualifies as an empiricist, as Trompenaars *et al* (1997) suggests. He has difficulties with Hofstede's approach whereby it seems that culture can be best measured and expressed in mathematical language. Hofstede does meet the definition by Smith (1998) that the positivist approach to the social sciences claim the label scientific, for he assumes that things can be studied as hard facts and the relationships between these facts established as scientific laws. For positivists, such laws have the status of truth and social objects can be studied in much the same way as natural objects. These views of Hofstede are confirmed throughout his work and also in his critique on Trompenaars. His considers his findings to be laws which do not change over time (even after 30 years), and he argues his fundamental belief that his dimensions would still be the same and could be proven empirically. He continuously advocates a rather standard positivist account (Smith -p.77, 1998), which emphasises the importance of value freedom, hard fights and prediction as a basis for offering policy proposals for governments, businesses and other private institutions. Yet there is hardly any evidence that Hofstede's claims are still accepted in this respect. Hofstede also unreservedly accepts the assumptions of phenomenalism, demonstrating his commitment to the use of empirical data as evidence; unwillingness to accept un-provable data, sentiment, imaginings, or illusions as proof. As an "-ism" phenomenalism is often contrasted with realism, because the former requires specific evidence of each "thing", whereas realism accepts that some "things" exist only as wholes or through processes, so that evidence (the empirical) is different from the real existence of the thing. Realism and thus Trompenaars *et al* (1998, 2000) separates evidence from existence, whereas phenomenalism usually conflates the two (Olsen 2001). Below a reflection will be given on the link between realism and Trompenaars.

2.3.10. Trompenaars and realism:

According to Smith (1998), realists argue that science only makes sense in open systems. Whereas the realist approach is deeply critical of positivism, it still attempts to use methods and assumptions of natural science to study the social world and where the empiricist identifies causal laws by identifying empirical regularities, a realist view of causality focuses on the structure of objects. For a realist, according to Smith (1998), reality has three levels (empirical, actual, and real or deep), which have to be distinguished if we are to understand how things work. These differences become clear analysing the critiques on Hofstede, as Trompenaars *et al* argues (1997) that Hofstede's work uses Aristotelian categories of A and non-A. If you are individualist you cannot be collectivist. You are at one end of a linear measure or another, occasionally in between. Trompenaars *et al* (1998, 2000) however uses dilemmas as a way of understanding differences in culture. It seems that this is one appropriate methodology to grasp the deeper meaning and understanding of this complex problem. Indeed, as Trompenaars *et al* (1997) states: (1) social science methodology is not culture free and (2) there is no neutral point "above" culture from which to view the universe and (3) it follows that many different ways of viewing culture are legitimate.

The realist school of thought does not insist that realism is both tangible and observable but rather believes that theories of explanation can be understood through careful abstractions of interrelationships and interactions. One can conclude that the realist approaches to the real world are attempts to identify and explain the structures and mechanisms through which social events are understood (handout Olsen 2001). This can be observed on both the work of Trompenaars *et al* (1998, 2000) as well as their critique on Hofstede (1997).

2.3.11. Quantitative research – Hofstede:

Quantitative research designs are characterised by the assumption that human behaviour can be explained by what may be termed as “social facts”, which can be investigated by methodologies that utilise “the deductive logic of the natural sciences” (Homa, 1994, p. 121). Quantitative investigations look for “distinguishing characteristics, elemental properties and empirical boundaries” and tend to measure “how much”, or “how often” (Nau, 1995). A quantitative research design allows flexibility in the treatment of data, in terms of comparative analysis, statistical analysis, and repeatability of data collection in order to verify reliability. Many of the scales used within these studies are also tested for validity and reliability, thus claiming further “scientific” credibility. The weaknesses of such quantitative research designs lie mainly in their failure to ascertain deeper underlying meanings and explanations, even when significant, reliable and valid.

2.3.12. Qualitative research – Trompenaars:

The classic qualitative study is one in which the findings are “grounded” in the data (Glaser and Strauss, 1967). A qualitative study seeks to identify underlying concepts and the relationship between them (Frankfort-Nachmias and Nachmias, 1996). The data for a qualitative study might include transcripts of in-depth interviews, observations or documents (Patton, 1991). Qualitative enquiry often takes the form of a case study. According to Yin (1994), case study is the preferred research approach when “how” or “why” questions are being posed – in other words, questions of process. Most researchers have been guided to believe that the role of qualitative enquiry is that of an advisable first step to be taken before the “real” enquiry – a quantitative enquiry – is undertaken. This view denigrates the role of qualitative enquiry.

Some social scientists would now subscribe to the view that qualitative and quantitative methodologies can both lead to valid research findings in and of their own right. According to Easterby-Smith *et al* (1991), there are many researchers who adopt a pragmatic view of deliberately combining quantitative and qualitative methods. It is not a matter of inflexibility adhering to one methodological approach simply because it is traditionally associated with a chosen paradigm of science.

Qualitative methodologies are strong in those areas that have been identified as potential weaknesses within the quantitative approach, e.g. the use of interviews, observations, case studies to provide a deep, rather than broad set of knowledge about a particular phenomenon. This depth allows the researcher to achieve “Verstehen”, or empathetic “understanding” (Smith 1998). The concept of Verstehen is the basis for a critique of quantitative research designs, and their empiricist emphasis. The argument used is that quantitative methods measure human behaviour “from outside”, without accessing the meanings that individuals give to their measurable behaviour. This perfectly illustrates the apparent differences between Hofstede (1996) and Trompenaars *et al* (1997).

2.3.13. Confronting realism and positivism:

The positivist paradigm provided the springboard for other paradigms like realism. Yet, realists seek interpretations and meanings of interactions, whereas the positivist looks for empirical evidence and regularities. The realist argues that science makes sense only in an open system (Smith 1998). In other words it is essential that methods must be appropriate to the nature of the object and the purpose and expectations of our enquiry (Sayer 1992). Positivists generalise from the observation of specific events, they claim that these generalisations are the principal source of explanations. Realists think otherwise, they tend to seek and observe regularities, and from these they propose models of structures to explain them. One will then have to undertake research to either establish or refuse the explanation put forward (Smith 1998). Interestingly, Hall (1976) explains this difference in approach quoting Nobel Price laureate Szent-Györgyi (1972), who classified two types according to an old Greek system: Apollonian, "which tends to develop established lines to perfection" (LC – low context), and Dionysian, which is more apt to open new lines of research (HC –high context). He says:

These are not merely academic problems. They have most important corollaries and consequences. The future of mankind depends upon the progress of the science, and the progress of science depends on the support it can find. Support mostly takes the form of grants, and the present methods of distributing grants unduly favours Apollonian. Applying for a grant begins with writing a project. The Apollonian clearly sees the future lines of his research and has no difficulty in writing a clear project. Not so the Dionysian, who knows only the direction in which he wants to go out into the unknown; he has no idea what he's going to find there and how he's going to find it. Defining the unknown or writing down the subconscious of self-conscious thinking must precede a Dionysian's observation.

Hall (1976) continues explaining that a Dionysian scientist must be deeply contexted in his work before he even writes a proposal. Szent-Györgyi (1972) goes on to state that in order to get research grants he had to lie about what he intended to do, make up proposals he knew would be acceptable. He states:

"…. Sitting in an easy chair I can cook up anytime a project, which must seem quite attractive, clear and logical. But if I go out into nature, into the unknown, to the fringes of knowledge, everything seems mixed up and contradictory, illogical and incoherent. This is what research does: it smoothes out contradiction, makes things simple, logical, and coherent. So when I bring reality into my projects they seem hazy and are rejected. The reviewer, feeling responsible for the "taxpayer's money", justly hesitates to give money for research, the lines of which are not clear to the applicant himself. A discovery must be, by definition, at variance with existing knowledge. During my life, I have made two. Both were rejected offhand by the popes of the field."

Hall (1976) thus takes a whole different approach to positivism and other schools of thought. Remembering the process of the DBA it now seems that the author of this thesis is very much a Dionysian without having realized the same, and that at the same time most of the supervising and teaching of the program (not the supervisor) has come from "Apollonians".

2.3.14. Objectivity – subjectivity:

Some philosophers according to Fay (1998) have claimed that an objective conclusion is one which "warrants acceptance by all who seriously investigate". But this he argues is a mistake. Investigators can proceed with their analysis in an objective manner and yet they arrive at different conclusions, indeed they may never agree. (Hofstede versus Trompenaars 1996- 1997).

Sayer (1992) says that objectivity in social science is a false, unattainable aim. He calls scientists "naive objectivists" if they advocate that objectivity is possible. The subject-object problem according to Smith (1998) focuses on the relationship between the researcher and the "things" he studied and highlights the way in which there are crucial differences between natural science and social science. Through Hofstede's absolute claims to validity and truth he seems not to recognize this difference. Yet starting with Hofstede, Trompenaars *et al* (1997) illustrates in various ways the subjectivity of Hofstede's work, arguing for example that as an employee to IBM, he got an undergraduate psychology degree and sold his project and ideas to IBM. Indeed, whereas Hofstede for more than 30 years has taken pride in his research, advocating the impressive data obtained, he has been unable to find funding to repeat research on similar scale since. His survey on which *Culture's Consequences* builds was held twice, around 1968 and around 1972, generating data drawn from 40 countries, 116.000 questionnaires, and about 50.000 respondents who all work for the multinational computer corporation IBM. Trompenaars *et al* (1997) correctly refers to the effects of IBM being headquartered in the USA and thus that data came from the interstices of the company itself. Furthermore, the questions made up by unknown members of IBM's personal department, had according to Trompenaars, their origins in American academic research of those days, and subsequently puts in doubt Hofstede's claim that he "discovered" the four (later five) fundamental dimensions of culture with a high-level cross-cultural impact on human behaviour. This also touches upon the issue of value free or situated knowledge.

Trompenaars’ *et al* (1998, 2000) books, on the other hand, use a wide variety of data and include raw data comprising of 50.000 cases from over 100 countries. Restricting those to managers from multinational and international corporations, some 30.000 comparative (valid) cases can be selected drawn from 55 countries. Both Trompenaars as well as his author Hampden-Turner received both undergraduate as well as doctorates in the USA. (PhD Wharton - Trompenaars, DBA Harvard – Hampden-Turner).

2.3.15. Situated knowledge:

According to Kuhn (1970), all social research is socially embedded and Smith (1998) acknowledges that research is socially positioned and that yet all researchers try to base their findings on evidence. Olsen (2001) additionally viewed that subjectivity is an inherent part of all social research. This is not necessarily true for natural science.

In line with Kuhn's concept, Hofstede's (1980, 1991) as well as Trompenaars *et al* (1998, 2000) scientific knowledge is both situated in the context of the historical and social practices which define (natural) science in a particular time and place. Consequently, the truth of a scientific statement is only relevant to those who share the belief system (value system) upon which such "truths" are based. Hofstede and Trompenaars *et al* do not seem to share the same belief systems.

Hofstede claims that if his research were to be repeated today (30 years later), it would provide the chance to empirically verify these notions and his "fundamental" argument that the five dimensions are stable over time. Hofstede denies that his research is socially embedded in time and assumes, implicitly, that his cultural consequences and findings are static. Trompenaars *et al* (1997) refer to Hofstede's paradigm of still being in the thrall of Newtonian science and celestial mechanics. It is merely a point of view.

2.3.16. Current issues in cross-cultural research:

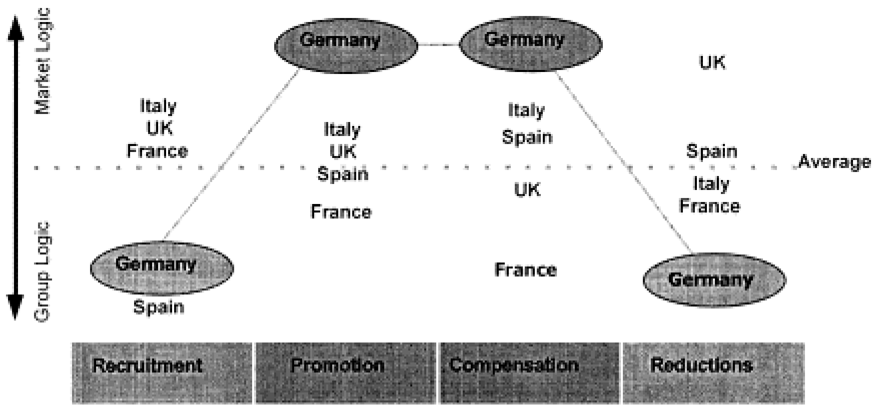
Landis and Wasilewski (1999) identified several areas relevant to future productive research in the field of intercultural and cross-cultural studies. Some of the key areas relevant to this thesis are discussed below. A theory that has the distinction of being one of the most researched derives from the work of Hofstede (Hofstede, 1980; Kim *et al.*, 1994). They question whether the seven Trompenaars dimensions (universalism, individualism, emotionalism specific vs. diffuse, achievement vs. ascription, time orientation, and attitudes toward the environment) are really derivations of the individualistic factors of Hofstede. Even more bothersome is the possibility that both approaches are faulty because they base their generalisations on the use of etic approaches to study emic phenomena as well as commit the ecological fallacy (the assumption that people who happen to reside within a defined geographical region share the same set of attitudes to the same extent). More to the point of this section, however, is Trompenaar's belief that the dimensions organise themselves in different ways in different cultures, thus calling into question the linear combinations implied by the Hofstede approach. Perhaps the reductionism to four dimensions in the Hofstede structure fails to capture the real differences in the way people in different cultures view their social world and it seems that Trompenaars is correct in suggesting that the dimensions are organised and prioritised differently in different cultures. Not only that, but we do not even know what all the possible dimensions might be. Most of the categories currently used according to Landis and Wasilewski (1999), just like Hofstede's, derive from some US normed construct (see also Trompenaars *et al*, 1997).

Somewhat strong arguments to be cautious with the methodology applied by Hofstede (1980, 1991) have been found by Segalla *et al* (2000). They argue in their research, which is restricted to European corporate integration, that traditional cross-cultural research is no longer useful for the problems facing Europe's cross border companies. In their paper, they report results of a study of European managerial values designed to uncover European values and conducted a six-country study of over 800 managers working in 60 companies in the European financial sector. The results of their study suggest that although European managers have widely-differing solutions to common managerial problems, there is an underlying logic – referred to as group logic or market logic- that guides their choices.

In their study, Segalla *et al* (2000) plea for the need of better cross-cultural knowledge, built on understanding how cultural values are tied to real organisational problems. They quote Roberts (1970) and Weinshall (1979) saying that most of the studies in the field are based on surveys, which are not well thought out... It is not well guided by theoretical underpinnings, data are often weak, and conclusions are difficult to comprehend. Organisations are rarely viewed as parts of their environment, yet understanding organisational environmental interactions seems a major practical reason for engaging in cross-cultural research. They refer to major studies by Hofstede (1980) and Trompenaars and Hampden-Turner (1998) as illustrations of cross-cultural research having matured during the 1980s. Yet, they provide for a whole range of clear demonstrations of what were the weaknesses with research of Hofstede and others, and argue that the context of the questions are clearly as important as the answer. This approach seems to confirm the findings of Hall (1976) where he stresses the overriding importance of context.

Segalla *et al* (2000) argue furthermore that the more general problem with finding human values is that they are notoriously difficult to identify, and quote Schein (1986) that values lie at the lowest level of human consciousness and are difficult to evoke. We seldom have the occasion to fully identify and understand our values and therefore they may not be fully understood. Simply asking a question is not sufficient to elicit a deep search for values according to Segalla *et al* (2000), and by means of this statement, they further critique this type of – traditional – research. However, in their own research, they have drifted alongside Trompenaars (1998) arguments to using dilemma scenarios; each centred on a specific problem (situation), and arrived at a new model, describing basically the suggestion that European managers have (only) two basic value systems.

Figure 11 Model of culture, Segalla *et al*



Rationality "Switching" Model, Segalla et al (2000)

Above figure from the study illustrates amongst which ‘dimensions’ they have measured value systems amongst the sample, and across dilemmas in recruitment, promotion, compensation and reductions. It shows that different nationalities may switch from one dimension to another depending on the setting of a specific problem or dilemma. According to Segalla *et al* (2000), these findings mean that previous cross-cultural research, which generated mean “country scores” measuring various, hypothesized values, will need to be re-evaluated. In fact, managerial actions are as much influenced by the context of the problems as whatever the manager underlying value system is, then the 'one size fits all' approach. Also traditional close-ended questionnaires so routinely used are considered inappropriate without some way of ensuring that they record the various situations in which the measured values are applied.

Hall (1976) goes even further than only arguing that context is relevant, and describes his views on low- and high context cultures (very much in line with Trompenaars’s dimension of universalism and particularism) and suggests that if one could get behind the scenes one would find context dependant results in the majority of research projects. Western science, according to Hall (1976) is striving for replicability and rigor (!) in methods and is conducted with a view to eliminating context.

Another issue of relevance according to Landis and Wasilewski (1999) is the development of Psychometrically Adequate Scales for Measuring Cross-cultural Adaptation and Other Dimensions. Many studies fail to find significant results (or they present weak findings) because the measures are psychometrically flawed. These measures will have low reliability and, consequently, low validity. Landis and Wasilewski (1999) refer to four papers, which have included rigorously developed measuring instruments (Dawson, Crano, & Burgoon 1996; Dunbar, 1997; Landis, Dansby, & Tallarigo, 1996; Pruegger & Rogers, 1994). Two of these researches present new quantitative measures and the third refines an already existing scale. Pruegger and Rogers developed a new measure, the Cross-cultural Sensitivity Scale (CCSS) (Pruegger & Rogers, 1994). All these efforts, however, seem not to accept that perhaps all theoretical models are incomplete. By definition they are abstractions and therefore leave things out. What they leave out is as important as, if not more important than, what is included, because it is what is left out that gives structure and form to the system (Hall, 1976).

According to Landis and Wasilewski (1999), there is a need for Reality-based Assessments of Cross-cultural Training Effectiveness. Kealey and Protheroe reviewed the state of assessing cross-cultural training and came to the conclusion that it is ` . . . seriously deficient' (Kealey & Protheroe, 1996, p. 159). They suggested that a `reliable' study of the impacts of expatriate training would need to include, at a minimum, the following four criteria:

1) a comparison between trained and untrained groups which have been matched on most important criteria as well as randomly selected;

2) pre and post knowledge measures of change in both cognitive and behavioural competencies [and affective competence];

3) longitudinal measures of subsequent performance on the job lasting fairly long periods of time; and;

4) impact measures, which are more objective than the self-reports of the trainees, including peer, supervisor, and host national assessments.

After reviewing much of the literature on cross-cultural training effectiveness, Kealey and Protheroe concluded that few, if any, studies meet all of the criteria (Kealey & Protheroe, 1996). The two studies (Landis & Bhagat, 1996a,b; Sorcher & Spence, 1982) that came closest to meeting the criteria were focused on domestic intergroup relations and may, therefore, be of doubtful application to the expatriate setting.

In training we often avoid discussions of “sensitive” topics that may make some members of the group uncomfortable, and there are certainly ethical reasons to be cautious here (Paige & Martin, 1996). Nevertheless, when the discussion may prevent embarrassing and possibly dangerous (e.g., STD and HIV infection, botched abortions, etc.) situations in-country, it may be worthwhile to take the risk. Sexuality is also a topic which involves many issues of power.

According to Landis and Wasilewski (1999) it has become rather traditional to start a paper, or workshop, on expatriate manager success (or lack thereof) to assert that most such assignments are failures. While this without doubt gets the attention of editors and potential sponsors, it is apparently a figure built on a rather nebulous base (Hofstede, 1997). Harzing (1995) has traced almost all such assertions back to a single article by Rosalie Tung (1981) which has been wildly misquoted as giving failure rates of around 40% for American firms (actually, her report suggests that only 7% of American firms had recall rates between 20-40%). It is apparent that most writers have been content to cite either Tung (1981) or one of the many other writers who cite her. In any case, some really serious research needs to be done to deal empirically with this interesting issue.

Landis and Wasilewski (1999) believe that we have spent too much time researching and training sojourners as opposed to expatriates or other international travellers. Convenience samples are the staple of much intercultural research, a design resulting from that most prized aspect of the academic: the sabbatical year. If the sample is not made up of students in a foreign university (or foreign students at one's home university), it may be Americans located in the country in which the sabbatical is located. In either case, the sample is dictated by the locale rather than some interesting characteristic of the sample. There are other groups that engage in intercultural interactions that may be able to offer interesting insights into the process. At the opposite end of the spectrum, we need to spend time researching, not just expatriate training, but research into how to build lasting relationships, true connections (Hall, 1998), entangling alliances, the maintenance of relationships through thick and thin, good times and bad.

2.3.17. Link to this research:

According to Hall (1976), the part of man's nervous system that deals with social behaviour is designed according to the principle of negative feedback. One is completely unaware of the fact that there is a system of controls as long as the program is followed (see also Hofstede, 1991 – software of the mind). Ironically – according to Hall (1976), this means that the majority of mankind is denied knowledge of important parts of the self by virtue of the way the control system works. The only time one is aware of the control system is when things do not follow the hidden program. Most cultural exploration however begins with the annoyance of being lost. The control system of the mind signals that something unexpected has arisen, that we are in uncharted water and are going to have to switch off the automatic pilot and man the helm ourselves (Hall, 1976). These observations when applied to this field of research raise other interesting issues. How for example do banks cope with these processes? Do they actually seek to work in cultures which are different from their own, or – alternatively - does their lending policy implicitly lead to a selection of cultures which seem similar?

Perhaps relevant in this aspect is the work of Thomas Kuhn (1970) who, reflecting on the emergence of the idea of oxygen during the late eighteenth century, wrote the following:

"Lavoisier.... saw oxygen where Priestly had seen ..... dephlogistinated air and where others had seen nothing at all.... At the very least, as a result of discovering oxygen, Lavoisier saw nature differently. And in the absence of that hypothetical fixed nature that he "saw differently," the principal of economy will urge us to say that after discovering oxygen Lavoisier worked in a different world" (Kuhn, 1970).

Relativism is the doctrine that either experience (in the case of epistemological relativism) or reality (in the case of ontological relativism) is a function of a particular conceptual scheme. Both imply that so deep are the differences which separate those within different frameworks that their experiences and beliefs would be fundamentally incommensurable (Fay, 1996). By incommensurable Fay (1996) means that no common measure can serve as a bridge among different conceptual schemes. Those inside one conceptual scheme would be living in their own reality, one different from those living in other conceptual schemes: and the experiences of the respective member would be so different that no basis could exist on which to understand each other. Bankers all over the world seem to agree on the fact that credit risks in large part are related to the competencies of management of companies and organisations. The argument can however be made that the assessment of management capabilities may be hindered in those cases where the culture is little understood. In other words, how do bankers evaluate management of another culture, if they understand little of it?

What can often be observed is that management of international and transnational companies and organisations has often been trained and educated in different cultures (usually Western). The question here that can be asked is whether, despite the fact that people from different cultures live in different worlds (according to ontological relativism), they change after such training and education. According to many authors, such as Hofstede (1980) their culture does not. So, when trained and educated in the West – for example – one can run the risk of falling into the "they are just like the folks at home syndrome," which according to Hall (1976) is one of the most persistent and widely held misconceptions of the Western world, if not the whole world. Also, in this context, one may wonder how universal rules and regulation coming from BIS (Basel II) will work in so many different cultures.

It also seems that some aspects of culture are more relevant to the subject than others. Particularly aspects of power distance, uncertainty avoidance, individualism, universalism versus particularism, as well as high versus low context are expected to play a more prominent role than some of the other culture dimensions. This research also refers to other specific aspects of culture – differences – for example as to how different cultures handle asymmetry of information, adverse selection and moral hazard; three issues which are perhaps more relevant to the type of cross-cultural relationships in banking and credit.

2.3.18. Research questions:

Following the above chapter on the topic of cross cultural research, the following hypotheses were formulated:

H.3.1. Cultural differences have played a role in there having been so many accidents (defaults) throughout history in international finance.

H.3.2. If the bank does not understand the cultural context of a particular country or region, it becomes highly doubtful it will understand the risks

H.3.3. Capabilities to make friends, combined with common sense ensure healthy bank-client relations

And sub-hypotheses;

H.3.3.1 Clients of banks would be benefited if banks were rated in terms of client's satisfaction

H.3.3.2 the commitment of most relationship banks depends largely on the weather (Umbrella whilst the sun is out, requesting it back when clouds appear)

H.3.3.3 the quality of a bank should also be rated in accordance with client satisfaction.

2.3.19. Concluding remarks:

In this final section of chapter 2, the relevance of cultural differences has been discussed. It was made clear that there are many different methodological approaches to study the phenomena of culture. The works of Hofstede (1980) have been thoroughly reviewed, as for many decades his work has been considered to be one of the leading references in the field. In later publications both Trompenaars (1998) as well as Segalla *et al* (2000) demonstrated that quantifying cultural differences along the five dimensions defined by Hofstede (1980) needed to be revised. In line with the writings of Hall (1976), context was considered of overriding importance as different culture dimensions may vary depending on the context of the particular problem or dilemma. One of the main problems with culture as defined in this thesis is that most of it remains covert, as the core of ones culture is driven by ones value system.

It is argued that despite the fact that culture is such a difficult concept to deal with, the solution will not be for it to be ignored. Rather it should be understood and acknowledged, as without further understanding and study of this concept much of the cross cultural challenges will not be addressed appropriately. This seems to hold particularly true for cross border lending.

CHAPTER 3 - METHODOLOGY

3.1. Introduction:

Methodology is understood to be the general principles behind the research, whereas methods are the principal techniques used to undertake the research. The methodology of any research underpins the values and assumptions that form the rationale for the research. It also directs the criteria that the researcher chooses to use for collecting and interpreting data. Methodology therefore "provides the link between technique and theory" (University Handout 2001).

It is never possible to understand completely any other human being: and no individual will ever really understand himself – the complexity is too great and there is not the time to constantly take things apart and examine them. This is the beginning of wisdom in human relations. However, understanding oneself and understanding others are closely related processes. To do one, you must start with the other, and vice versa (Hall, 1976 page 69). This observation by Hall serves as one of the perspectives on which this thesis has been built.

Fay (1996) suggests that there is no self-understanding without other-understanding, and the extent of our self-consciousness is limited to the extent of our knowledge of others. To identify other as different requires that we also identify the ways we are similar. Much social thought consists of oppositional categories, such as the case in cross cultural research (self versus other, particular vs. universal, insider vs.

outsider etc). The same dualistic thinking mark meta-theories in the philosophy of social science: atomism vs. holism, cause vs. meaning etc. Fay (1996) warns against those pernicious dualism and argues that such thinking promotes an “either – or” mentality in which one category precludes it’s supposed opposite. Often one side of a dichotomy depends on and invokes the other – in which case the dichotomy is subverted. Frequently an entity can be in both categories, as it has also been demonstrated in findings of Segalla *et al* (2000) and publications by Trompenaars *et al* (1997), the latter in his reply to Geert Hofstede (1996).

Within the context of this argument and this thesis it is perhaps illustrative to quote van Deventer and Imai (2005) in their book: Credit risk Models and the Basel Accords, (page 135), where, after referring to different researchers having found the different levels of statistical significance, they quote;

“What we do believe is that quantitative credit models provide cheaper, faster and more accurate indices of credit quality than the traditional credit analysis practiced by most financial institutions”.

It can be argued here that depending on the context they may be right. Such being the case in a large domestic market as the USA, where financial institutions using large databases in consumer lending (credit card business, mortgage lending), as well as the credit market to the small and medium sized companies, can be efficient users of (sophisticated) credit models. This may perhaps not be the case with the larger issuers of debt instruments, such as has been the case with

Parmalat, Enron, Worldcom and the like. A similar argument can be made for cross border lending.

The other pillar perhaps is the philosophical perspective referred to as relativism, which is the doctrine that either experience (in the case of epistemological relativism) or reality (in the case of ontological relativism) is a function of a particular conceptual scheme. Epistemological relativism claims not only that our perceptions are organized differently according to the linguistic or conceptual system to which we belong, but also that our ways of thinking are determined by our conceptual scheme. In the work of Thomas Kuhn (1970), the thinker most responsible for the idea that scientific thinking necessarily occurs within a conceptual scheme, it can be seen that epistemological relativism leads to ontological relativism.

Epistemological and ontological relativism taken together imply that the differences which separate those within different frameworks are so deep, that their experiences and beliefs would be fundamentally incommensurable (Fay, 1996). In this branch of thinking and research, to which the author of this thesis subscribes, claims that things are different from different points of view and the idea that different viewpoints are equally valid. Moreover, contrary viewpoints may well be equally valid across particular and peculiar societal settings. Fay (1996) furthermore argues that no common measure can serve as a bridge among different conceptual schemes. Those inside one conceptual scheme would be living in their own reality, one different from those living in other conceptual schemes: and the experiences of the respective members would be so different that no basis could exist on which to understand each other.

For the last 20 years the researcher has been constantly travelling between and within Europe and Latin America, more specifically, between the Netherlands and the Rio de la Plata (Uruguay and Argentina). A former colleague whilst travelling together for the first time suggested that; "one, who travels far, can tell great stories and yet those who travel further, should keep their stories for themselves". In later experiences this advice has helped a great deal: it is rather difficult and sometimes quite impossible for people from different realities to understand each other. This seems to be obvious always when we deal with great contrasts in our world (USA – Iraq, North –South, East - West, Rich – Poor, Catholic – Muslim).

3.2. Truth, knowledge and reality:

Fay (1996) in the chapter: "Can we understand each other objectively", explains that the central point in construing truth is the distinction between what is in our minds and what actually obtains outside of them. It is quite natural to think that in those cases, in which the content of our minds is at variance with external realities, these contents are false; and that when the content of our minds mirror what is outside of them these contents are true.

Some philosophers according to Fay (1998) have claimed that an objective conclusion is one which "warrants acceptance by all who seriously investigate". But this he argues is a mistake. Investigators can proceed with their analysis in an objective manner and yet they arrive at different conclusions, indeed they may never agree. Sayer (1992) says that objectivity in social science is a false, unattainable aim. He calls scientists "naive objectivists" if they advocate that objectivity is possible. The subject-object problem according to Smith (1998) focuses on the relationship between the researcher and the "things" he studied and highlights the way in which there are crucial differences between natural science and social science.

3.3. Situated knowledge:

“Science is nothing but trained and organized common sense” (T.H. Huxley)

According to Kuhn (1970), all social research is socially embedded and Smith (1998) acknowledges that research is socially positioned and that yet all researchers try to base their findings on evidence. In line with Kuhn's concept most - and also financial scientific knowledge - is both situated in the context of the historical and social practices which define (natural) science in a particular time and place. Consequently, the truth of a scientific statement is only relevant to those who share the belief system (value system) upon which such "truths" are based. Clearly finance theories are only relevant to those who share the belief system, which to some extent may be explained by the fact that it is a rather specialized matter, which rarely appeals to other fields of science. Academic finance continuously advocates a rather standard positivist account (Smith, 1998) which emphasises the importance of value freedom, hard facts and prediction as a basis for offering policy proposals for governments, businesses and other private institutions. Most practitioners and scholars in the field of finance – seem to adhere to a positivist approach, especially those representing the dominant paradigm i.e. IMF, World Bank, Central Banks, BIS and other regulating bodies and institutions.

Smith (1998) argues that positivist approach to the social sciences claim the label scientific, for he assumes that things can be studied as hard facts and the relationships between these facts established as scientific laws. For positivists, such laws have the status of truth and social objects can be studied in much the same way as natural objects. Often their research is quantitatively based.

The traditional view is that quantitative enquiry examines data which are numbers, while qualitative enquiry examines data which are narrative (Easterby-Smith *et al*, 1991). Inherent in this dichotomy is the view that quantitative enquiry generally adopts a deductive process, while qualitative enquiry generally adopts an inductive process. The traditional view is that quantitative researchers subscribe to a "positivist" paradigm of science, while qualitative researchers subscribe to a realist paradigm. Guba and Lincoln (1994) argue that the choice of research paradigm, rather than the choice of research method is the overriding concern.

Quantitative research designs are characterized by the assumption that human behaviour can be explained by what may be termed "social facts", which can be investigated by methodologies that utilize “the deductive logic of the natural sciences” (Homa, 1994, p. 121). Quantitative investigations look for “distinguishing characteristics, elemental properties and empirical boundaries” and tend to measure “how much”, or “how often” (Nau, 1995). A quantitative research design allows flexibility in the treatment of data, in terms of comparative analysis, statistical analysis, and repeatability of data collection in order to verify reliability. The weaknesses of such quantitative research designs lie mainly in their failure to ascertain deeper underlying meanings and explanations, even when significant, reliable and valid.

The classic qualitative study is one in which the findings are “grounded” in the data (Glaser and Strauss, 1967). A qualitative study seeks to identify underlying concepts and the relationship between them (Frankfort-Nachmias and Nachmias, 1996). The data for a qualitative study might include transcripts of in-depth interviews, observations or documents (Patton, 1991). Qualitative enquiry often takes the form of a case study. According to Yin (1994), case study is the preferred research approach when “how” or “why” questions are being posed – in other words, questions of process. Most researchers have been guided to believe that the role of qualitative enquiry is that of an advisable first step to be taken before the “real” enquiry – a quantitative enquiry – is undertaken. This view denigrates the role of qualitative enquiry.

Some social scientists would now subscribe to the view that qualitative and quantitative methodologies can both lead to valid research findings in and of their own right. According to Easterby-Smith *et al* (1991), there are many researchers who adopt a pragmatic view of deliberately combining quantitative and qualitative methods. It is not a matter of inflexibility adhering to one methodological approach simply because it is traditionally associated with a chosen paradigm of science. Qualitative methodologies are strong in those areas that have been identified as potential weaknesses within the quantitative approach, e.g. the use of interviews, observations, case studies to provide a deep, rather that broad set of knowledge about a particular phenomenon.

This depth allows the researcher to achieve “Verstehen”, or empathetic “understanding” (Smith 1999). The concept of Verstehen is the basis for a critique of quantitative research designs, and their empiricist emphasis. The argument used is that quantitative methods measure human behaviour “from outside”, without accessing the meanings that individuals give to their measurable behaviour.

Another criticism which may hold true for the particular field of finance is that – consistent with the positivist paradigm – or especially the functionalist approach – the field seems to run the risk of producing more and more facts confirming a status quo of the science and the belief systems. It seems to lead to the conviction that an even more refined technical approach to credit, to credit risk, to credit measurement, and to markets in general will lead to a more appropriate management and control of the same. Publications in recent years on credit defaults, instability of financial markets and participants, clear demonstrations of problems of asymmetry of information, including adverse selection and moral hazard, as well as agency costs, all seem to indicate the contrary.

There may be room for a more balanced approach to these issues, which then should include an analysis of the problems from different perspectives. Professor Francis (2001) suggested in his presentation; some issues in management research, that key issues in management require an understanding of underlying social and economic processes, including agency theory, transaction costs theory, institutional theory and evolutionary approaches to economics, sociology and psychology, which can all play their part in developing our understanding of this issues.

This point of view is also expressed by Stiglitz (2000) in his article; “the contributions of the economics of information to twentieth century economics”, where he outlines the following: “Some of the advances.... will entail an integration of economics with other social sciences- with psychology, on, for instance, how individuals process information, form expectations, and select among possible signals; and with sociology, on, for instance, the creation of social knowledge and signaling conventions”.

The mere fact that no references can be found on the relationship between (cross border) lending and culture, and the arguments previously stated on the dominant paradigm in finance, all seem to indicate that in this particular field the multi-disciplinary approach advocated above, has not yet started. Perhaps this thesis may be considered a small step towards this end.

3.4. Approach and methods:

This research has been guided by the belief that the role of this research is exploratory, a more qualitative enquiry and that of an advisable first step to be taken before a real enquiry – a quantitative enquiry – can be undertaken. The hypotheses formulated and the applied methodology, which will be explained further, both combined, intend to establish a reasonable and plausible argument whether practitioners share the view that cultural impacts influence the effectiveness of cross border lending and whether further credit rating (of hard factors), as a result of Basel II, will sufficiently, according to Grunert *et al* (2005); “alleviate asymmetric information problems between borrowers and lenders”.

3.5. Methods:

Given the rather intensive and exploratory character of this research, whereby the research questions focused on what and how the patterns work, the choice has been made to use to different methods, which were both felt adequate to achieve the objectives.

3.5.1. The questionnaire:

One of the main instruments used in this study has been the use of a questionnaire. Literature is rather inconsistent using both questionnaires as well as surveys. Hofstede (1994) for example refers to his research in “Culture Consequences” both to the Hermes questionnaire as well as the Hermes survey. Using surveys is one way of collecting data. Survey research involves the administration of questionnaires or interviews to relatively large groups of people (Singleton and Straits 1999). Survey research, while a relatively new field, has become one of the most popular methodologies, not just in sociology, but in other disciplines also. They are being used for measuring demographic characteristics, behaviour frequencies, personal beliefs and individual attitudes on issues and towards products. Usually their structure is rather rigid, as most researchers believe that objectivity and accuracy is best achieved by treating each and every respondent in the same fashion. It can furthermore be argued that whilst using closed questions, it allows getting information for many individuals with relative little effort and in a short time. Furthermore standard use of questionnaires allow for it to be anonymous, which can enhance the response rate.

In this research, however, it has been decided to invite participants to use their names for identification. Reasons being that during the conference the questionnaires were filled out in front of the research assistant, who assisted them going through the questionnaire. In this way it could be ensured which of the conference participants had participated, and which one not. In total 44 participants took part in this part of the research. Secondly, the development of an online identical survey instrument allowed for identifying who had participated, as the invitation to participate had been sent individually to members of a selected group of bankers and company executives. Another often sited weakness of survey instruments is the lack of interaction. In this research this has been improved by using the conference through which participants were exposed to refinement of concepts and subsequent questions. Also through the publication of the key findings of the conference, the conference papers and the abstracts, those participating in the on-line survey, were to some extent more adequately informed.

3.5.2. The conference:

Although the use of a single methodology has been advocated by a number of authors, many of the supporting arguments are decidedly pragmatic, such as time constraints, the need to limit the scope of a study, and the difficulty of publishing the findings (Creswell, 1994).

The crucial aspect in justifying a mixed methodology research design is that both single methodology approaches (qualitative only and quantitative only) have strengths and weaknesses. The combination of methodologies, or triangulation, on the other hand, can focus on their relevant strengths. The researcher should aim to achieve the situation where "blending qualitative and quantitative methods of research can produce a final product which can highlight the significant contributions of both" (Nau, 1995,), where "qualitative data can support and explain the meaning of quantitative research. As in all research, consideration must be given to construct validity, internal validity, external validity, and reliability (Yin, 1994)

Denzin (1984) identified four types of triangulation: Data source triangulation, when the researcher looks for the data to remain the same in different contexts; Investigator triangulation, when several investigators examine the same phenomenon; Theory triangulation, when investigators with different view points interpret the same results; and Methodological triangulation, when one approach is followed by another, to increase confidence in the interpretation. In this research methodological triangulation has been used in order to increase the confidence and reliability of the findings.

3.5.3. Limitations of the methods:

For the purpose if this exploratory research the use of the questionnaire, with its strengths and weaknesses as has been described before, was considered an adequate instrument for the exploratory objectives of this research. They are certainly limitations to both the sample as well as the sample size regarding the validity of the findings, the sample consisting of both bankers and senior company executives operating in cross border finance, but limited between a small part of Western Europe and an even smaller part of Latin America.

Especially the organization of a conference to test hypothesis brings with it several limitations, as just a few of the hypotheses can be discussed and or tested and several key concepts, even in a conference which lasted three days, could not be sufficiently explored. The conclusions, validity and reliability of findings in a conference setting are open for debate. These limitations are accepted for this particular research and the results the conference has been able to produce are considered to be of substantial qualitative value.

3.5.4. Validity and reliability:

Validity of the research instrument can be measured in different ways, one of which being the response rate to the invitations to participate in a survey. The following results for the on-line survey can be reported. Given that the mailing was sent those who participated previously in the seminar, and were asked to invite 5 to 10 immediate colleagues to participate in the on-line questionnaire, some assumptions have been made as to how response rate in this case could be calculated, Given that this indirect approach does not tell us how many effectively have been approached. The results can be illustrated below, whereby 4 different calculations were made, depending what is reasonable.

Table 5 Response rate on-line questionnaire

Resume of mailings questionnaire	factor 1	factor 2	factor 3	factor 4
Mailing sent to participant of the seminar	40	80	120	160
Mailing to members of DBA news	95	95	95	95
Total	135	175	215	255
Online respondents received	61	61	61	61
Response rate in percentage	45,19%	34,86%	28,37%	23,92%

The mailing with the invitation to participate in the on-line part of the survey was sent to two different subgroups;

(1) The participants of the conference, who were invited to ask 5 to 10 direct colleagues to participate in the survey. Different calculations have been made assuming which kind of factor would be considered as reasonable, given the fact that this type of indirect approach to invite for participation in a survey is considerably less effective than a direct approach.

(2) A direct and personal approach was made to members of the DBA News (weekly newsletter), which consisted of 95 individuals.

The result of these findings is, depending on the assumption of factors that the response rate can assumed to be between 24 and 45 %.

During the conference we were able to interview 45 senior executives who were eligible to participate in the survey. Assuming the total of all eligible participants, the response rate has been over 80%, which is great part was due to logistic and organizational difficulties (in finding the time and moment to take a conference participant apart).

3.5.5. Ethical implications of the research:

There are various ethical aspects concerned with any type of research, the disclosure of information, on data and findings and revealing sources. According to Fay (1996) objectivism objectivity consists of looking at the world from a god's-eye point of view in which all of the viewer's interest and pre-suppositions are eliminated and the world is seen directly as it is. Another way of expressing this according to Fay (1996), is that the objectivist ideal envisions the disappearance of the author who in effect becomes a recording device upon which reality is written. The problem with this picture is the epistemological incoherence. All inquiry according to Fay (1996) is inevitably perspectival and its results inherently partial and interested. All knowledge claims are necessarily embedded within a specific way of engaging the world. It follows that objectivity cannot be the elimination of all cognitive and moral pre-suppositions; far from opening the eyes of potential cognizers such an elimination would in fact render them blind, unable to see anything at all.

Conference quote, Mr. Nanno Kleiterp (page 130); *I think that, for me, it was a quite unique meeting because there are not many meetings where development bankers and clients come together. Normally what we see in meetings is that it's all bankers, or it's all soy crushers, etc.; all is organized by sector. And I think that the idea of Gert Jan to bring people together in this way made it a very special meeting. Of course, there was one motive behind, which I didn't see in writing anywhere, that was that he has to finish his thesis, isn't it?*

The above quote from Mr. Nanno Kleiterp at the end of the conference contained some critical elements which rather appropriately called for explanation and perhaps defence in this particular chapter. Without going into too much detail, the following observations should be made:

The prepositions, the presentations of previous findings from literature, the design and content of both the conference itself as well as the questionnaire are all a product of previous research findings. The researcher does not claim objectivity, as has been explained throughout this thesis, yet a critical approach (as some may have felt this to be) to banks, or to credit ratings agencies, or to supervisory institutions (BIS), have no bearing in any other interest than this particular piece of research. The particular questions for example, such as (1) Why Banks Exist and (2) Credit rating agencies, despite their long history and expertise do not really possess competencies, which may prevent default risk and (3) The role of credit rating agencies should be more critically assessed and their influence (oligopoly) in finance should be reduced; all these issues have been raised by many other scholars in various academic journals. The research questions have likewise also been critical towards companies, such as in (1) most companies tend to act opportunistically in their bank relations. The purpose of any inquiry is, furthermore, to seek variance and one of the ways to achieve this is by opting for a critical-realist approach.

Secondly, it is not correct that in the approach to the conference there has not been explicit mentioning and reference to the fact that the conference, both in its design as well as in its purpose, also served for the researcher to use the material for the finalisation of the DBA thesis, as can be seen in the following statement on the invitation; (quote; We also feel that it will be an appropriate opportunity for DEG and FMO, to present themselves as professional long-term financial partners to key companies in the region. We certainly anticipate content contribution from both DEG and FMO. If agreed we will leave the chair for the formal part to Mr. Mulder. He will also be using part of his doctorate findings and research to enhance content to the central theme (his thesis, banks, credit and culture – differences). Secondly, the invitation to participate in the questionnaire clearly refers to the purpose of the inquiry, as well as due explanation has been given throughout the conference.

The four-page invitation to speakers at the conference, not only raised 30 possible topics for speakers to choose from, but also structured the content of the program using and making reference (through hyperlinks) to the three management papers.

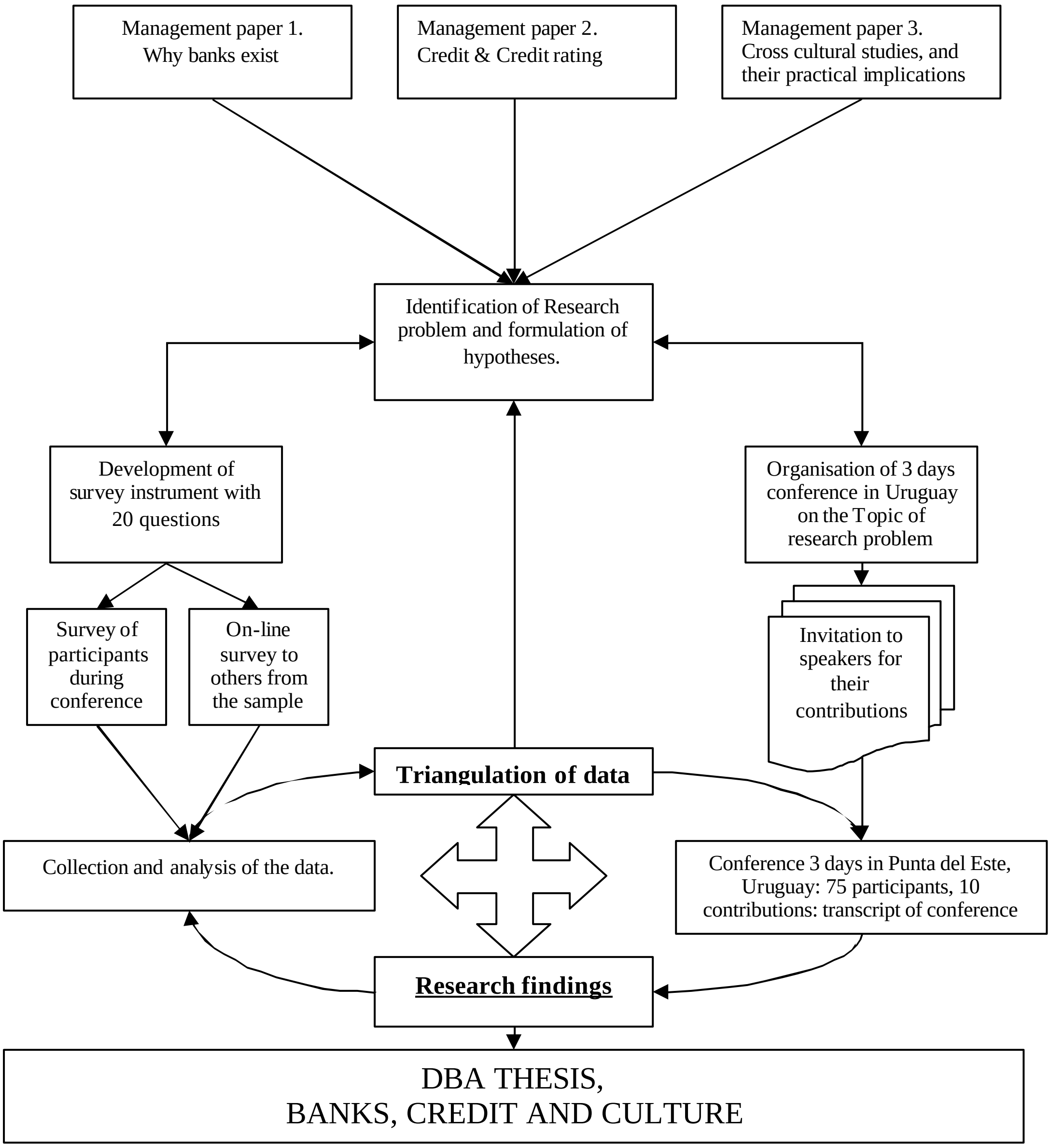
And yes, had the invitation to participate in the conference been extended, just because it served to finalize a doctorate thesis, then DEG, FMO and DBA would not have agreed to sponsor the event, and we would not have had a program with a content which was felt appropriate before, during and after the conference had taken place, by a large majority of the attendees.

Perhaps, on another note, it would be good to observe that in terms of ethics, one could be more careful with managing concepts which one has been studying at great detail and then to suppose that those concepts, even to some extent, are known and familiar to the particular audience, such as that present at the conference. One thing would be to present certain findings before a group of specialists on that particular subject, or to be dealing with those in front of a business setting. The preparation for the presentations of the research could have been improved upon, in order to make it somewhat more productive. The discussion on credit rating as well as culture issues have been evaluated positively, yet a subject as why banks exist, and explaining it by making reference to rather abstract terminologies such as agency theory, transactions cost theory and the like, was experienced as rather confrontational, being this obviously unintentional.

3.6. The research process:

Please find below a diagram on the research approach and process:

Figure 12 Research design



The research process and approach as outlined above can be furthermore explained and commented as follows:

Step 1:

Management papers were written on the different subjects, such in accordance with the requirements for the DBA program of the University of Bradford.

Step 2:

Identification of the research problem and formulation of hypotheses. All of the hypotheses were directly drawn from the findings in one of the management papers. Perhaps this process can be best illustrated by providing the following figure:

Figure 13 Generic research process

Models:	An overall framework for looking at reality
↓	
Concepts:	An idea deriving from a given model
↓	
Theory:	A set of concepts used to define and/or explain some phenomenon
↓	
Hypothesis:	A testable proposition
↓	
Methodology:	A general approach to studying research topics
↓	
Method:	A specific research technique
↓	

Findings:

(Figure adopted from Silverman, 2000)

Step 3:

Organization of a three-day conference in Punta del Este Uruguay, in order to gather bankers from Europe and their clients and prospects from the Mercosur countries (Uruguay, Brazil, Argentina). Co-sponsors of the conference were found and were addressed (FMO & DEG, both development banks from respectively the Netherlands and Germany). The company of which the author is a director was the third sponsor, each being responsible for 1/3 of the total costs. In the invitation to the co-sponsors the following paragraph was included:

“We also feel that it will be an appropriate opportunity for DEG and FMO, to present themselves as professional long-term financial partners to key companies in the region. We certainly anticipate content contribution from both DEG and FMO. If agreed we will leave the chair for the formal part to Mr. Mulder. He will also be using part of his doctoral findings and research to enhance content to the central theme (his thesis, banks, credit and culture – differences)”:

Step 4:

The objective of the conference was to provide a balanced mix of views from both the banking side as well as the corporate side on the various themes and issues. It was the intent to achieve also a rather balanced representation through different countries, both for the banks

(Germany, the Netherlands, Belgium, UK) as well as the companies (Brazil, Argentina and Uruguay).

The following persons and institutions were identified and approached as possible contributors to the conference:

Table 6 List of invited speakers

Banks	**Results:**
1. Hendrik Lühl DEG	Accepted
2. Karl Weinfurtner DEG	Accepted
3. Nanno Kleiterp FMO	Accepted
4. Paul van Heerde - ING	Accepted
5. Fred Arnold – KBC	Accepted
6. Hans Hanegraaf - Fortis	Accepted
7. Martin Schmitz - West LB	Not accepted
8. Rafael Bonasso - Rabobank – Argentina	Accepted
Companies	
1. Ricardo Zerbino – Fanapel – Uruguay	Accepted
2. Osvaldo Bertone – ACA - Argentina	Accepted
3. Bengt Hallqvist – Consultant (FMO) - Brazil	Accepted
4. Alejandro Benvenuto – Nidera – Argentina	Not accepted
5. Roberto Gazze – Vicentin - Argentina	Accepted
6. Tomas Hinrichsen, JJH - Argentina	Accepted (had to excuse later)
7. Horacio Aranguren, Molinos Rio de la Plata – Argentina	Not accepted/ only as member of panel
8. Juan Diego Ferrés – Granol Brazil	Accepted

The potential speakers were approached with a detailed outline of the proposed conference. Of the invitees of companies 6 out of 8 accepted the invitation (75%), whereas with regard to the banks 7 out of

8 accepted (87.5%). The proposal to speakers carried several objectives amongst which the most important were:

- To approach them with suggestions for themes and title of presentations, all of which were drawn from the literature and referred to in one of the management reports. The different contributors to the conference were given a choice of subjects to choose from.
- To make explicit the requirements for content of their presentation, as well other aspects related to time constraints.
- To inform about the background of the conference and the issues which were drawn from the existing literature in the different fields.

Structure of the conference:

The three days were divided into 5 different parts, most consisting of a block of roughly 4 hours. One of these blocks was to be reserved for leisure activities. Each block could have 4 to 5 presentations and each presentation to be limited to 20-25 minutes, preferably using only slides.

Block 1: General introduction, opening and welcome

Wednesday morning, arrival and “inscription” of the guests

11.00 Opening with the presence of special invitees, the Ambassadors of the Netherlands and Germany, followed by lunch.

Outline of the program for attendees, introduction of speakers, formulation of structure etceteras.

Block 2: Why do banks exist?

Introduction and presentation of the main findings of the management paper with the above title.

Presentations to be given by FMO and DEG, amongst others. Possible questions/issues:

- Why do (FMO/DEG) exist, origin – mission- strategy
- Major trends in the financial sector, consequences for banks, for clients, implications both in terms of opportunities as well as treats.
- What do banks expect from clients (corporate governance, moral hazards, adverse selection, the role of accountants)
- What may clients expect from (FMO/DEG) (commitment, added value, pricing conditions aligned to risks)
- Risk measurement, role of external credit rating
- Country risk – so what? Theory and practice.
- Banks – a necessary evil, or what?
- The future of the European banking system.
- The role of local banks (Brazil, Argentina, Uruguay) – asset or liability?

Note suggested speakers: DEG, FMO, ACA (Argentina), and Brazilian company, Rabobank/Vereins

Block 3: Credit and credit rating, consequences to banks and companies

Introduction and presentation of the main findings of the management paper with the above title.

- Basel II outline – consequences for credit markets
- Rating Agencies – asset or liability?
- Company experience with rating process: positive aspects, negative aspects
- Comparison professionalism and approach – housebank and rating agency
- Credit risk measurement: how does it work? Does it?
- Credit risk measurement, moral hazard and adverse selection, how to design and apply appropriate tools.
- Default probability: theory and practice.
- Basel II and internal rating systems – will it work and if so, how?
- Country rating and consequences for our company? Consequences to average cost of capital.
- BIS, Credit rating and us (non OECD countries)
- Tier one capital (Germany 6,8%, Average OECD 13,4 and what's next)

Note suggested speakers: AGD (Acevedo/Urquia), (Brazilian company), ING Bank, Dresdner/WestLB, FANAPEL (Zerbino)

Block 4: Relationship banking – cultural differences

Introduction and presentation of the main finding of the management paper with the above title.

- Relationship banking and good weather
- What may be expected from a relationship bank?
- Why do companies consider relationship with housebanks important?
- Does culture matter? Uncertainty avoidance, long and short term orientation.
- Being a banker and a friend: an impossible combination? (link to quote of Edward T. Hall)
- Relationship banking, how does it work for us? (case study)
- Long term investments in bank relations: will it pay?

Note suggested speakers: Vicentin (Roberto Gazze), Tomas Hinrichsen (Hinrichsen S.A., Karel Valken (Nidera), Fortis Bank, KBC.

Step 5:

Two months before the conference, a pre-advice was sent out to approximately 130 individuals, equally distributed between companies and financial institutions. Without exception they all qualified as practitioners in the field of cross border lending, either as borrower or as lender. It was made clear in the pre-advice that about 60-80 persons were expected to attend and that, furthermore, invitations would be sent on a personal basis. Although practically all addressees represented a company and/or financial institution with activities and presence in the region (Mercosur), it was not the idea to have invitations issued in any other way than on a personal basis, this to ensure a proper representation both in terms of level as well as focus. It was specially agreed that the aim was for quality of the people present in the conference and not the quantity. It was also deemed, in discussions with the co-sponsors, that a meeting of this kind could only produce good dialogue if and when the group would not be larger than 60-80 persons.

Step 6:

Development of the survey to be used during the conference, as well as thereafter for on-line. Testing the survey instrument, with fellow students and receiving input from supervisor.

Step 7:

Data collection, during the seminar with a personal approach. Each of the participants was requested to participate individually in the survey, whereby questions of the survey were put forward (by a trained psychologist). Following the conference, during which 45 respondents participated, it was decided to add an on-line survey to other members of the sample, this to increase the number of participants in the survey. The final number of participants thus obtained reached 106.

Step 8:

Data analysis, transcript and analysis of the entire conference, using triangulation.

Step 9:

Reporting of findings in a DBA thesis.

3.7. Sample:

The unit of analysis was defined for this research as being both bankers as well as their clients, each of whom is or has been actively involved in cross border lending. In the particular data set of this research, these involve, on one side, European bankers involved in lending to Mercosur clients, irrespective of whether they are physically based in Europe or in the region. The relevant aspect here is that the credit decision by the bank is being taken by credit committees based in Europe. On the client side these involve executives mainly from the financial area of the companies or at the level of the executive board, actively engaged in dealing with the European banks. On either sides the participants in the data set, involve executives being responsible for rather large sizes of credit (between US$ 5 – and US$ 50 million per credit facility). These individuals are the ones who on a regular basis are dealing directly, very often face-to-face, with the relationship and the credit facilities between them. Most have travelling experiences, i.e. the bankers know the clients in their own setting, and most clients regularly visit the banks in Europe. In this way it can be argued that both sides have been exposed to credit, credit rating and new BIS regulation, as well as experiencing different ways and forms of cultural differences. Defined in this way, this unit of analysis is believed to be representative for this piece of research. The argument that the sample demonstrates strong experiences (between 15 and 21 years) in their field is being shown in the following two tables, one distributed to region, and the second over banks, companies and others.

Table 7 (i) and (ii) Years of activity (regionally) and per sector

Report

years of activity in the sector (S1.6)

Europe (1), Latin	Mean	N	Std. Deviation
Europe	15,81	54	10,341
Latin America	21,40	48	14,640
Others	19,50	4	4,123
Total	18,48	106	12,569

Report

years of activity in the sector (S1.6)

bank (1), company (2)	Mean	N	Std. Deviation
bank	16,24	58	9,122
company	21,87	40	15,800
other	17,75	8	13,905
Total	18,48	106	12,569

Generalizability is a standard aim in quantitative research and is normally achieved by statistical sampling procedures. Such sampling has two functions: First, it allows the researcher to feel confident about the representativeness of the sample; “if the population characteristics are known, the degree of representativeness of a sample can be checked” (Arber, 1993). Second, such representativeness allows making broader inferences; “The purpose of sampling is usually to study a representative subsection of a precisely defined population in order to make inferences about the whole population” (Arber, 1993).

In stratified sampling, the population is divided into groups (strata) and a random sample is obtained from every stratum. In cluster sampling, the population is divided into groups called clusters, not all of the clusters are sampled. If a cluster is included in the sample, all of the cases in the cluster are included in the sample.

Stratified sampling works best if the strata are homogeneous so that relatively few points can represent each stratum well. Sampling error will arise primarily from variability within the strata.

Cluster sampling works best if the clusters are as heterogeneous as possible. Sampling error will occur because of variability between clusters. There should be no sampling error within the clusters if each member is included.

Normally, cluster sampling produces greater sampling error than random or stratified sampling. However, the loss of precision may be outweighed by the efficiency of data collection.

In this research stratified sampling or purposive sampling had been applied. Purposive sampling allows choosing cases because they illustrate some feature or process in which we are interested (Silverman, 2000). In this research, the requirements of the sample implied those who had experience in cross border lending, were experienced working with different cultures and those who were, to some extent, familiar with existing and forthcoming BIS regulation on banks. Companies who only work with local banks, as well as bankers who only work in local markets, did not qualify for this research.

The selection of the sample was drawn from a database of the sponsoring company (DBA corporate Finance), and are all those executives from both banks and companies who had been receiving the weekly DBA newsletter for several years already. The newsletter informs recipients on news and developments in Agribusiness, economics and finance as well as banking. It has a strong focus on Mercosur developments. The data base for the DBA news consists of 95 individuals, who all have been approached for the research.

Those invited to participate in the conference, however, were only those more senior executives from banks and companies who very actively and intensively work in cross border finance, mainly between Europe and Mercosur. As can be seen from the data, 4 respondents were classified as “other”, i.e. not European and not Latin American. These were identified to be 2 bankers from the USA and 2 bankers from Asia. Given the marginal effect on the outcome of the research it was decided to include them in the sample.

3.7.1. The practice of data collection:

The collection of the data can be divided into two steps: first, the collection of the questionnaires during the conferences, which given the setting of the conference and the level of the representatives (senior executives), was found to be more effective to perform with the help of a research assistant, who ensured that most participants were personally invited to participate in the research. They were also guided through the questionnaire.

Secondly, after the first set of questionnaires was gathered during the conference, it was decided to increase the number of participants from 44 during the conference, to include those who had not been participating in the conference, but who did match the requirements of the sample, i.e. other bankers and representatives from companies out of the DBA news data base. The following results can be reported, between online and survey, the latter meaning the ones collected during the conference.

Table 8 Distribution questionnaires

(1) online (2) survey

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	online	62	58,5	58,5	58,5
	survey	44	41,5	41,5	100,0
	Total	106	100,0	100,0	

In addition, participants of the conference were invited to approach direct colleagues in order for them to also participate in the research. In total the research produced 108 responses, out of which two had to be disregarded, because they were only partially completed. Out of the total of 106 valid respondents, only 2 returned the questionnaire not having disclosed their names. They are included though in the total of 106 respondents. As it can be seen in the table below, almost 80% of respondents have the level of account manager and above.

Table 9 Distribution of sample in position

President (1), MD/board (2), div head (3), account mger (4), staff (5), other (6) (s1.4)

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	President	11	10,4	10,4	10,4
	Managing director/ board	19	17,9	17,9	28,3
	Division or departm. head	32	30,2	30,2	58,5
	Accountmanager	22	20,8	20,8	79,2
	Staff	6	5,7	5,7	84,9
	Others	16	15,1	15,1	100,0
	Total	106	100,0	100,0	

We did not score particularly well in terms of representation between males and females as the following chart will show. This is however consistent with the dominant paradigm in international finance:

Table 10 Distribution of sample to sex

male (1) female (2) (S1.2)

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	male	104	98,1	98,1	98,1
	female	2	1,9	1,9	100,0
	Total	106	100,0	100,0	

On the distribution between respondents from bank, companies and other, it can also be said that a fairly representative distribution has been obtained, as can be seen in the following table:

Table 11 Distribution of sample per sector

bank (1), company (2) or others (3) (S1.5)

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	bank	58	54,7	54,7	54,7
	company	40	37,7	37,7	92,5
	other	8	7,5	7,5	100,0
	Total	106	100,0	100,0	

Furthermore, in terms of seniority of the respondents, it was found that more than 85% were of the age of 35 years or older at the time of participating in the research.

The survey also made a distinction in respondents in terms of origin, referred to as country/region of residence. The following distribution in terms of origin can be reported:

Table 12 Distribution of sample by region and sector

Europe (1), Latin Am (2), others (3) * bank (1), company (2) or others (3) (S1.5) Crosstabulation

			bank (1), company (2) or others (3) (S1.5)			
			bank	company	other	Total
Europe (1), Latin Am (2), others (3)	Europe	Count	39	10	5	54
		% within Europe (1), Latin Am (2), others (3)	72,2%	18,5%	9,3%	100,0%
		% within bank (1), company (2) or others (3) (S1.5)	67,2%	25,0%	62,5%	50,9%
		% of Total	36,8%	9,4%	4,7%	50,9%
	Latin America	Count	16	29	3	48
		% within Europe (1), Latin Am (2), others (3)	33,3%	60,4%	6,3%	100,0%
		% within bank (1), company (2) or others (3) (S1.5)	27,6%	72,5%	37,5%	45,3%
		% of Total	15,1%	27,4%	2,8%	45,3%
	Others	Count	3	1		4
		% within Europe (1), Latin Am (2), others (3)	75,0%	25,0%		100,0%
		% within bank (1), company (2) or others (3) (S1.5)	5,2%	2,5%		3,8%
		% of Total	2,8%	,9%		3,8%
Total		Count	58	40	8	106
		% within Europe (1), Latin Am (2), others (3)	54,7%	37,7%	7,5%	100,0%
		% within bank (1), company (2) or others (3) (S1.5)	100,0%	100,0%	100,0%	100,0%
		% of Total	54,7%	37,7%	7,5%	100,0%

It can therefore be explained that of the total number of respondents, there have been 4 reported as “others” i.e. not being from neither Europe nor Latin American. These 4 were a mix from both Asia and the USA.

3.7.2. The development of the questionnaire:

A questionnaire is a document for generating primary data by means of answers given by a respondent to a series of prepared questions (Butler, 2001). Whilst designing a questionnaire it is essential to have clarity about the research objectives, the unit of analysis, and variables. According to Butler (2001), good questions are:

- Clear and unambiguous and short
- Discriminate between respondents (because of variance)
- Can be answered quickly (hence forth it was decided to using closed end questions, with ordinal variables on a Likert scale from 1 to 5
- Is in harmony with the respondents way of thinking and interest (affirmative in respect of interest, perhaps not so much in the way of thinking, as variance is what we seek and therefore some questions may be challenging and or provocative)
- Questions are short, to the point and in simple language.
- Avoids a double negative.

3.7.3. Questionnaire design:

The questionnaire was divided into 4 different sections: (1) general data, (2) bank-client relationship, (3) bank credit and credit rating and (4) relationship banking – cultural differences. It was supposed that section titles could help establish context, and that related questions would help the respondent think efficiently. It was understood that presentation of questions with straightforward answers first could help to warm up the respondent for harder questions.

Regarding the layout, the consistency was considered elementary and use of the same format for the same type of questions was applied. There was enough space for circling numbers as well as enough space between questions in order to avoid confusion. The questions were numbered in a sequence as such would be easier to follow. The total number of questions was limited to 20, similar to the number of the value survey model used by Hofstede (1980).

Before the questionnaire was used, a pilot was launched amongst five fellow students and the supervisor in order to check the questionnaire, using a checklist drawn from Janes (1999), including the works of Babbie (1990) and intended to test the practicability, transparency, clearness, usage, and logic of the questionnaire, and especially to test whether the questions were considered to be:

- Related to the problem at hand.
- The correct type to get the best information.
- Clear, unambiguous, precise. Giving definitions where appropriate; avoiding jargon or slang unless needed or appropriate.

- Not leading.
- Able to be answered by the subjects.
- Not double-barreled.
- Short.
- Not negative.
- Unbiased.

All 6 invitees (5 fellow students and the supervisor) responded to the invitation to report back and subsequent modifications were made. Furthermore the questionnaire was translated into Spanish by a qualified translator and subsequently the Spanish version was translated by a second certified translator back into English, to be compared for any mistakes and confusions (University handout Butler, 2001).

3.7.4. Practical issues of gaining access:

Access to data is considered to be one of the main obstacles for research. A DBA can provide an empirical setting allowing for easier assess to opinion leader and data. This has been the case in this particular research where, thanks to co-sponsors and the host company, a 3-day conference could be organized bringing together 80 senior executives and have most of them participating in the survey. Publicity and permanent marketing of the event, the company and the issues have helped to pave the way for others to participate in the online survey. Whereas in terms of quantity of data generated for this research hopes could always be higher, it is the quality of the data, which allows for this research to be highly representative.

3.7.5. Problems experiences during data collection:

During the conference we were able to produce “only” 44 questionnaires. Obviously during such a setting it was found problematic to be separating the participant in order to have them participate in the survey. As these were done with the help and by invitation from the research assistant, the time necessary to complete the survey was on average 20 minutes. During the 3 days – and the time available during the official part of the conference - this meant 44 x 20 minutes, i.e. almost 15 hours.

The conference counted with simultaneous translation and the entire conference could subsequently be audio taped and transcribed not only for the benefit of this research, but likewise for the benefit of all of those who participated.

The on-line survey which was performed shortly after the conference took place caused the usual amount of effort and reminders to have invitees respond to the invitation. Following a personalized invitation, two reminders were sent in some cases, asking people to participate. Thanks to a personalized approach and identification and registration of the names of participants, a response rate between 25% and 45% could be obtained[7].

[7] See analysis on chapter 3.5.4.

CHAPTER 4 - RESEARCH FINDINGS

4.1. Introduction:

The approach taken in this chapter is to report on the findings of both the questionnaire and the conference findings at the same time, using mainly descriptive statistics, and for each hypothesis, conference quotes have been used for illustration, mostly in support of the context of the hypothesis, or as the case may be, for the hypothesis itself. The quotes are provided in italic, in order to avoid confusion. The whole transcript of the conference is provided in the Annex 1. At the end of this chapter a summary of hypotheses and conclusions will be given, in order to be able to see in a bird's eye view what have been the results of this study. Several key concepts, hypothesis and sub- hypothesis could be confirmed.

Hofstede suggested (1980) six areas for continued research, one of them he considered most important and was about the consequences for organizations. Hofstede counted on the critical support of enlightened and creative practitioners to, for example, learn about how the new insights of his study could contribute to turning cultural conflict in multicultural organizations into cultural synergy. Now, 25 years have passed by and although Hofstede is one the most referenced social scientist of the last decades, his ambition – unfortunately – seems to have been a bit too high.

This research in the area of banks, credit and culture started off in a more ambitious form 4 years ago. Then, Hofstede's type of research was not found in the area of finance and the specific relationship between credit (risks) and culture (differences) had not been studied thus far. The focus of the study needed to be gradually amended into an exploratory research in order to be able to answer the key hypothesis of this study: whether culture should be a concept to be taken into consideration, according to practitioners in the field of cross border finance.

The findings of the questionnaire clearly confirm this hypothesis, whereby 90.6% agreeing and strongly agreeing and the remaining 10 (9.4%) to be undecided. No disagreements were registered, as it is illustrated in the following frequency distribution:

Table 13 Frequency distribution Key hypothesis

if the bank does not understand the cultural context of a particular country or region, it becomes highly doubtful it will understand the risks

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	strongly agree	52	49,1	49,1	49,1
	agree	44	41,5	41,5	90,6
	undecided	10	9,4	9,4	100,0
	Total	106	100,0	100,0	

4.2. Review of the hypotheses and their results:

The first information obtained from the questionnaire consists typically of frequency distributions for the different answer categories of one question. All twenty questions of the questionnaire consistently used the same five points Likert answer scales, from strongly agree – agree – undecided - disagree - to strongly disagree. All the questions used therefore are a so-called ordinal scale, which means that the answer categories show a natural and unambiguous rank order. Most of the frequencies distributions are skewed.

For further processing of the information contained in the frequency distributions, it is often necessary to reduce the information to a single number per frequency distribution. This can be done by using a measure of central tendency. As measures of central tendency, the mean and the median are available. The mean loses the least information, is easier to compute, and plays a role in all parametric statistical calculations. However, it formally presupposes interval scales which we do not have. The median is the theoretically more correct measure, but for short scales with many cases per answer category it approaches the mean closely. In the analysis of these data, the choice has been to consider the scales as quasi-interval scales and to use the mean as a measure of central tendency for such scales. SPSS calculations of the means and standard deviations have been made, the latter which however are rarely used for the interpretation and analysis; large standard deviations can be a warning that we are dealing with heterogeneous groups of respondents and that we should look for criteria to further break down our groups. The data have been analyzed between groups, “groups” being any sets of respondents that were assumed to be homogeneous as to certain external criteria (such as bank/companies and Latin American/ European). The major analysis tool has been cross tabulations, as these provided the most insight.

In using the calculation of the mean, the standard deviation, and the cross-tabulations, a fairly close approximation of the results of the questionnaire can be demonstrated. It can furthermore be argued that given the ordinal scale and corresponding values being used, a hypotheses may be considered accepted if and when the value scores;

$\mu = 2.5$ and

In-conclusive if and when a value scores;

$2.5 < \mu < 3.5$

Rejected if and when a value scores;

$\mu = 3.5$

and assuming a calculated standard deviation not exceeding 1. given that large standard deviations can be a warning that we are dealing with heterogeneous groups of respondents and that we should look for criteria to further break down our groups.

4.3. Findings of hypothesis H1: Why banks exist

Please find below a summary of all of the key hypotheses and sub-hypotheses which were dealt with in the questionnaire;

H.1.1. In general banks seem to be very competent with regard to understanding risks. (Mean 3.00 standard deviation of 1.124 - undecided).

Table 14 Cross tabulation hypothesis H.1.1.

ank (1), company (2) or others (3) (S1.5) * in general banks seem to be competent with regards to understanding risks Crosstabulation

			in general banks seem to be competent with regards to understanding risks					
			strongly agree	agree	undecided	disagree	strongly disagree	Total
bank (1), company (2) or others (3) (S1.5)	bank	Count	2	27	10	19		58
		% within bank (1), company (2) or others (3) (S1.5)	3,4%	46,6%	17,2%	32,8%		100,0%
	company	Count	2	9	7	20	2	40
		% within bank (1), company (2) or others (3) (S1.5)	5,0%	22,5%	17,5%	50,0%	5,0%	100,0%
	other	Count		2	3	3		8
		% within bank (1), company (2) or others (3) (S1.5)		25,0%	37,5%	37,5%		100,0%
Total		Count	4	38	20	42	2	106
		% within bank (1), company (2) or others (3) (S1.5)	3,8%	35,8%	18,9%	39,6%	1,9%	100,0%

Whereas total frequency distribution as shown above, only provides a mixed response with nearly 40% agreeing, 20% undecided and 40% disagreeing, using cross tabs in SPSS, discriminating the respondents in their respective categories of banks, companies and others, reveal a more interesting finding which is that 50% of the banks believe that banks are competent, whereas 55% of the respondents from companies believe that bank do not possess the competencies to understand risks. In addition the 32.8% (and 17.2% undecided) of the banks disagreeing to the statement, indicates that even within banks a majority seems to be in doubt whether banks do well in this crucial aspect of their business. These arguments are supported by the following calculations:

Table 15 Mean, Frequency distribution per sector and Std. Deviation H.1.1.

in general banks seem to be competent with regards to understanding risks * bank (1), company (2) or others (3) (S1.5)

in general banks seem to be competent with regards to understanding risks

bank (1), company (2)	Mean	N	Std. Deviation
bank	2,79	58	,951
company	3,28	40	1,037
other	3,13	8	,835
Total	3,00	106	,995

Conference quote Mr Rafael Bonasso (page 37); *I think it is key what we need to focus on as banks is who do you want to do business with. As long as profitability is the name of the game I believe that banks are going to be losers in the future. If we are able to select the right companies that we believe are going to be the survivors, no matter what happens in the long-term, if time is what they need, time is what they are going to get* ;

and (2) Karl Weinfurther (page 39*);* *….I think this is a difference with commercial banks. In addition to investing in projects which are profitable we also want to contribute to sustainable development, and we look very much at both environmental and social aspects of our financing.*

And (3) Roberto Gazze (page 49) *However, it is necessary for banks to have a clear policy. It is the only way for results to be observed, and certain banks have been able to handle this. They have been cautious, and they have stood beside the companies. It is not pleasant to feel unprotected.*

Reports by Caprio and Klingebiel (1996, 2003) indicate that most episodes of (bank) insolvency are caused by a mixture of bad luck, bad policies – both microeconomic (regulatory) and macroeconomic – and bad banking. The latter in part for when a banking system grows rapidly (Caprio and Klingebiel 1996) it is difficult for supervisors (or even bankers) to keep abreast of loan quality, since their information usually arrives late. The question here may be raised; what is bad banking?

The fact that preventing default risk is a very complex area was somehow illustrated by Mr. Paul van Heerde (commodity banker), (conference paper page 106); *Now, if I look at what ING has lost over the past 20 years, it was always (because of) fraud. It was not so much in terms of clients being very speculative, clients doing funny things that they are not telling you about, other than simply doing something with the books. Sometimes, fraud driven by those sort of things, by speculation or by other actions that the client could not cope with and didn't want to go to the bank at an early stage and rather let it go – I think in Dutch you call that "quit or double"– to try to improve his position.*

H.1.2. Clients of banks would be benefited if banks were rated in terms of client's satisfaction (mean of 2.19 SD .995 - accepted).

Table 16 Cross tabulation H.1.2.

: (1), company (2) or others (3) (S1.5) * bank clients would be benefited if banks were rated in terms of clients satisfac
Crosstabulation

			bank clients would be benefited if banks were rated in terms of clients satisfaction					
			strongly agree	agree	undecided	disagree	strongly disagree	Total
bank (1), company (2) or others (3) (S1.5)	bank	Count	10	33	3	10	2	58
		% within bank (1), company (2) or others (3) (S1.5)	17,2%	56,9%	5,2%	17,2%	3,4%	100,0%
	company	Count	9	24	4	1	2	40
		% within bank (1), company (2) or others (3) (S1.5)	22,5%	60,0%	10,0%	2,5%	5,0%	100,0%
	other	Count	3	4	1			8
		% within bank (1), company (2) or others (3) (S1.5)	37,5%	50,0%	12,5%			100,0%
Total		Count	22	61	8	11	4	106
		% within bank (1), company (2) or others (3) (S1.5)	20,8%	57,5%	7,5%	10,4%	3,8%	100,0%

In line with the findings under hypothesis H.3.3.1 (Clients of banks would be benefited if banks were rated in terms of clients satisfaction), this finding is confirming the hypothesis with nearly 80% of the total being in agreement. No notable differences can be observed on the other frequencies reported. Neither such relation, nor suggestion has been found in previous research. The finding is perhaps something to be taken into consideration for banks, preparing their marketing and for discussions between banks and their ratings agencies. Please find below the table with the calculations of the means and standard deviation. It confirms that with a SD of 1.066 the bank respondents are somewhat heterogeneous.

Table 17 Mean, frequency distribution per sector and Std. Deviation H.1.2.

Report

bank clients would be benefited if banks were rated in terms of clients satisfaction

bank (1), company (2)	Mean	N	Std. Deviation
bank	2,33	58	1,066
company	2,08	40	,944
other	1,75	8	,707
Total	2,19	106	1,006

Conference quote Mr. Roberto Gazze (page 47); *We also had to go through a process by which the banks, at least many of them, had to redefine their strategies. We felt that they did not have a clear picture of where they were going, whether they were commercial banks or investment banks, a series of issues that were not clear when we talked to them. Of course all this affected the relationship with our banks, and fortunately a few of them (less than five) have maintained a consistency, a commitment that is very strong, and which strengthened the relationship, if anything, during these periods of crisis. We all know that in a friendly relationship the other party does not expect to be thanked, but they know very well that we are deeply grateful and it is something that we wish to continue through time.*

H.1.3. The long history in banking and the lack of alternatives means that banks will continue to exist for many more years (mean of 2.10 SD of 1.006 accepted).

Table 18 Cross tabulation H.1.3.

(1), company (2) or others (3) (S1.5) * the long history in banking and the lack of alternatives means that banks will contin exist Crosstabulation

			he long history in banking and the lack of alternatives means that banks will continue to exist					
			strongly agree	agree	undecided	disagree	strongly disagree	Total
bank (1), company (2) or others (3) (S1.5)	bank	Count	14	31	7	5	1	58
		% within bank (1), company (2) or others (3) (S1.5)	24,1%	53,4%	12,1%	8,6%	1,7%	100,0%
	company	Count	8	20	10	1	1	40
		% within bank (1), company (2) or others (3) (S1.5)	20,0%	50,0%	25,0%	2,5%	2,5%	100,0%
	other	Count	2	6				8
		% within bank (1), company (2) or others (3) (S1.5)	25,0%	75,0%				100,0%
Total		Count	24	57	17	6	2	106
		% within bank (1), company (2) or others (3) (S1.5)	22,6%	53,8%	16,0%	5,7%	1,9%	100,0%

The findings reported above seem to confirm the findings of existing literature as described in Chapter 2 section 2.1. in that answering the question why banks exist, a rather complex combination of existing economic theories, the lack of alternatives and the fact that banks exist for over 5.000 years seem to provide convincing evidence of the finding with 75% of respondents agreeing to the hypothesis.

H.1.4. With current supervision and regulation on banks one can be confident about low systemic risks (mean of 3.42 SD .994 - undecided)

Table 19 Cross tabulation H.1.4.

k (1), company (2) or others (3) (S1.5) * with current supervision and regulation on banks...confident of low systemic ri Crosstabulation

			/ith current supervision and regulation on banks...confident of low systemic risks					
			strongly agree	agree	undecided	disagree	strongly disagree	Total
bank (1), company (2) or others (3) (S1.5)	bank	Count	2	15	13	21	7	58
		% within bank (1), company (2) or others (3) (S1.5)	3,4%	25,9%	22,4%	36,2%	12,1%	100,0%
	company	Count		3	13	19	5	40
		% within bank (1), company (2) or others (3) (S1.5)		7,5%	32,5%	47,5%	12,5%	100,0%
	other	Count		2	3	2	1	8
		% within bank (1), company (2) or others (3) (S1.5)		25,0%	37,5%	25,0%	12,5%	100,0%
Total		Count	2	20	29	42	13	106
		% within bank (1), company (2) or others (3) (S1.5)	1,9%	18,9%	27,4%	39,6%	12,3%	100,0%

The above cross-tab calculation provides rather inconclusive results, other than that 60% of the companies seem to disagree that with current supervision and regulation one can be confident about low systemic risks. In the recalculation of mean by comparing between groups, one learns, however that the hypothesis gets rejected by both companies with a mean of 3.65 and standard deviation of .802, as well as by the respondents from Latin America with 3.63 and a standard deviation of .866. These findings then seem to confirm the view that these segments of the market are not of the opinion that there are low systemic risks, with current supervisions and regulation on banks. Again, with several Latin American countries recently suffering banking crises, these can hardly be called surprising.

Table 20 (i) and (ii) Mean, frequency distribution per region (i) sectors (ii), and Std. deviation H.1.4.

with current supervision and regulation on banks...confident of low systemic risks * bank (1), company (2) or others (3) (S1.5)

with current supervision and regulation on banks...confident of low systemic risks

bank (1), company (2)	Mean	N	Std. Deviation
bank	3,28	58	1,089
company	3,65	40	,802
other	3,25	8	1,035
Total	3,42	106	,994

with current supervision and regulation on banks...confident of low systemic risks * Europe (1), Latin Am (2), others (3)

with current supervision and regulation on banks...confident of low systemic risks

Europe (1), Latin	Mean	N	Std. Deviation
Europe	3,22	54	1,058
Latin America	3,63	48	,866
Others	3,50	4	1,291
Total	3,42	106	,994

These conclusions are furthermore rather consistent with the findings of Caprio and Klingebiel (2003), which report on systemic banking crises in several high income OECD countries including Japan (1991 – present), Finland (1991-1994), Norway (1987-1993), Spain (1977-1985), Sweden (1991), and for example on border-line non-systemic banking crises with the savings and loan institution, for example, The United States (1984-1991), where 1,300 banks failed (costs US$ 180 billion or 3% of GDP). Subsequently it seems not to dependant on country and/or region, but can affect any country.

H.1.5. Banks play a crucial, mostly constructive role within the world economy (Mean of 2.22 and SD .828 accepted).

Table 21 Cross tabulation H.1.5.

), company (2) or others (3) (S1.5) * banks play a crucial, mostly constructive role within the world economy Crosstab

			banks play a crucial, mostly constructive role within the world economy					
			strongly agree	agree	undecided	disagree	strongly disagree	Total
bank (1), company (2) or others (3) (S1.5)	bank	Count	12	36	7	3		58
		% within bank (1), company (2) or others (3) (S1.5)	20,7%	62,1%	12,1%	5,2%		100,0%
	company	Count	1	27	5	6	1	40
		% within bank (1), company (2) or others (3) (S1.5)	2,5%	67,5%	12,5%	15,0%	2,5%	100,0%
	other	Count	1	4	2	1		8
		% within bank (1), company (2) or others (3) (S1.5)	12,5%	50,0%	25,0%	12,5%		100,0%
Total		Count	14	67	14	10	1	106
		% within bank (1), company (2) or others (3) (S1.5)	13,2%	63,2%	13,2%	9,4%	,9%	100,0%

This finding with more than 75% agreeing and strongly agreeing clearly suggests that respondents agree with the hypothesis that banks play a crucial and mostly constructive role within the world economy, this being in line with current economic theories. An interesting difference, although, can be observed between banks and companies, where banks seem to be rather more convinced about their positive and constructive role in the world economy (and companies tending to remain undecided) as shown in the following table:

Table 22 Mean, frequency distribution per sector and Std. Deviation H.1.5.

banks play a crucial, mostly constructive role within the world economy * bank (1), company (2) or others (3) (S1.5)

banks play a crucial, mostly constructive role within the world economy

bank (1), company (2)	Mean	N	Std. Deviation
bank	2,02	58	,737
company	2,48	40	,877
other	2,38	8	,916
Total	2,22	106	,828

H.1.6. With increased knowledge and modern techniques in finance, the role of relationship in bank -client relations will diminish (Mean of 3.38 SD 1.125 undecided).

Table 23 Cross tabulation H 1.6.

l), company (2) or others (3) (S1.5) * with increased knowledge and modern techniques in finance... role of relationsh diminish Crosstabulation

			ith increased knowledge and modern techniques in finance... role of relationship will diminish					
			strongly agree	agree	undecided	disagree	strongly disagree	Total
bank (1), company (2) or others (3) (S1.5)	bank	Count	2	12	6	32	6	58
		% within bank (1), company (2) or others (3) (S1.5)	3,4%	20,7%	10,3%	55,2%	10,3%	100,0%
	company	Count	5	7	5	20	3	40
		% within bank (1), company (2) or others (3) (S1.5)	12,5%	17,5%	12,5%	50,0%	7,5%	100,0%
	other	Count	1	1	1	4	1	8
		% within bank (1), company (2) or others (3) (S1.5)	12,5%	12,5%	12,5%	50,0%	12,5%	100,0%
Total		Count	8	20	12	56	10	106
		% within bank (1), company (2) or others (3) (S1.5)	7,5%	18,9%	11,3%	52,8%	9,4%	100,0%

62% of the respondents disagreeing with the question posed to them, seems to imply that a majority is still of the opinion that the concept of relationship banking is here to stay for a while. No improvement in the findings could be obtained between groups comparison, and also at these levels, standard deviations remain too high for any reasonable observation. It is here where the sub-hypotheses provide further insight and clarification.

H.1.6.1. Most companies tend to act opportunistically in their bank relations (Mean of 2.77 and SD 1.107 undecided).

Table 24 Cross tabulation H.1.6.1.

(1), company (2) or others (3) (S1.5) * most companies tend to act opportunistically in their bank relations Crosstabul

			ost companies tend to act opportunistically in their bank relation					
			strongly agree	agree	undecided	disagree	strongly disagree	Total
bank (1), company (2) or others (3) (S1.5)	bank	Count	5	24	9	18	2	58
		% within bank (1), company (2) or others (3) (S1.5)	8,6%	41,4%	15,5%	31,0%	3,4%	100,0%
	company	Count	4	14	7	13	2	40
		% within bank (1), company (2) or others (3) (S1.5)	10,0%	35,0%	17,5%	32,5%	5,0%	100,0%
	other	Count	2	4	1	1		8
		% within bank (1), company (2) or others (3) (S1.5)	25,0%	50,0%	12,5%	12,5%		100,0%
Total		Count	11	42	17	32	4	106
		% within bank (1), company (2) or others (3) (S1.5)	10,4%	39,6%	16,0%	30,2%	3,8%	100,0%

Calculation between different groups did not reveal any additional findings. With 50% of respondents acknowledging that most companies tend to act opportunistically in their bank relations, it is indicated that the concept of relationship banking is not that strong, at least within this specific sample. Calculation on different groups did not reveal any additional findings.

Conference quote Mr. Roberto Gazze (page 47); *What Vicentin seeks in relationships with banks:*

- *Continuity*
- *Consistency*
- *Commitment (especially personal)*
- *Professionalism*
- *Competitiveness in costs and service*
- *Chemistry and frequent contact*

All these points are in theory what one has to try to achieve with friendly banks. These are concepts that one tries to achieve in relationships with banks. But if you look carefully, these concepts should be applied not only to relationships with banks but with friends, wives, girlfriends, partners, with people from the football team... That these items converge at the same time is quite difficult in a normal relationship, and even more so in relationships with banks. Many times these concepts are affected by matters completely beyond the relationship itself. We Argentines – well, I believe that people from the whole region can relate to this –have not only suffered but even caused some crises ourselves.

H.1.6.2. Banks are considered by most clients as a necessary evil (Mean of 2.95 SD 1.124 undecided)

Table 25 Cross tabulation H.1.6.2.

bank (1), company (2) or others (3) (S1.5) * banks are considered by most clients as a necessary evil Crosstabulation

			banks are considered by most clients as a necessary evil					
			strongly agree	agree	undecided	disagree	strongly disagree	Total
bank (1), company (2) or others (3) (S1.5)	bank	Count	1	23	4	25	5	58
		% within bank (1), company (2) or others (3) (S1.5)	1,7%	39,7%	6,9%	43,1%	8,6%	100,0%
	company	Count	3	20	3	12	2	40
		% within bank (1), company (2) or others (3) (S1.5)	7,5%	50,0%	7,5%	30,0%	5,0%	100,0%
	other	Count	1	4	2	1		8
		% within bank (1), company (2) or others (3) (S1.5)	12,5%	50,0%	25,0%	12,5%		100,0%
Total		Count	5	47	9	38	7	106
		% within bank (1), company (2) or others (3) (S1.5)	4,7%	44,3%	8,5%	35,8%	6,6%	100,0%

Conference quote Mr. Osvaldo Bertone (page 52); *My challenge, facing an audience like this one, is not an easy one. I was told that I had to discuss the issue of whether banks are a necessary evil or what. I* *think that this title is a little bit aggressive. In ACA we carried out a few studies, not for this seminar but because we wanted to know how to deal with or position ourselves in our relationships with banks. We have always thought that a bank is a partner, not a partner in the sense of owning shares, and more so in our case, as in a cooperative it is impossible for a bank to be a partner, as Karl was saying earlier; but rather a partner in the sense of being a participant in our business, a helper in our business, someone who knows it well.*

With a 57.5% of companies to confirm the hypothesis, and over 40% of the banks sharing this feeling, produces a result which can be supporting different claims and points towards the finding of the confidential internal survey[8] of a major bank, where 2000 corporate clients reported to prefer to work without a bank (if they only could) which can be illustrated looking at the substantial difference in the mean between groups;

Table 26 Mean, frequency distribution per sector and Std. Deviation H.1.6.2.

banks are considered by most clients as a necessary evil * bank (1), company (2) or others (3) (S1.5)

banks are considered by most clients as a necessary evil

bank (1), company (2)	Mean	N	Std. Deviation
bank	3,17	58	1,110
company	2,75	40	1,127
other	2,38	8	,916
Total	2,95	106	1,124

The finding reported above can support two different claims: (1) That the concept of “relationship” in banking is rather different from what is often interpreted as a relationship. There may be some

[8] The author has been involved in a major survey amongst client in a large international bank, details of which are not available

confusion on the questions as to what a relationship bank or housebank actually represents, or as Mr. Paul van Heerde commented (conference paper page 105); *what they consider to be a relationship bank, and what we consider to be a relationship bank. That difference is not entirely clear to me, maybe that's something worth a discussion later on.*

(2) That the appreciation of banks perhaps is rather different depending from which perspective a question is asked, as can be seen in the following calculation, where the difference between Latin America and Europe is notable, despite the rather large standard deviations;

Table 27 Mean, frequency distribution per region and Std, deviation H.1.6.2.

banks are considered by most clients as a necessary evil * Europe (1), Latin Am (2), others (3)

banks are considered by most clients as a necessary evil

Europe (1), Latin	Mean	N	Std. Deviation
Europe	3,15	54	1,106
Latin America	2,69	48	1,114
Others	3,50	4	1,000
Total	2,95	106	1,124

Conference quote Mr. Karl Weinfurtner (page 41); *We consider regional know-how is very important, but at the same time sectorial know-how is regarded as a key issue. We would like that our project managers when they come to you are able to understand your business, that they can do a smooth risk-oriented appraisal of the project so they should not come to you and stay in agricultural terms and tell you "Oh, what a wonderful cow", and you have to tell them that it is a bull.*

H.1.6.3. Housebanks play an important and largely positive role in the process of corporate control; and borrowers with a strong bank–

borrower relationship receive more competitive credit on average. (Mean of 2.29 and SD .850 - accepted)

.....and this is really relationship banking, that you are so involved with this that you feel it, you can smell it (Bengt Hallqvist, conference quote page 74).

Table 28 Cross tabulation H.1.6.3.

bank (1), company (2) or others (3) (S1.5) * housebanks play important and positive role in the process of corporate control; and borrowers with strong bank-borrower relationship receive more competitive credit on average Crosstabulation

			housebanks play important and positive role in the process of corporate control; and borrowers with strong bank-borrower relationship receive more competitive credit on average				
			strongly agree	agree	undecided	disagree	Total
bank (1), company (2) or others (3) (S1.5)	bank	Count	9	35	8	6	58
		% within bank (1), company (2) or others (3) (S1.5)	15,5%	60,3%	13,8%	10,3%	100,0%
	company	Count	4	23	7	6	40
		% within bank (1), company (2) or others (3) (S1.5)	10,0%	57,5%	17,5%	15,0%	100,0%
	other	Count		5	1	2	8
		% within bank (1), company (2) or others (3) (S1.5)		62,5%	12,5%	25,0%	100,0%
Total		Count	13	63	16	14	106
		% within bank (1), company (2) or others (3) (S1.5)	12,3%	59,4%	15,1%	13,2%	100,0%

Conference quote Mr. Rafael Bonasso (pag 35); *So in a few words, what I believe the new model is, a model that we believe is always in place, not only in the good times but also in bad times. It is a real partnership between banks and corporates, where we all share the risks and rewards.*

Although the concept of housebanks may not be universally known (special reference to findings in North Western European countries) the confirmation of the hypothesis, with nearly 72%, confirms that a housebank (strong relationship bank), is expected to produce positive results and effects on either improved corporate control as well as more competitive credit for the client. This seems to indicate that depending on the quality and the depth of the relationship (housebank), the appreciation for the concept may be very positively interpreted, especially seen from the Latin American perspective which is illustrated is the following table;

Table 29 Mean, frequency distribution per region and Std. deviation H.1.6.3.

housebanks play important and positive role in the process of corporate control; and borrowers with strong bank-borrower relationship receive more competitive credit on average * Europe (1), Latin Am (2), others (3)

housebanks play important and positive role in the process of corporate control; and borrowers with strong bank-borrower relationship receive more competitive credit on average

Europe (1), Latin	Mean	N	Std. Deviation
Europe	2,41	54	,901
Latin America	2,21	48	,798
Others	1,75	4	,500
Total	2,29	106	,850

Conference quote Mr. Bengt Hallqvist (page 73); *Here we come into relationship banking, and that is: everyone concerned must understand the family company, even the family company themselves. And of course the bankers. In relationship banking, and also if you are involved as an outside director or even for the families themselves to understand, you have to know them all, including in-laws. Very often problems are generated through the in-laws. They have not the same feeling of family connection as those who really are the bloodlines, and it's very often that problems start that way. You have to understand the family problems, in relationship banking you have to have a feeling of what's going on…* and

Now it's very, very important, and this is really relationship banking, that you are so involved with this that you feel it, you can smell *it. And maybe you can as a banker or as another family member start doing things to avoid a catastrophe.*

4.4. Summary of calculation of mean, frequencies and standard deviation:

Table 30 Summary means, frequencies and Std. Deviation H.1 - H 1.6

Report

bank (1), company (2) or others (3) (S1.5)		in general banks seem to be competent with regards to understanding risks	bank clients would be benefited if banks were rated in terms of clients satisfaction	the long history in banking and the lack of alternatives means that banks will continue to exist	with current supervision and regulation on banks... confident of low systemic risks	banks play a crucial, mostly constructive role within the world economy	with increased knowledge and modern techniques in finance... role of relationship will diminish	most companies tend to act opportunistically in their bank relations	banks are considered by most clients as a necessary evil	housebanks play important and positive role in the process of corporate control; and borrowers with strong bank-borrower relationship receive more competitive credit on average
bank	Mean	2,79	2,33	2,10	3,28	2,02	3,48	2,79	3,17	2,19
	N	58	58	58	58	58	58	58	58	58
	Std. Deviation	,951	1,066	,931	1,089	,737	1,047	1,088	1,110	,826
company	Mean	3,28	2,08	2,18	3,65	2,48	3,23	2,88	2,75	2,38
	N	40	40	40	40	40	40	40	40	40
	Std. Deviation	1,037	,944	,874	,802	,877	1,209	1,137	1,127	,868
other	Mean	3,13	1,75	1,75	3,25	2,38	3,38	2,13	2,38	2,63
	N	8	8	8	8	8	8	8	8	8
	Std. Deviation	,835	,707	,463	1,035	,916	1,302	,991	,916	,916
Total	Mean	3,00	2,19	2,10	3,42	2,22	3,38	2,77	2,95	2,29
	N	106	106	106	106	106	106	106	106	106
	Std. Deviation	,995	1,006	,883	,994	,828	1,125	1,107	1,124	,850

4.5. Findings of hypothesis H2: Credit and credit rating

The role of rating agencies such as Standard and Poor's, Moody's and Fitch-IBCA has increased during the last decades. Both country credit ratings as well as company credit ratings have become indispensable tools in today' s finance. Also as a result of Basel II rating will become more important, yet most of the rating is done on the basis of hard factors, those which can be objectively measured. Findings in both literature and during the conference indicated however that there are many aspects which are not that easy to measure as is illustrated in the following quote:

Conference quote Mr. Ricardo Zerbino (page 81); *on management quality: we believe that this is very important, it has been mentioned here* *in other presentations, the quality of the people is the most important element of the company. Machines and technology can be bought, but what makes performance different in the market is the quality of customer service, and profitability has a lot to do with management and direction.*

H.2.1. The role of credit rating agencies generally can be described as constructive and a valuable complementary tool. (Mean of 2.25 SD .976 - accepted)

Table 31 Cross tabulation H.2.1.

(1), company (2) or others (3) (S1.5) * the role of credit rating agencies generally can be describes as constructive a valuable complementary tool Crosstabulation

			the role of credit rating agencies generally can be describes as constructive and a valuable complementary tool					Total
			strongly agree	agree	undecided	disagree	strongly disagree	
bank (1), company (2) or others (3) (S1.5)	bank	Count	3	38	9	7	1	58
		% within bank (1), company (2) or others (3) (S1.5)	5,2%	65,5%	15,5%	12,1%	1,7%	100,0%
	company	Count	5	19	9	6	1	40
		% within bank (1), company (2) or others (3) (S1.5)	12,5%	47,5%	22,5%	15,0%	2,5%	100,0%
	other	Count	1	5		2		8
		% within bank (1), company (2) or others (3) (S1.5)	12,5%	62,5%		25,0%		100,0%
Total		Count	9	62	18	15	2	106
		% within bank (1), company (2) or others (3) (S1.5)	8,5%	58,5%	17,0%	14,2%	1,9%	100,0%

The finding confirms the hypothesis with 67% to agree and 17% undecided and is also confirmed by the following quote;

Conference quote Mr Osvaldo Bertone (page 54); *We have also rated ACA in order to provide additional information to our banks, if we want to be their partners, we want them to know who their partner is. We have tried to create trust, beyond the figures we may provide;*

And, Mr. Ricardo Zerbino (page 80); *we should consider that credit rating, with all its imperfections, is a tool which is very useful for private investors, for institutional investors who act in the capital market and also for financial institutions, particularly banks, because it is a reference element which is very important, which complements auditing, which only gives us a vision of what has happened up to that moment, and can give us a glimpse of the solidity and the financial structure of the company, but it does not look beyond in general terms. Rating considers the risk factors of the issuer and the systemic factors. It considers the elements of risk associated with the macro economy of the country, it takes into account the possibilities of growth of the country where the company is located, the risk of devaluation, how the credit market is in general, what risk there is in the banking system. It also measures the tendencies concerning inflation and how they can affect the companies, combined with devaluation, in accordance with the structure of the liabilities, taking into account local currency, foreign currency, and what position the company has in terms of currencies and its liabilities. It analyzes factors of the company, of the industry, of the operational aspects, and it also analyzes factors of the economic environment or macroeconomic factors. It also takes into account political, institutional, legal, regulatory factors, fiscal risks, it takes into account cultural aspects of the country, and this has been mentioned a lot between yesterday and today, cultural aspects are very important when a company's ability to develop in certain fields is being judged. Basically it also provides an* *outlook of the future from the present financial situation of the issuer, and its projection for the future.*

H.2.2. Credit rating agencies, despite their long history and expertise do not really possess competencies, which may prevent default risk (Mean of 2.25 and SD of 1.005 - accepted).

Conference quote Mr. Ricardi Zerbino (page 80); *A last comment is that (rating is not so useful) in periods of good economic progress. This may sound difficult to understand, but I would say that in the same way as one looks at a lighthouse that has a real use at night when it is dark, and vision is imperfect, a good rating is also like a lighthouse in the middle of the night or in stormy periods. It makes a company different from another in the market, it is a firm sign for doubtful investors, or scared investors, it is a basic element for institutional investors, so I believe that this value is a lot greater than in periods of progress when the markets are growing and investors are willing to take more risks, when an investor wishes to widen the scope of his investments and in general investors are not scared of risk factors pertaining to the environment.*

Table 32 Cross tabulation H.2.1.

1), company (2) or others (3) (S1.5) * credit rating agencies, despite long history and expertise don't posses compete which may prevent default risk Crosstabulation

			credit rating agencies, despite long history and expertise don't posses competencies, which may prevent default risk					
			strongly agree	agree	undecided	disagree	strongly disagree	Total
bank (1), company (2) or others (3) (S1.5)	bank	Count	9	31	8	9	1	58
		% within bank (1), company (2) or others (3) (S1.5)	15,5%	53,4%	13,8%	15,5%	1,7%	100,0%
	company	Count	6	21	7	4	2	40
		% within bank (1), company (2) or others (3) (S1.5)	15,0%	52,5%	17,5%	10,0%	5,0%	100,0%
	other	Count	2	4		2		8
		% within bank (1), company (2) or others (3) (S1.5)	25,0%	50,0%		25,0%		100,0%
Total		Count	17	56	15	15	3	106
		% within bank (1), company (2) or others (3) (S1.5)	16,0%	52,8%	14,2%	14,2%	2,8%	100,0%

Conference quote Mr. Rafael Bonasso (page 58); *We know that a rating at the end of the day is a third party that analyzes how the bank is today, things might change in the future.*

Despite the fact that under hypothesis (H.2.1.) credit rating was positively evaluated as a complementary tool, the finding on this hypothesis brings to doubt the general assumption regarding credit rating agencies (despite their 100 year of experience) to help preventing default risks effectively. This leads to the following hypothesis, whether their role should be more critically accessed.

H.2.3. The role of credit rating agencies should be more critically assessed and their influence (oligopoly) in finance should be reduced (Mean of 2.25 and SD .976 - accepted).

Table 33 Cross tabulation H.2.3.

1), company (2) or others (3) (S1.5) * the role of credit rating agencies should be more critically assessed and their influe finance should be reduced Crosstabulation

			he role of credit rating agencies should be more critically assessed and their influence in finance should be reduced					
			strongly agree	agree	undecided	disagree	strongly disagree	Total
bank (1), company (2) or others (3) (S1.5)	bank	Count	12	28	7	10	1	58
		% within bank (1), company (2) or others (3) (S1.5)	20,7%	48,3%	12,1%	17,2%	1,7%	100,0%
	company	Count	8	22	5	4	1	40
		% within bank (1), company (2) or others (3) (S1.5)	20,0%	55,0%	12,5%	10,0%	2,5%	100,0%
	other	Count		7	1			8
		% within bank (1), company (2) or others (3) (S1.5)		87,5%	12,5%			100,0%
Total		Count	20	57	13	14	2	106
		% within bank (1), company (2) or others (3) (S1.5)	18,9%	53,8%	12,3%	13,2%	1,9%	100,0%

With both banks and companies (and others) overwhelmingly agreeing with the statement, this seems to confirm the findings of the literature (Chapter 2, section 2.2.) in that the role of ratings agencies and their influences is under scrutiny. This does not cover, however, that improved internal rating by banks following Basel II should be regarding the same. This clearly was left aside in the question.

Conference quote Mr. Ricardo Zerbino (page 81); *So to conclude, credit rating is a necessary tool, as all tools it is imperfect, and we have already seen that it does not necessarily provide security, nor has it prevented crises in different markets of the world, but it's very useful for investors, it's useful for the issuers, because it helps the issuing company to revise and focus on its risk factors, and I would say that it is indispensable for the development of the capital market.*

H.2.4. The credit analysis process of a credit rating agency and those of a housebank are comparable in terms of depth and quality (Mean of 3.35 and SD .957 - undecided).

Conference quote Mr. Jan Portegies (page 88); *Linking it perhaps to Mr. Zerbino's presentation from a little while back, it may improve your credit rating, although perhaps today we may not see substantial evidence that credit rating agencies are quantifying the aspects of corporate governance in their rating of the company, but we are confident that it is inevitable as we go along corporate governance will be something that these agencies will take a look at more closely, and if you are in good shape in respect of that, in the end it may also mean that you pay a lower price for your credit.*

Table 34 Cross tabulation H.2.4.

(1), company (2) or others (3) (S1.5) * the credit analysis process of a credit rating agency and those of a house banl comparable in terms of depth and quality Crosstabulation

			e credit analysis process of a credit rating agency and those of house bank are comparable in terms of depth and quality					
			strongly agree	agree	undecided	disagree	strongly disagree	Total
bank (1), company (2) or others (3) (S1.5)	bank	Count		14	14	28	2	58
		% within bank (1), company (2) or others (3) (S1.5)		24,1%	24,1%	48,3%	3,4%	100,0%
	company	Count	4	6	12	16	2	40
		% within bank (1), company (2) or others (3) (S1.5)	10,0%	15,0%	30,0%	40,0%	5,0%	100,0%
	other	Count		1	4	2	1	8
		% within bank (1), company (2) or others (3) (S1.5)		12,5%	50,0%	25,0%	12,5%	100,0%
Total		Count	4	21	30	46	5	106
		% within bank (1), company (2) or others (3) (S1.5)	3,8%	19,8%	28,3%	43,4%	4,7%	100,0%

The 28.3% of total respondents undecided seems to indicate that the question and the underlying concept were perhaps not too clear to all respondents. In order to be able to reply to this question, (practical) experiences with both credit rating as well as the credit process of banks need to be available. This is not often the case, both with bankers as well as with companies. Especially for Latin American

companies, external credit rating is a novelty, and only experienced by the very large companies which have been having sporadically access to capital market instruments. The fact that nearly 50% disagree with the hypothesis indicates that a majority (taking the undecided into consideration) still supposes that the quality and depth of credit analysis between banks and credit rating agencies are not comparable, leaving unanswered which one is considered better.

Conference quote Mr. Karl Weinfurtner (page 85); *Most companies in Germany have no ratings. Most are family-owned companies, medium-size companies, and for them I think there was no necessity in the past for a rating, because of the close ties they had to banks, what was called housebank, principal bank relationship. But this will change in the future, with Basel II coming.*

H.2.5. The new Basel II regulations, to be implemented in 2006, will further contribute to a better risk management and control of financial institutions and markets (Mean 2.62 and SD .798 undecided)

Table 35 Cross tabulation H.2.5.

ık (1), company (2) or others (3) (S1.5) * the new Basel II regs., implemented 2006, will further contribute to a better ri management and control of financial instit and markets Crosstabulation

			ȩ new Basel II regs., implemented 2006, will further contribute to ȩtter risk management and control of financial instit and markets					
			strongly agree	agree	undecided	disagree	strongly disagree	Total
bank (1), company (2) or others (3) (S1.5)	bank	Count	4	27	18	8	1	58
		% within bank (1), company (2) or others (3) (S1.5)	6,9%	46,6%	31,0%	13,8%	1,7%	100,0%
	company	Count	1	9	28	1	1	40
		% within bank (1), company (2) or others (3) (S1.5)	2,5%	22,5%	70,0%	2,5%	2,5%	100,0%
	other	Count	1	5	2			8
		% within bank (1), company (2) or others (3) (S1.5)	12,5%	62,5%	25,0%			100,0%
Total		Count	6	41	48	9	2	106
		% within bank (1), company (2) or others (3) (S1.5)	5,7%	38,7%	45,3%	8,5%	1,9%	100,0%

Conference quote Mr. Hendrik Lühl (page 59): *I think that the problem is that the internal approval procedures, at least in the banks, and DEG is also governed in Germany by the banking commission, are changing. You have a veto right in these days by a credit department and even if the big bosses say "Well, we should do that", they have a veto and these are people who do not travel. I mean, you can be lucky if they have some experience. In DEG luckily they do, these are people who come from the operational level. But this is something that is imposed to us by law and it is very difficult to overcome*[9].

The most striking observation here is that 70% of the companies are still undecided, meaning that they seem to have no opinion yet on the meaning and impacts of Basel II. With over 50% of the banks supporting the claim that Basel II will contribute to better risk

[9] Anecdote: Two members of the board of a large German bank, had agreed to be in favour of a new credit ((US$ 25 -50 million), one board member responsible for commercial and the other for risk management. The proposal stranded in the newly formed internal credit rating department, who were unable to apply an acceptable rating to the credit, given that the standard operating procedures did not allow adjusting one of the risk components, given the structure of the transaction. The banks lost the business and the client.

management of banks and markets, this seems to contradict very recent findings of the Centre for Study of Financial Innovation (Banana Skins 2005). In this report, 440 respondents rank the rise of regulation to be the number one risk facing the industry and the costs and distractions of regulation, as well as the false sense of security it brings, were the main reasons cited for its strong showing (CSFI, 2005). The industry, according to this report, clearly believes that regulators are getting it wrong both from a cost perspective, driven by what banks see as an excessive focus on consumer protection, and from too much complexity, which is seen as killing competition and promoting a herd instinct in financial institutions (CSFI, 2005). It has been observed in many meetings during the last few years that bankers, in their contacts with clients, frequently referred to Basel II changes and the fact that the business subsequently would become more difficult, especially to unrated and unsecured clients. Susan Rice, chief executive of Lloyds TSN Scotland was quoted in the CSFI report (2005) by saying that; “If (banks) take a view that regulations are being ‘done’ to them, they are also likely ‘to do’ to their customers, rather than responding to their needs and those of the market. Yet that is probably just as important for running a business based on pillars of integrity and probity as the regulation itself, perhaps more so”

Conference quote Mr. Osvaldo Bertone (page 52); *I believe that knowing people is at least as important as the figures on the balance sheet, especially concerning their professionalism and their* *honourableness. I think that when people are honourable, there may be problems, but they can be solved easily.*

In order to check whether the comparison of means between groups would substantially change the finding, the following calculation has been made, which confirms that the average of banks would be more inclined and "others" would indeed to accept the hypothesis;

Table 36 Mean, frequency distribution by sector and Std. Deviation H.2.5.

Report

the new Basel II regs., implemented 2006, will further contribute t a better risk management and control of financial instit and markets

bank (1), company (2)	Mean	N	Std. Deviation
bank	2,57	58	,881
company	2,80	40	,648
other	2,13	8	,641
Total	2,62	106	,798

Conference quote Mr. Rafael Bonasso (page 34); *So having said this, what are the lessons learnt from the crisis? …..banks: you should always be looking for the right client, right client that can be defined by the following characteristics: what is the character of the shareholders and the management, in tough times is where really you see whether companies are willing to share all the information with you, moving into the right direction….*

H.2.6. The new Basel II regulations carry the risk of a further widening of the gap between high-income and low-income countries. (Mean of 2.73 and SD .900 undecided)

Table 37 Cross tabulation H.2.6.

.), company (2) or others (3) (S1.5) * the new Basel II regs carry the risk of further widening of the gap between high i and low income countries Crosstabulation

			he new Basel II regs carry the risk of further widening of the gap between high income and low income countries					
			strongly agree	agree	undecided	disagree	strongly disagree	Total
bank (1), company (2) or others (3) (S1.5)	bank	Count	7	17	19	13	2	58
		% within bank (1), company (2) or others (3) (S1.5)	12,1%	29,3%	32,8%	22,4%	3,4%	100,0%
	company	Count	2	12	24	2		40
		% within bank (1), company (2) or others (3) (S1.5)	5,0%	30,0%	60,0%	5,0%		100,0%
	other	Count		3	3	2		8
		% within bank (1), company (2) or others (3) (S1.5)		37,5%	37,5%	25,0%		100,0%
Total		Count	9	32	46	17	2	106
		% within bank (1), company (2) or others (3) (S1.5)	8,5%	30,2%	43,4%	16,0%	1,9%	100,0%

Rather inconclusive in its findings, with 43.4 % undecided, it should be noted that, although this hypothesis has been strongly argued by academics such as Ferri *et al* (2001) who suggested that the Basel II proposal would increase the volatility of capital needs of banks in non-high-income countries vs. high-income countries' banks, it is a concept which was practically unknown to practitioners, given that the implementation of Basel II was still 2 years away at the time of the survey and the concept was at the time still a rather futuristic one. Separated by groups we find, however, that the hypothesis is accepted from the Latin American perspective, as shown in the table below:

Table 38 Mean, frequency distribution by region and Std. Deviation H.2.6.

the new Basel II regs carry the risk of further widening of the gap between high income and low income countries * Europe (1), Latin Am (2), others (3)

the new Basel II regs carry the risk of further widening of the gap between high income and low income countries

Europe (1), Latin	Mean	N	Std. Deviation
Europe	2,91	54	1,033
Latin America	2,50	48	,684
Others	3,00	4	,816
Total	2,73	106	,900

4.5.1. Summary of calculation of means, frequencies and standard deviation:

Table 39 Summary Mean, frequency distribution and Std. Deviation H.2.1 - H.2.6.

Report

bank (1), company (2) or others (3) (S1.5)		the role of credit rating agencies generally can be describes as constructive and a valuable complementary tool	credit rating agencies, despite long history and expertise don't posses competencies, which may prevent default risk	the role of credit rating agencies should be more critically assessed and their influence in finance should be reduced	the credit analysis process of a credit rating agency and those of a house bank are comparable in terms of depth and quality	the new Basel II regs., implemented 2006, will further contribute to a better risk management and control of financial instit and markets	the new Basel II regs carry the risk of further widening of the gap between high income and low income countries
bank	Mean	2,40	2,34	2,31	3,31	2,57	2,76
	N	58	58	58	58	58	58
	Std. Deviation	,836	,983	1,046	,883	,881	1,048
company	Mean	2,48	2,38	2,20	3,15	2,80	2,65
	N	40	40	40	40	40	40
	Std. Deviation	,987	1,030	,966	1,075	,648	,662
other	Mean	2,38	2,25	2,13	3,38	2,13	2,88
	N	8	8	8	8	8	8
	Std. Deviation	1,061	1,165	,354	,916	,641	,835
Total	Mean	2,42	2,35	2,25	3,25	2,62	2,73
	N	106	106	106	106	106	106
	Std. Deviation	,904	1,005	,976	,957	,798	,900

4.6. Findings of hypotheses H3: Culture differences

Conference quote Mr. Bengt Hallqvist (page 95); *I think the important thing is to have a clear idea of what is the best practice. Now the way to go from your current situation to best practice - it's a long way and a lot of companies will never get there. A lot of cultural differences make some of these requirements inadequate or impossible. So I think it's important to have an idea of what is best practice. Practically every code – and there are maybe 100 codes in the world – they are more or less in agreement about most of the basic things. Now the way to apply it, you have to adjust to the situation, you have to adjust to the country, to cultural differences, to the size of the company, to the values of the company and so on and so forth.*

H.3.1. Cultural differences have played a role in there having been so many accidents (defaults) throughout history in international finance (Mean of 2.39 and SD 1.001 - accepted).

Conference quote Mr. Hans Hanegraaf (page 123); *And cultural differences mainly become apparent when things don't develop as you want or expect, because then you really want to have an answer quickly, you say "I want to do this and that this way", because you're under stress and people react very differently.*

Table 40 Cross tabulation H.3.1.

, company (2) or others (3) (S1.5) * cultural differences have played a role in there having been so many defaults thro history in international finance Crosstabulation

			tural differences have played a role in there having been so ma defaults throughout history in international finance					
			strongly agree	agree	undecided	disagree	strongly disagree	Total
bank (1), company (2) or others (3) (S1.5)	bank	Count	8	27	14	7	2	58
		% within bank (1), company (2) or others (3) (S1.5)	13,8%	46,6%	24,1%	12,1%	3,4%	100,0%
	company	Count	8	16	10	5	1	40
		% within bank (1), company (2) or others (3) (S1.5)	20,0%	40,0%	25,0%	12,5%	2,5%	100,0%
	other	Count	2	5		1		8
		% within bank (1), company (2) or others (3) (S1.5)	25,0%	62,5%		12,5%		100,0%
Total		Count	18	48	24	13	3	106
		% within bank (1), company (2) or others (3) (S1.5)	17,0%	45,3%	22,6%	12,3%	2,8%	100,0%

Although with almost 25% undecided both among banks as well as companies, the hypothesis was accepted with 62.3% agreeing and strongly agreeing with the statement. Given the SD of 1.001 and the fact that 25% were undecided, a further breakdown in groups was performed showing that European respondents seem to agree even more than others with a mean of 2.33 and a SD of .971 whereas the companies respondents measured 2.38 yet with a SD of 1.030 (too high).

Table 41 (i) and (ii) Mean, frequency distribution by sector (i) and region (ii) and Std. Deviation H.3.1.

cultural differences have played a role in there having been so many defaults throughout history in international finance * bank (1), company (2) or others (3) (S1.5)

cultural differences have played a role in there having been so many defaults throughout history in international finance

bank (1), company (2)	Mean	N	Std. Deviation
bank	2,45	58	,994
company	2,38	40	1,030
other	2,00	8	,926
Total	2,39	106	1,001

cultural differences have played a role in there having been so many defaults throughout history in international finance * Europe (1), Latin Am (2), others (3)

cultural differences have played a role in there having been so many defaults throughout history in international finance

Europe (1), Latin	Mean	N	Std. Deviation
Europe	2,33	54	,971
Latin America	2,35	48	,978
Others	3,50	4	1,291
Total	2,39	106	1,001

Conference quote Mr. Karl Weinfurtner (page 40); *We are interested in long-term relationships and in long term cooperation and I think that to have long term relation it requires that you build up mutual confidence and understanding. It requires a type of relationship building. Confidence is vital to get through difficult times. And I think we need to take into account different aspects. For example in DEG we are investing in Latin America, in Eastern Europe, in Africa, in Asia. We have to take cultural differences into account. So we need a specific approach to our partners, we don't want to treat our partners in Asia the same as we treat our partners in Latin America because it's a different cultural* *perspective, it's a different cultural approach and we have to take this into account.*

Conference quote Robert Louzada (page 22); *The point is that I would add that it is not only cultural differences that we have. We might be working very well at the working level, shall we say, with people of both countries, but suddenly something changes from outside. There is very strong influence in strategy in different countries not being decided by the people who work together, but being decided at other levels of the company......It is not only the cultural cooperation in the short term, it is more of strategies that start to defer, and start to go one or the other way. And then, cooperation does not have any sense any more.*

H.3.2. If the bank does not understand the cultural context of a particular country or region, it becomes highly doubtful it will understand the risks (Mean of 1.60 and SD .657 - accepted).

Table 42 Cross tabulation H.3.2.

bank (1), company (2) or others (3) (S1.5) * if the bank does not understand the cultural context of a particular country or region, it becomes highly doubtful it will understand the risks Crosstabulation

			if the bank does not understand the cultural context of a particular country or region, it becomes highly doubtful it will understand the risks			Total
			strongly agree	agree	undecided	
bank (1), company (2) or others (3) (S1.5)	bank	Count	28	23	7	58
		% within bank (1), company (2) or others (3) (S1.5)	48,3%	39,7%	12,1%	100,0%
	company	Count	17	20	3	40
		% within bank (1), company (2) or others (3) (S1.5)	42,5%	50,0%	7,5%	100,0%
	other	Count	7	1		8
		% within bank (1), company (2) or others (3) (S1.5)	87,5%	12,5%		100,0%
Total		Count	52	44	10	106
		% within bank (1), company (2) or others (3) (S1.5)	49,1%	41,5%	9,4%	100,0%

By far the clearest of all responses and at the heart of the thesis, this result indicates that a large majority of the respondents support the key hypothesis of this thesis, confirming that, whereas there seems to be an agreement on the fact that credit risks in large part are related to the management competencies - effective corporate governance and integrity of management and organization - the argument can be made that the assessment of management capabilities, governance and integrity may be hindered in those cases where the culture is little understood. In other words, if the bank does not understand the cultural context of a particular country or region, it becomes highly doubtful it will understand the risks.

Conference quote Mr. Nanno Kleiterp (page 7); *We have learned a lot of lessons from that experience because always in a crisis you see a test for the choices you make and it is a test for the relationships you* *have. And what we can see is that we may say that during the crisis that occurred in Argentina at the end of 2001 and of course the related crisis in the financial system in Uruguay, with the effort we invested in the client selection ……Of course on the other hand we had some clients who ran into difficulties, through a variety of issues such as currency mismatches, and also …. insufficient corporate governance and in some instances that has even led in those difficult situations to frauds in institutions which meant that we had a very difficult time with some of our investments.*

Our strategies are built on knowing our business and environment, recognizing and adequately mitigating, and building on selected local and international partnerships with specialized and focused experience.

And , Mr. Osvaldo Bertone (page 53); *With regard to risks, I spoke about two types: company risk and country risk. Unfortunately I am old enough to refer to my experience. I have been in ACA for 31 years, and only recently I became the general manager. Before that I was always strongly involved in the financial area. So I have gone through crises, as many as those of you who are not so young either may recall, crisis like Sacetru, the Falkland Island crisis, hyperinflation, the tequila effect, etc. We have had relationships with several banks. Which were the banks who overcame those problems without going down themselves? It were the banks who knew Argentina……….. The risk was higher, but so was the spread.*

H.3.3. Capabilities to make friends, combined with common sense ensure healthy bank-client relations (Mean of 2.17 and SD of 1.046 - accepted).

To my way of thinking, the most important rule of establishing a relationship is to show an interest in your subject (Mr. Fred Arnold, conference quote page 102).

Table 43 Cross tabulation H.3.3.

1), company (2) or others (3) (S1.5) * capabilities to make friends, combined with common sense ensure healthy bank relations Crosstabulation

			apabilities to make friends, combined with common sense ensur healthy bank-client relations					
			strongly agree	agree	undecided	disagree	strongly disagree	Total
bank (1), company (2) or others (3) (S1.5)	bank	Count	17	22	7	10	2	58
		% within bank (1), company (2) or others (3) (S1.5)	29,3%	37,9%	12,1%	17,2%	3,4%	100,0%
	company	Count	9	25	3	1	2	40
		% within bank (1), company (2) or others (3) (S1.5)	22,5%	62,5%	7,5%	2,5%	5,0%	100,0%
	other	Count	1	6	1			8
		% within bank (1), company (2) or others (3) (S1.5)	12,5%	75,0%	12,5%			100,0%
Total		Count	27	53	11	11	4	106
		% within bank (1), company (2) or others (3) (S1.5)	25,5%	50,0%	10,4%	10,4%	3,8%	100,0%

Conference quote Mr. Osvaldo Bertone (page 58); *Therefore in ACA we have always privileged long-term relationships with banks. In spite of the fact that the people have changed, we have relationships of more than 30 years with certain banks, very fruitful relationships, with ups and downs, and with a few arguments in the middle, as it should be. I do not think that anyone gets on so well with a wife that there are never any arguments! At least in my case, I think that there are more arguments than necessary, but I think that with banks, the same criteria should apply. I believe that this is a very important point. In the case of ACA, and I am not saying this because in this environment it is easy to* *say, we prefer to work with European banks. We decided that we did not want to work with US banks. The reason for this is that we do not want opportunity business. We want long-term commitment. This is an ACA policy which was defined a long time ago.*

The hypothesis was derived from a statement from Edward T. Hall (1996) where he argued that after a life-long study of the subject of transnational management, he had come to conclude that of all the capabilities managers should have in order to operate successfully, the far most important one was the capability of making friends in other cultures. The findings confirm that respondents tend to agree with the statement, with perhaps the additional argument that from a Latin American perspective, even more attention is paid to friendship, as is shown by the following;

Table 44 Mean, frequency distribution per region and Std. Deviation H.3.3.

capabilities to make friends, combined with common sense ensure healthy bank-client relations * Europe (1), Latin Am (2), others (3)

capabilities to make friends, combined with common sense ensure healthy bank-client relations

Europe (1), Latin	Mean	N	Std. Deviation
Europe	2,22	54	1,058
Latin America	2,02	48	1,000
Others	3,25	4	,957
Total	2,17	106	1,046

And sub-hypotheses;

H.3.3.1 Clients of banks would be benefited if banks were rated in terms of clients' satisfaction (Mean of 2.02 and SD .946 accepted).

Table 45 Cross tabulation H.3.3.1.

ık (1), company (2) or others (3) (S1.5) * the quality of a bank should also be rated in accordance with client satisfacti Crosstabulation

			e quality of a bank should also be rated in accordance with clier satisfaction					
			strongly agree	agree	undecided	disagree	strongly disagree	Total
bank (1), company (2) or others (3) (S1.5)	bank	Count	11	37	1	9		58
		% within bank (1), company (2) or others (3) (S1.5)	19,0%	63,8%	1,7%	15,5%		100,0%
	company	Count	16	19	1	2	2	40
		% within bank (1), company (2) or others (3) (S1.5)	40,0%	47,5%	2,5%	5,0%	5,0%	100,0%
	other	Count	2	5	1			8
		% within bank (1), company (2) or others (3) (S1.5)	25,0%	62,5%	12,5%			100,0%
Total		Count	29	61	3	11	2	106
		% within bank (1), company (2) or others (3) (S1.5)	27,4%	57,5%	2,8%	10,4%	1,9%	100,0%

This table contains a very important finding of this study with over 85% of the respondents either agreeing or strong agreeing with the hypothesis. This finding correlates with hypothesis H.1.2. [Clients of banks would be benefited if banks were rated in terms of client's satisfaction (mean of 2.19 SD .95 accepted)]. It has been the only specific question which verifies whether respondents have been consistent in their approach to the questionnaire. Although the framing of the question has another dimension, the essence of the question remains fairly the same. The finding confirms that the role and place of banks in the market is special (Corrigan 1982, 2000) since the marketing of banking products is rarely a product of client research and needs.

H.3.3.2. The commitment of most relationship banks depends largely on the weather (Umbrella whilst the sun is out, requesting it back when clouds appear) (Mean of 2.58 and SD 1,162 - undecided).

Conference quote Mr. Roberto Gazze; *It is not pleasant to feel unprotected.*

Table 46 Cross tabulation H.3.3.2.

›ank (1), company (2) or others (3) (S1.5) * the commitment of most relationship banks depends largely on the weathe› Crosstabulation

			e commitment of most relationship banks depends largely on th weather					
			strongly agree	agree	undecided	disagree	strongly disagree	Total
bank (1), company (2) or others (3) (S1.5)	bank	Count	6	26	6	15	5	58
		% within bank (1), company (2) or others (3) (S1.5)	10,3%	44,8%	10,3%	25,9%	8,6%	100,0%
	company	Count	9	17	4	9	1	40
		% within bank (1), company (2) or others (3) (S1.5)	22,5%	42,5%	10,0%	22,5%	2,5%	100,0%
	other	Count	1	5	2			8
		% within bank (1), company (2) or others (3) (S1.5)	12,5%	62,5%	25,0%			100,0%
Total		Count	16	48	12	24	6	106
		% within bank (1), company (2) or others (3) (S1.5)	15,1%	45,3%	11,3%	22,6%	5,7%	100,0%

Given a standard deviation of 1.162 and a mean above 2.5 the hypothesis remains undecided. A further breakdown into groups has been made, leading to an interesting observation: separated between groups, both companies with a mean 2.40 (SD 1.150) but particularly subjects from Latin America with a mean of 2.29 and a standard deviation of 1.031, show more acceptance with the hypothesis, albeit a too high standard deviation. This could be expected and is consistent with the experiences that Latin American companies have had with the commitment of their banks during the several banking (and other) crises that have taken place, which have lead them to believe that banks walk away every now and than when the weather gets tough.

Table 47 (i) and (ii) Mean, frequency distribution per sector (i) and region (ii) and Std. Deviation H.3.3.2.

the commitment of most relationship banks depends largely on the weather * bank (1), company (2) or others (3) (S1.5)

the commitment of most relationship banks depends largely on the weather

bank (1), company (2)	Mean	N	Std. Deviation
bank	2,78	58	1,200
company	2,40	40	1,150
other	2,13	8	,641
Total	2,58	106	1,162

the commitment of most relationship banks depends largely on the weather * Europe (1), Latin Am (2), others (3)

the commitment of most relationship banks depends largely on the weather

Europe (1), Latin	Mean	N	Std. Deviation
Europe	2,76	54	1,196
Latin America	2,29	48	1,031
Others	3,75	4	1,258
Total	2,58	106	1,162

Conference quote Mr. Hendrik Lühl (page 12) *To summarize, DEG is a long-term partner. We come when the weather is bad and we do not run away when the weather is bad.*

Conference quote Mr. Rafael Bonasso (page 33); *.....in Argentina, no matter that in the macro context there was a sovereign default, there were scarce financial resources, there was a strong devaluation, unstable political environment, and economic recession, we were able to do business...........but it is clear that during tough times many friends disappear.*

And, not in relation to the former speaker, but rather aiming at those banks who had decided to leave – or step out the business at the midst of the crises;

Mr. Henk van der Heiden (page 56*); Again you are saying the right thing, but where were the banks in the meantime?......but in the past two or three years there were very serious problems, and when there are two or three years without liquidity, because of the lack of cooperation of the institutions, one doesn't exist any more as a company.*

4.6.1. Summary of calculation of means and standard deviation:

Table 48 Summary Mean, frequencies and Std. Deviation H-3.1.- H 3.3.

Report

bank (1), company (2) or others (3) (S1.5)		cultural differences have played a role in there having been so many defaults throughout history in international finance	if the bank does not understand the cultural context of a particular country or region, it becomes highly doubtful it will understand the risks	capabilities to make friends, combined with common sense ensure healthy bank-client relations	the quality of a bank should also be rated in accordance with client satisfaction	the commitment of most relationship banks depends largely on the weather	bank clients would be benefited if banks were rated in terms of clients satisfaction
bank	Mean	2,45	1,64	2,28	2,14	2,78	2,33
	N	58	58	58	58	58	58
	Std. Deviation	,994	,693	1,167	,907	1,200	1,066
company	Mean	2,38	1,65	2,05	1,88	2,40	2,08
	N	40	40	40	40	40	40
	Std. Deviation	1,030	,622	,932	1,042	1,150	,944
other	Mean	2,00	1,13	2,00	1,88	2,13	1,75
	N	8	8	8	8	8	8
	Std. Deviation	,926	,354	,535	,641	,641	,707
Total	Mean	2,39	1,60	2,17	2,02	2,58	2,19
	N	106	106	106	106	106	106
	Std. Deviation	1,001	,657	1,046	,946	1,162	1,006

4.7. Summary of findings of the research hypotheses:

A table is provided below in order to provide a clear overview of the key findings of the research. The terminology used to assign a result on the findings varies from (1) "not tested" (which as it has been explained, is the case for several hypotheses not discussed at the conference), which were 10 out of the total of 20; (2) "undecided" for the hypothesis where the mean value shows 2,5 < µ < 3,5 or where inconclusive results were obtained during the conference and; (3) "rejected" where µ = 3,5 or where the conference findings indicated disagreement with the hypothesis (this confirmed by specific quotes); and (4) "accepted" where µ = 2,5 or where conference findings confirm the same.

Table 49 Summary of finding on the hypotheses

SUMMARY FINDINGS

Hypothesis	literature findings	conference findings	questionnaire findings total	questionnaire findings banks	questionnaire findings companies
H.1.1. In general banks seem to be very competent with regard to understanding risks.	accepted	not tested	undecided	accepted	undecided
H.1.2. Clients of banks would be benefited if banks were rated in terms of client's satisfaction	undecided	not tested	**accepted**	**accepted**	**accepted**
H.1.2.1. The quality of a bank should also be rated in accordance with client satisfaction	undecided	not tested	**accepted**	**accepted**	**accepted**
H.1.3. The long history in banking and the lack of alternatives means that banks will continue to exist for many more years	accepted	not tested	accepted	accepted	accepted
H.1.4. With current supervision and regulation on banks one can be confident about low systemic risks	accepted	not tested	undecided (*)/accepted	undecided	undecided
H.1.5. Banks play a crucial mostly constructive role within the world economy	accepted	not tested	accepted	accepted	accepted
H.1.6. With increased knowledge and modern techniques in finance the role of relationship in bank -client relations will diminish	accepted	not tested	undecided	undecided	undecided
H.1.6.1. Most companies tend to act opportunistically in their bank-relations	accepted	not tested	undecided	undecided	undecided
H.1.6.2. Banks are considered by most clients as a necessary evil	undecided	rejected	undecided	undecided	undecided
H.1.6.3. Housebanks play an important and largely positive role in the process of corporate control; and borrowers with a strong bank–borrower relationship receive more competitive credit on average.	accepted	accepted	accepted	accepted	accepted

H.2.1. The role of credit rating agencies generally can be described as constructive and a valuable complementary tool.	accepted	accepted	accepted	accepted	accepted
H.2.2. Credit rating agencies, despite their long history and expertise do not really possess competencies, which may prevent default risk.	undecided	accepted	accepted	accepted	accepted
H.2.3. The role of credit rating agencies should be more crit ically assessed and their influence (oligopoly) in finance should be reduced.	undecided	undecided	accepted	accepted	accepted
H.2.4. The credit analysis process of a credit rating agency and those of a housebank are comparable in terms of depth and quality.	undecided	undecided	undecided	undecided	undecided
H.2.5. The new Basel II regulations, to be implemented in 2006, will further contribute to a better risk management and control of financial institutions and markets.	undecided	undecided	undecided	undecided	undecided
H.2.6. The new Basel II regulations carry the risk of a further widening of the gap between high income and low income countries.	accepted	not tested	undecided (*)/accepted	undecided	undecided
H.3.1. Cultural differences have played a role in there having been so many accidents (defaults) throughout history in international finance.	undecided	not tested	**accepted**	**accepted**	**accepted**
H.3.2. If the bank does not understand the cultural context of a particular country or region, it becomes highly doubtful it will understand the risks	undecided	**accepted**	**accepted**	**accepted**	**accepted**
H.3.3. Capabilities to make friends, combined with common sense ensure healthy bank-client relations	undecided	accepted	accepted	accepted	accepted
H.3.3.2. The commitment of most relationship banks depends largely on the weather (Umbrella whilst the sun is out, requesting it back when clouds appear).	accepted	undecided	accepted	accepted	accepted

(*) Between group analysis lead for Latin American respondents to accepted

CHAPTER 5 - DISCUSSION, LIMITATIONS AND RECOMMENDATIONS TO FURTHER RESEARCH AND CONCLUSIONS

5.1. Introduction:

The final chapter of the thesis will provide a discussion as concise as possible, limitations of the results, a review of possible recommendations for further research and the conclusions of this research. It has not been an easy journey, yet a very satisfying one, which hopefully will be appreciated by as many of the colleagues in the field of cross border finance, especially all of those who have willingly participated in the conference and the questionnaire. Certainly the findings will be communicated to them in an appropriate form, as it can not be expected for people to read through the entire doctorate thesis. It will depend to a large extent on the feedback in the coming period whether some of the findings qualify for further publication.

A second objective of this thesis is to comply with the regulations of the University of Bradford in partial fulfilment of the requirement for the degree of Doctor in Business Administration. Although there are no universal standards for a thesis, it usually requires students to make a substantial contribution to the knowledge in a specific field of research. It should therefore also reflect the standards of originality required for a doctorate (Butler, University of Bradford 2000). The term thesis refers to an orderly and scholarly presentation of an argument. A thesis furthermore should take the reader through an argument and needs to be in conversation with existing literature in the chosen fields of research.

The relationship between banks, credit rating and culture is not an area which had been thoroughly explored by scholars and practitioners. Cross border lending however can not be undertaken without crossing cultures. This research explored this particular relationship (lending to other cultures) and tried to explain the role and position of banks, through combining existing economic theories. This was considered relevant as it is the banks through which a large majority of cross border finance is being channelled. The position and the role banks in this aspect has been analyzed and researched.

New international regulation, referred to as Basel II, seeks to improve on existing international standards (Basel I), which only set minimum capital standards for banks, and ought to be implemented by 2006 in more than 100 countries. It does not require national supervisors to impose capital requirements automatically, but they have significant flexibility to determine how best to ensure that banks are sufficiently capitalized in relation to their unique risk. To measure the risk of the individual banks, internal credit ratings systems are being developed which must ensure that risks are appropriately measured and accounted for. It is here where credit rating and their effectiveness are being reviewed, and questions are raised whether they are appropriate and effective, particularly given that so-called soft factors are barely considered by both regulators (Basel II) and current credit rating practice. In the area of cross border finance it was supposed that cross culture consequences needed to be considered.

Culture and coping with its differences is still debated. Both in the field of cross-cultural studies, scholars still argue on concepts and adequate or inadequate methodologies, whereas practitioners in business and politics continue to display relative little interest to its concept and consequences. Bankers all over the world are being trained on how to read balance sheets, yet little attention is being paid as to by whom and how precisely these balance sheets came to existence, other than the accountancy standards applied, but also their existing research suggests that cultural factors come in play.

Bankers furthermore seem to agree on the fact that credit risks in large part are related to the management competencies, effective corporate governance and integrity of management and organization. The argument could however be made that the assessment of management capabilities, governance and integrity may be hindered in those cases where the culture is little understood. In other words, how do bankers evaluate management of another culture, if they understand little of it? This aspect has been further explored in this research.

5.2. Discussion of the findings:

Given the exploratory nature of this thesis some may argue that the thesis is perhaps too broad in scope. Although this argument could be made, it is the complexity of the cross border lending, which makes that the concepts can hardly be more focused or – alternatively - individually researched. Findings especially those confirming a hypothesis not previously reported in literature may give reason for excitement. Yet, it is often not in the acceptance of a hypothesis were the actual problem or interesting finding is hidden. An example of this kind can be the outcome of the first hypothesis, that “in general banks seem to be very competent with regard to understanding risks”, where the responses of banks and companies relate in a rather asymmetric way (Banks considering that they do, and companies viewing that they don’t). In line with the philosophical underpinning of the research guided by ontological relativism, interpretation of the results may be different according to different social constructs. The results therefore are open for debate and different kinds of interpretation.

The approach will be consistent with the remaining structure of the thesis in that results will be discussed by sections on banks and cross border lending (paragraph 5.2.1.), on credit and credit rating and their effectiveness, in particular in view of the 2006 Basel II regulations to be implemented (paragraph 5.2.2.) and last but not least the impact of culture differences (paragraph 5.2.3.).

5.2.1. On the notion of why banks exist:

The most notable finding under this heading is the conclusion about the findings that both clients of banks would be benefited, if banks were rated in terms of clients or clients’ satisfaction, and that –

asked separately - the quality of the banks should also be rated in accordance with client satisfaction. It is argued that these findings are first of all relevant to the marketing side of a bank, which is a complex area. Perhaps transparency of banks could be improved using the tool of providing rating of banks in terms of clients' satisfaction. Secondly these findings perhaps should be relevant for ratings agencies – and supervisory institutions – as to consider client satisfaction as an additional factor measuring the quality of a bank.

Banking has existed and stood the test of times over thousands of years and given the fact that their key function has been an intermediary one, this could not have been otherwise possible had markets not been imperfect. Hypothesis 1.3.; "The long history in banking and the lack of alternatives means that banks will continue to exist for many more years", provided convincing evidence of the finding with 75% of respondents agreeing or strongly agreeing to the hypothesis.

Additionally asked (hypothesis 1.5.) whether the role of banks is considered crucial and mostly constructive within the world economy, the findings suggest that respondents do agree with the hypothesis, such in line with current economic theories. An interesting difference although could be observed between banks and companies, whereby banks seem to be rather more convinced about their positive and constructive role in the world economy, whilst companies tend to remain undecided.

Fundamental to understanding these aspects of why banks exist, both transactions cost theory as well as agency theory is considered to be of importance.

Relevant quotes from the conference in view of distinguishing opportunism as explained by Williamson (1985); (1) Mr. Ricardo Zerbino (page 81*); On management quality: we believe that this is very important, it has been mentioned here in other presentations, the quality of the people is the most important element of the company* and (2) Conference quote Mr. Osvaldo Bertone (page 52); *I believe that knowing people is at least as important as the figures on the balance sheet, especially concerning their professionalism and their honourability. I think that when people are honourable, there may be problems, but they can be solved easily.*

Two executives of rather large companies, arguing in the same direction, pointing out what according to them should be the most important aspect. The question then could be raised: how to do this? One way of approaching this phenomena is illustrated by the emphasis on relationship banking, by Mr. Bengt Hallqvist; *...and this is really relationship banking, that you are so involved with this that you feel it, you can smell it (Bengt Hallqvist, conference quote page 74).*

Transaction cost theory explains why organizations exist and that, sometimes, the cost of managing economic exchanges across markets is greater than the cost of managing economic exchanges within the boundaries of an organisation. This simple logic seems to have worked for banks. Transaction cost theory also has its limitations as it focuses on cost minimisation, whereby economising is more fundamental than strategizing (Williamson 1976). It furthermore neglects the role of social relationship in economic transactions (highly relevant for banking) that discounts the impact of social relationships and culture. Granovetter (1985) for example pointed out that transactions are influenced by expectations that are formed by the history of the relationship.

According to the next hypothesis (H.1.6.3.); "housebanks play an important and largely positive role in the process of corporate control; and borrowers with a strong bank–borrower relationship receive more competitive credit on average", the following conclusions can be drawn: Although the concept of housebanks may not be universally known (specially refers to findings in North Western European countries) the acceptance of the hypothesis, with nearly 72% confirming that a housebank (strong relationship bank), is expected to produce positive results and effects on either improved corporate control as well as more competitive credit for the client, suggest that indeed according to Granovetter (1985) transactions are influenced by expectations that are formed by the history of the relationship and that according to these findings it bears a positive influence not only on price, but also on quality of the relationship.

Given the complexity of banks, their large history, the central role in economies, and the interdependency of various relationships, agency theory comes in play and helps to analyse what motivates different principals and agents to organise themselves in the ways they do.

Barth *et al* (2004) provide helpful insights in the supervision of banks and agency problems, indicating that: First, banks are costly and difficult to monitor. This leads to too little monitoring of banks, which implies sub-optimal performance and stability. These insights are consisting with the findings of Caprio and Klingebiel (2003), where they report on systemic banking crises in both non-OECD as well as high income OECD countries. Official supervision can ameliorate this market failure. Second, because of informational asymmetries, banks are prone to contagious and socially costly bank runs (for example Argentina 2001, Uruguay 2002). Supervision in such a situation serves a socially efficient role. Third, many countries choose to adopt deposit insurance schemes. This situation (1) creates incentives for excessive risk-taking by banks, and (2) reduces the incentives for depositors to monitor banks. Strong, official supervision under such circumstances can help prevent banks from engaging in excessive risk-taking behaviour and thus improve bank development, performance and stability (Caprio and Klingebiel, 2003).

Alternatively, powerful supervisors may exert a negative influence on bank performance. Powerful supervisors may use their powers to benefit favoured constituents, attract campaign donations, and extract bribes (Shleifer and Vishny, 1998; Djankov *et al.*, 2002 and Quintyn and Taylor, 2002). Under these circumstances, powerful supervision will be positively related to corruption and will not improve bank development, performance and stability. From a different perspective Kane (1990) and Boot and Thakor (1993) focus on the agency problem between taxpayers and bank supervisors. In particular, rather than focusing on political influence, Boot and Thakor (1993) model the behaviour of a self-interested bank supervisor when there is uncertainty about the supervisor's ability to monitor banks. Under these conditions, they show that supervisors may undertake socially sub-optimal actions. Thus, depending on the incentives facing bank supervisors and the ability of taxpayers to monitor supervision, greater supervisory power could hinder bank operations (Barth *et al*, 2004). This has also been confirmed in a report (CSFI, 2005) where 440 respondents rank the rise of regulation to be the number one risk facing the (banking) industry and the costs and distractions of regulation as well as the false sense of security it brings were the main reasons cited for its strong showing. The industry according to this report clearly believes that regulators are getting it wrong both from a cost perspective, driven by what banks see as an excessive focus on consumer protection, and from too much complexity, which is seen as killing competition and promoting a herd instinct in financial institutions (CSFI, 2005).

Intermediation theory, transaction cost theory and agency theory combined helps us understand why banks exist, what is their role in societies and the role of regulation and supervision, as well as their effectiveness.

5.2.2. On credit and credit rating:

Credit risk, or the risk of default, has always been a major topic of concern for banks and other financial intermediaries, and any agent committed to a financial contract for that matter. While concern for the possible default of counterparty on an agreed-upon financial contract is centuries old, modern techniques and models have arisen in the last decades that help master the problem. Whereas external credit rating exists for already 100 years, only in recent years banks have started to formalize their own internal credit rating, inspired by changing regulatory frameworks. What credit rating actually entails is best described by one of the speakers at the conference;

Mr. Ricardo Zerbino (page 80); *we should consider that credit rating, with all its imperfections, is a tool which is very useful for private investors, for institutional investors who act in the capital market and also for financial institutions, particularly banks, because it is a reference element which is very important, which complements auditing, which only gives us a vision of what has happened up to thatmoment, and can give us a glimpse of the solidity and the financial structure of the company, but it does not look beyond in general terms.*

Before credit rating and credit ratings agencies came into play, all financing was either done on a transactional basis, i.e. commodity finances for example or on the basis of a relationship between borrower and financier. At the beginning of the relationship, as in Stiglitz and Weiss (1981), there is no possibility to select borrowers according to their quality. Hence, problems of adverse selection and moral hazard have to be considered. In this research the argument was made whether Basel II improved regulation could help to solve these problems, and – alternatively - whether they may become counterproductive to the suggested strengths and the position of housebanks (relationship banking) – in a close long term relationship with the borrower, as pointed out by Hendrik Lühl (conference paper Annex 1).

A credit rating is not, in general, an investment recommendation concerning a given security and as has been illustrated by the findings on hypothesis H.2.1., the role of credit rating agencies can be described as a constructive and valuable complementary tool. While the rating agencies use similar methods and approaches to rate debt, they sometimes however come up with different ratings of the same debt investment. In their studies of the credit rating industry Cantor and Packer (1994) illustrated this.

The dominant paradigm seems to suggest that increasing application of technology and modelling, whilst measuring credit risk, in large part inspired by market developments, such as derivative market development, globalisation, the liberalisation of financial markets, and last but not least the suggestion that with stricter controls, through Central Bank and Basel II regulation, credit risk and secondary systemic risks may be better managed. It is made clear however that through the findings of hypothesis 2.2., arguing that credit rating agencies, despite their long history and expertise do not really possess competencies, which may prevent default risk, the role of ratings agencies is limited and relative, as illustrated by Mr. Rafael Bonasso; Conference quote (page 58); *We know that a rating at the end of the day is a third party that analyzes how the bank is today, things might change in the future.*

In addition through the acceptance of hypothesis 2.3., the conclusion could be drawn that the role of credit rating agencies should be more critically assessed and their influence in finance should be reduced. Although given the oligopoly in the market of rating agencies (more than 80% of the business being conducted by only three companies), it is clear that the influence of these agencies can be very high and perhaps sometimes too high. Given the specific sample however, consisting of not too many credit rated companies in rather immature markets on one side and bankers banking that same market, the outcome of this question could substantially differ should the issue be posed in mature capital market surroundings. It shows us that here too it all depends from which perspective the issue is being approached, as the following two statements from the conference illustrate;

Conference quote Mr. Ricardo Zerbino (page 81); *So to conclude, credit rating is a necessary tool, as all tools it is imperfect, and we have already seen that it does not necessarily provide security, nor has it prevented crises in different markets of the world........... and I would say that it is indispensable for the development of the capital market.*

Conference quote Mr. Karl Weinfurtner (page 85); *Most companies in Germany have no ratings. Most are family-owned companies, medium-size companies, and for them I think there was no necessity in the past for a rating, because of the close ties they had to banks, what was called housebank, principal bank relationship. But this will change in the future, with Basel II coming.*

The findings on hypothesis H.2.5., “The new Basel II regulations, to be implemented in 2006, will further contribute to a better risk management and control of financial institutions and markets”, remained undecided. The most striking observation here being that 70% of the companies were still undecided, meaning that they seemed to have no opinion yet on the meaning and impacts of Basel II. While over 50% of the banks support the claim that Basel II would contribute to better risk management of banks and markets, this seems to contradict the findings of the Center for Study of Financial Innovation. In this report (Banana Skins 2005) 440 respondents rank the rise of regulation to be the number one risk facing the (banking) industry and the costs and distractions of regulation as well as the false sense of security it brings were the main reasons cited for its strong showing (CSFI, 2005). The industry according to this report clearly believes that regulators are getting it wrong both from a cost perspective, driven by what banks see as an excessive focus on consumer protection, and from too much complexity, which is seen as killing competition and promoting a herd instinct in financial institutions (CSFI, 2005). The possibility of their being a problem with implementing Basel II is illustrated by the following quote; Conference quote Mr. Hendrik Lühl (page 59)*; I think that the problem is that the internal approval procedures at least in the banks, and DEG is also governed in Germany by the banking commission, are changing. You have a veto right in these days by a credit department and even if the big bosses say “Well, we should do that”, they have a veto and these are people who do not travel.*

I mean, you can be lucky if they have some experience…. But this is something that is imposed to us by law and it is very difficult to overcome.

Ferri *et al* (2001) suggested that the Basel II proposals would increase the volatility of capital needs of banks in non-high-income countries vs. high-income countries' banks. In fact, bank and corporate ratings in non-high-income countries appear to be strongly related – and in an asymmetric way – to changes in sovereign ratings. This aspect has been looked at through hypothesis H.2.6., "The new Basel II regulations carry the risk of a further widening of the gap between high income and low income countries", which did find that separated in groups, Latin American respondents did accept the hypothesis. Obviously it is here that the question can be asked to which extent the Basel II framework is a result of a truly global effort, or whether the influence of OECD countries is dominant.

The thesis also illustrated to which extent the dominant paradigm in this particular field seems to re-enforce the belief that improved regulation and an even more refined approach to credit and credit rating, both internal as well as external, may improve agency costs. It has been suggested that for the particular field of finance and consistent with the positivist paradigm – especially the functionalist approach – the field seems to run the risk of producing more and more facts confirming a status quo of the science and their belief systems. Any adequate analysis of the nature and role of the mathematical language in finance necessarily requires fundamental understanding of the worldviews underlying the views expressed with respect to the nature and role of language (Ardalan, 2002).

5.2.3. On cross cultural differences:

Culture in the organization literature may be the great taboo of today, Hofstede wrote already in 1980 and a taboo is something we are all involved in but not supposed to speak about. It is this premise from Hofstede (1980) which has in part inspired this particular research.

Speaking on codes of best practice (comparable with what Basel II intends to do to financial markets) Former President of Volvo Latin America, co- founder of the Brazilian institute of Corporate Governance, member of the board of a range of different companies, both in location and size, and thus a man of great experience, worded the importance of culture difference (and its core values) in the most appropriate way;

Conference quote Mr. Bengt Hallqvist (page 95); *……the way to go from your current situation to best practice - it's a long way and a lot of companies will never get there. A lot of cultural differences make some of these requirements inadequate or impossible. ……. Now the way to apply it, you have to adjust to the situation, you have to adjust to the country, to cultural differences, to the size of the company, to the values of the company and so on and so forth*.

Hall, in "The dance of life" (1983), argues that humans live in a single world of communication, but that they divide that world into two parts; words and behaviour (verbal and non-verbal). Words representing perhaps 10 percent of the total emphasize the unidirectional aspects of communication – advocacy, law, and adversarial relationships- while behaviour, the other 90 percent, stresses feedback on how people are feeling, ways of avoiding confrontation, and the inherent logic that is the birthright of all people. Words are the medium of business, politicians, and our world leaders, all of whom in the final analysis deal in power, so that words become instruments of power. Hall (1983) asks; how is it possible to maintain a stable world in the absence of feedback from the other 90 percent of communication?

The concept of power and more in particular the dimension found or confirmed by Hofstede (1980) called power distance, varies according to different (national) cultures and makes that people familiar with organizations in different countries are often struck by the variety of organizational solutions to the same task problem. Its consequences to organizations may imply more or less centralization, taller or flatter organization pyramids and larger or smaller proportions of supervisory personnel (Hofstede 1980). Unfortunately, no previous studies in the relationship of cross-border finance with culture differences have been found, upon which this concept could then be further explored. The thesis then took the shape of a more exploratory journey.

It would be good (for bankers) to be aware of the observation made by Hall (1976) where he argued that the part of man's nervous system that deals with social behaviour is designed according to the principle of negative feedback. One is completely unaware of the fact that there is a system of controls as long as the program is followed (see also Hofstede, 1991 – software of the mind). Ironically – according to

Hall (1976) this means that the majority of mankind is denied knowledge of important parts of the self by virtue of the way the control system works. The only time one is aware of the control system is when things do not follow the hidden program. Most cultural exploration however begins with the annoyance of being lost. The control system of the mind signals that something unexpected has arisen, that we are in uncharted water and are going to have to switch off the automatic pilot and man the helm ourselves (Hall, 1976). This was illustrated by a comment from one the speakers at the conference;

Conference quote Mr. Hans Hanegraaf (page 123); *and cultural differences mainly become apparent when things don't develop as you want or expect………*

These observations should be applied to this field of research and inevitably raise a number of interesting issues. How for example do banks cope with these processes? Do they actually seek to work in cultures which are different from their own, or – alternatively - does their lending policy implicitly lead to a selection of cultures which seem similar? How much flexibility is needed for uniform regulations (Basel II) to be adequately and meaningful applied in more than 100 countries by 2006? How much understanding of the other culture is needed, in cross border lending, in order to make an informed judgment on the quality of the company, the integrity and capabilities of management and all other aspects relevant to the corporate governance?

Chapter 2, section 2.3. reviewed the more prominent publications, dealt with the relative strengths and weaknesses of the different methodologies in research, and outlined some of the current issues in cross-cultural research. Hall (1976) describes his views on low- and high context cultures (very much in line with Trompenaars's dimension of universalism and particularism) and suggests that if one could get behind the scenes one would find context dependant results in the majority of research projects. Coincidentally this has been one of the key criticisms on Hofstede work by Segalla *et al* (2000), where they found that scores on dimensions of culture varied according to the context of the question and that the context of the questions was clearly as important as the answer. Western science, according to Hall (1976) is striving for replicability and rigor (!) in methods and is conducted with a view to eliminating context.

In their study Segalla *et al* (2000) plea for the need of better cross-cultural knowledge, built on understanding how cultural values are tied to real organizational problems. This is perhaps one the reasons why also in the field of cross border finance there is still quite a lot of work to do.

5.3. Discussions of the key findings:

Under hypothesis H.3.1.: "Cultural differences have played a role in there having been so many accidents (defaults) throughout history in international finance", a fairly qualitative opinion has been asked from the respondents. One of the underlying problems here is that statistics on banking and finance do not reveal specific data on credit losses, for example at BIS and or the World Bank). Only in the last decade there has been a trend of somewhat more disclosure of balance sheet and profit and loss data by banks. However, for a number of reasons banks do not disclose specific origin of profits (for example country or product wise) and limit statements to; "contribution of in profits from international ......", or as the case may be distribution of profitability to divisions, such as investment banking, retail banking and whole banking. Banks neither disclose origin of losses, either be these related to specific credit losses, nor losses in propriety trading, nor losses related to the disposal of previously acquired banks or finance units (for example ING Group, with Barings and BHF (Germany). The statement on credit losses usually is being restricted to the mere mentioning of "Additions to the provision for loan/investment losses". [10]

More and more banks provide links towards the specific external rating agencies report, however these reports neither provide any more information than; "Financial performance in 2003 is also benefiting from lower credit and investment losses and efficiency gains" (Moody's/ING data). As argued in Chapter 2, section 2.2., there seems to be another aspect of agency problem in this regard.

Despite the more qualitative nature of the question, whilst discriminating to European and Latin American respondents, we find

[10] (see for example http://www.ing.com/index.jsp or http://www.abnamro.com/com/ir/ir.jsp

clear results in accepting the hypothesis, despite a rather high 25% of undecided. This can be understood by the arguments given above. Interesting questions can be raised here, whether international banks working with high profile cases like for example Parmalat, or with Enron and Worldcom[11], simply sustain that the causes are fraud or whether other elements of wrong risk assessment may have been in play. In fact we do not know. It can be argued however that it is convenient to the banks to refer to fraud, every time credit losses are reported.

If the bank does not understand the cultural context of a particular country or region, it becomes highly doubtful it will understand the risks, and this has been at the core of this thesis (Hypothesis H.3.2.). This last one was the clearest of all responses which confirmed that, whereas there seems to be an agreement on the fact that credit risks in large part are related to the management competencies - effective corporate governance and integrity of management and organization - the argument can be made that the assessment of management capabilities, governance and integrity may be hindered in those cases where the culture is little understood. In other words, if the bank does not understand the cultural context of a particular country or region, it becomes highly doubtful it will understand the risks. Rightfully the contributors to the conference observed the following key aspects;

[11] Bernie Ebbers, the former boss of WorldCom, has been found guilty in a federal court in New York of a massive fraud, and faces up to 85 years in jail, The Economist, March 16, 2005

Conference quote Mr. Nanno Kleiterp (page 7); *We have learnt a lot of lessons from that experience because always in a crisis you see a test for the choices you make and it is a test for the relationships you have.*

Mr. Osvaldo Bertone (page 53); *With regard to risks, I spoke about two types: company risk and country risk. Unfortunately I am old enough to refer to my experience..... I have gone through crises, as many as those of you who are not so young either may recall...*

The key conclusion here is recognition of the importance of a bank not understanding the cultural context of a particular country or region; it becomes highly doubtful it will understand the risks. Now some may argue that this is too obvious. Or they may say; so what? We knew this all along and we mitigate those risks by choosing the right strategy, appropriate credit rating, risk adverse account management. For illustrating purposes some of these examples displayed in the conference, are summarized below, with the aim to demonstrate that most of those observations, strategies, recommendations or however we should label them, contain elements of soft factors, things which are hard to measure, most of them however implicitly acknowledge that understanding the culture context is relevant, if not fundamental;

1. *Our strategies are built on knowing our business and environment, recognizing and adequately mitigating, and building on selected local and international partnerships with specialized and focused experience (Kleiterp).*

2. *We have always privileged long-term relationships with banks. In spite of the fact that the people have changed, we have relationships of more than 30 years with certain banks, very fruitful relationships, with ups and downs, and with a few arguments in the middle, as it should be* (Bertone).
3. *Knowing people is at least as important as the figures on the balance sheet, especially concerning their professionalism and their honourableness* (Bertone).
4. *.. it depends on the rating agency and on the attitude of the company that is being rated. It depends on the two parties, because there has to be interaction, in-depth interaction. A certain amount of information has to be generated beyond the audited balance sheets, there has to be regular reporting* (Zerbino)
5. *The quality of the people is the most important element of the company* (Zerbino).
6. *The most important rule of establishing a relationship is to show an interest in your subject*(Arnold).
7. *This is really relationship banking, that you are so involved with this that you feel it; you can smell it*(Hallqvist).
8. *We want them to know who their partner is. We have tried to create trust, beyond the figures* (Bertone)
9. *The problems that were reported were due to insufficient corporate governance and or fraud* (Lühl)

In conclusion it seems to be that practitioners acknowledge the relevance of culture in their practice, which is not only confirmed by the findings of the questionnaire, but also illustrated by the comments from the conference, as outlined above as well as in Chapter 4 of this thesis.

It remains therefore to be questioned how regulators – and in particular credit risk managers in banks – will go forward. It has been argued that current regulations in the making do not provide solutions to these issues, as was also found by Grunert *et al* (2005). They found that even in domestic lending and analyzing credit file data from four major German banks, evidence that the combined use of financial and non-financial factors leads to a more accurate prediction of future default events than the single use of each of these factors. Perhaps it would be recommendable to check why the industry according to the report of CSFI (2005), clearly believes that regulators are getting it wrong both from a cost perspective, driven by what banks see as an excessive focus on consumer protection, and from too much complexity, which is seen as killing competition and promoting a herd instinct in financial institutions (CSFI, 2005).

It could be argued though that culture in the organization literature still remains the great taboo of today as Hofstede wrote already in 1980, something we are all involved in but not supposed to speak about. This research showed that the subjects of this research in majority acknowledged such: it is now up to the regulators to do the same.

5.4. Limitations:

This study shares most of the limitations of any piece of research and the two quotes from the introduction of this thesis still hold:

"The ideas which are here expressed so laboriously are extremely simple and should be obvious. The difficulty lies, not in the new ideas, but in escaping from the old ones, which ramify, into every corner of our minds" (J.M. Keynes, The General Theory, l973).

"The facts all contribute only to setting the problem, not to its solution" (L. Wittgenstein, Tractatus, p. 149).

This research has been guided by the belief that the role of this research was exploratory, a more qualitative enquiry and that of an advisable first step to be taken before a real enquiry – a quantitative enquiry – can be undertaken. The hypotheses formulated and the applied methodology, both combined, intended to establish a reasonable and plausible argument whether practitioners share the view that cultural impacts influence the effectiveness of cross border lending and whether further credit rating (of hard factors), as a result of Basel II, will sufficiently, according to Grunert *et al* (2005); "alleviate asymmetric information problems between borrowers and lenders".

For the purpose if this exploratory research the use of the questionnaire, with its strengths and weaknesses as has been described before, was considered an adequate instrument for the exploratory objectives of the this research. They are certainly limitations to both the sample as well as the sample size regarding the validity of the findings, the sample to consist of both bankers and senior company executives operating in cross border finance, but limited between a small part of Western Europe and an even smaller part of Latin America.

Especially the organization of a conference to test hypothesis brings with it several limitations, as just a few of the hypotheses could discussed and or tested and several key concepts, even in a conference which lasted three days, could not be sufficiently explored. The conclusions, validity and reliability of findings in a conference setting are open for debate. The quotes which have been used may be considered by their authors as being taken out of perspective and perhaps in some cases a different meaning was their intent. Should this have occurred; my well intended and sincere apologies are hereby offered. The abstract of the entire conference however is enclosed with this thesis (annex 1). It should however be stressed that all statements and opinions are personal ones and do not represent the formal position of any the companies which could directly or indirectly be related to this study.

All the limitations and restrictions mentioned above are accepted to be the exclusive responsibility of the author.

5.5. Recommendations for further research:

Following the main findings from this research the following recommendation could be made:

On agency theory and agency problems, to expand on research by Kane (1990) and Boot and Thakor (1993) who focus on the agency problem between taxpayers and bank supervisors. In particular, rather than focusing on political influence, Boot and Thakor (1993) model the behaviour of a self-interested bank supervisor when there is uncertainty about the supervisor's ability to monitor banks. Under these conditions, they show that supervisors may undertake socially sub-optimal actions. Thus, depending on the incentives facing bank supervisors and the ability of taxpayers to monitor supervision, greater supervisory power could hinder bank operations (Barth *et al*, 2004). Greater transparency and accountability seems to be the way to go forward. What we have seen in the banking crises here[12] in Argentina and Uruguay (2001, 2002), which were clear bank runs, common depositors were still under the assumption that their savings (mostly in US$ billets) were just kept by the banks in the safe. For as long as taxpayers are still that illiterate in this respect, the agency relation between them and central bank (or supervisory institution), remains unacceptably high. Greater transparency was required here, as no-one cared to explain that depositors money had went (85%) to buy government bonds, which were declared in default.

[12] The author lives in Uruguay

Both qualitative as well as quantitative research is needed in order to get insight as to how successful banks have been in the last decennia with cross border lending. How does profitability of these activities relate to the amount of credit losses? How much hobby is involved? What conclusions could be drawn from these data? In an earlier pilot study for this thesis, it was considered using case studies of corporate failures and subsequent bank losses, and to interview different actors from different perspectives as to establish an understanding of the reasons behind those failures. Such type of research is only being done at a rather limited (and confidential) scale in some financial institutions. Those investigations however have a more internal character, whereas an external approach would be considered more useful.

On Credit and Credit rating, especially in view of Basel II; how would it be possible, given the findings of Grunert *et al* (2005), the conclusions of the report from the CSFI (2005) and the findings of this research, that the structure of the Basel II framework be amended, for it to include these reported soft factors, including and specifically culture aspects in case of cross-border lending in order to alleviate asymmetric information problems between borrowers and lenders.

Instead of banks rating clients, the findings of this study show that companies (clients) should be rating the banks as well. It should be researched why this is not being done, as reported in this thesis, and secondly how this could be done (broadly and institutionally). Opinions of both regulators and rating agencies should be considered. Rating banks in terms of client satisfaction would – as has been argued – improve transparency of bank services. In consultancy it has been frequently suggested to companies to perform such analysis, and obviously large multinational companies have done this already for many years. It is in this way that they decide whether a bank may be considered a core bank, or housebank and which banks are to be invited when a specific transaction comes to the market. Some generic criteria for rating the bank could be:

- Commitment with - and understanding of the bank with the company/sector/country
- Standing of the bank, including rating
- Quality and pricing of the products
- Insight in how and by whom decisions are being made regarding the credit for the company; is there any contact with these decision makers
- Level and commitment of account management, including job rotation

It has been argued that culture in the organization literature still remains the great taboo of today as Hofstede wrote already in 1980, something we are all involved in but not supposed to speak about. This research showed that the subjects of this research in majority acknowledged such and it would be an advisable first step for the regulators to do the same. A follow up on the suggestion by Segalla *et al* (2000) who plead for the need of better cross-cultural knowledge, built on understanding how cultural values are tied to real organizational problems. In such research related to cross border finance it seems that some aspects of culture will be more relevant to the subject than others. Particularly aspects of power distance, uncertainty avoidance, individualism, universalism versus particularism, as well as high versus low context are expected to play a more prominent role than some of the other culture dimensions. Perhaps such research may also identify other specific aspects of culture – differences – for example as to how different cultures handle asymmetry of information, adverse selection, opportunism and moral hazard; issues which are perhaps more relevant to the type of cross-cultural relationships in banking and credit.

In their study Segalla *et al* (2000) plea for the need of better cross-cultural knowledge, built on understanding how cultural values are tied to real organisational problems. Given that culture is considered relevant within cross-border lending (and this could perhaps be extended to all cross border activities of banks) how can bankers be educated and trained in the field cross-cultural studies?

5.6. Conclusions:

Behaviour is at the roots of cross cultural studies and it is in this field where the core hypotheses of the thesis were formulated and tested. Economics is known to be a behavioural science and it is for example transaction cost theory, which rests on two essential assumptions about the behaviour of economic actors (be they individuals or firms) engaged in transactions: bounded rationality and opportunism (Barney and Hesterley, 1996). Bounded rationality means that those who engage in economic transactions are ‘intendedly rational, but only limitedly so’ (Simon 1947: xxiv).

Opportunism is also a departure from the behavioural assumptions used in mainstream economics. While traditional economics assumes simply that economic actors behave out of self-interest, transaction cost theory assumes the possibility of self-interest seeking with guile (Williamson 1975:26). For Williamson (1985:47), opportunism includes lying, stealing and cheating, but it more generally refers to the incomplete or distorted disclosure of information, especially calculated efforts to mislead, distort, disguise, obfuscate or otherwise confuse’ partners in an exchange.

Relevant quotes from the conference in view of distinguishing opportunism as explained by Williamson (1985); (1) Mr. Ricardo Zerbino (page 81); *On management quality: we believe that this is very important, it has been mentioned here in other presentations, the quality of the people is the most important element of the company* and (2) Conference quote Mr. Osvaldo Bertone (page 52); *I believe that knowing people is at least as important as the figures on the balance sheet, especially concerning their professionalism and their honourability. I think that when people are honourable, there may be problems, but they can be solved easily.*

Two executives, of rather large companies, arguing in the same direction, pointing out what according to them should be the most important aspect. The question to be raised could be then: how to do this? One way of approaching this phenomena is illustrated by the emphasis on relationship banking, by Mr. Bengt Hallqvist; ....*and this is really relationship banking, that you are so involved with this that you feel it, you can smell it* (Bengt Hallqvist, conference quote page 74).

The Basel committee which published the new Basel II framework on bank regulation and supervision is considered an excellent product by its Chairman Jaime Caruana, and was agreed by all Committee members and the result of long and careful discussions, wide consultations and comprehensive impact studies (The Banker, 2004). Whereas Basel II covers the entire risk profile and supervision of financial institutions, this research was limited to the cross border lending by banks to companies and provides the views from both practicing international bankers and their customers on their expectations regarding Basel II, credit rating and the relevance of context and culture differences.

Boot and Thakor (1993) model the behaviour of a self-interested bank supervisor when there is uncertainty about the supervisor's ability to monitor banks. Under these conditions, they show that supervisors may undertake socially sub-optimal actions. Thus, depending on the incentives facing bank supervisors and the ability of taxpayers to monitor supervision, greater supervisory power could hinder bank operations (Barth *et al*, 2004). This has also been confirmed in a report (CSFI, 2005) in which 440 respondents rank the rise of regulation to be the number one risk facing the (banking) industry and the costs and distractions of regulation as well as the false sense of security it brings were the main reasons cited for its strong showing. The industry according to this report clearly believes that regulators are getting it wrong both from a cost perspective, driven by what banks see as an excessive focus on consumer protection, and from too much complexity, which is seen as killing competition and promoting a herd instinct in financial institutions (CSFI, 2005).

The findings on hypothesis H.2.5., "The new Basel II regulations, to be implemented in 2006, will further contribute to a better risk management and control of financial institutions and markets", remained undecided. The most striking observation here being that 70% of the companies were still undecided, meaning that they seemed to have no opinion yet on the meaning and impacts of Basel II.

Speaking on codes of best practice (comparable with what Basel II intends to do to financial markets) Former President of Volvo Latin America, co- founder of the Brazilian institute of Corporate Governance, member of the board of a range of different companies, both in location and size, and thus a man of great experience, worded the importance of culture difference (and its core values) in the most appropriate way; Conference quote Mr. Bengt Hallqvist (page 95); …… *it's a long way and a lot of companies will never get there. A lot of cultural differences make some of these requirements inadequate or impossible…. ..Now the way to apply it, you have to adjust to the situation, you have to adjust to the country, to cultural differences, to the size of the company, to the values of the company and so on and so forth.*

In a three days conferences titled; “The future of relationship banking”, 80 senior executives from international banks and large companies were gathered in Punta del Este, Uruguay [13] and were asked to speak about these aspects. A transcript of the conference is provided as annex to this thesis (Annex 1) and serves to triangulate the other findings of this research. Main findings of three management papers were presented by the researcher during the conference. A survey was performed during the conference and in addition, through an online survey, in total 106 practitioners in the field participated in the survey. Results show a variation of conclusions, but very especially seem to confirm the view, contrary to the approach taken in Basel II, that cultural differences and context are felt to be highly relevant in cross border lending.

The relationship between banks, credit rating and culture is not an area which has been thoroughly explored by scholars and practitioners. Cross border lending however can not be undertaken without crossing cultures. This research explored this particular relationship (lending to other cultures) and explained the role and position of banks, through combining existing economic theories.

Grunert *et al* (2005) have found that even in domestic lending the role of non-financial factors in internal credit ratings remain ambiguous, whilst the eligibility of financial factors as inputs for internal credit ratings is widely accepted. Analyzing credit file data from four major German banks, they found evidence that the combined use

[13] Conference sponsored by FMO, DEG and DBA March 21-24, 2004, Hotel Conrad Punta del Este

of financial and non-financial factors leads to a more accurate prediction of future default events than the single use of each of these factors. It is argued in this thesis that in case of cross border lending these non-financial factors may be even more relevant.

The key argument of this research was that within the context of banks and credit – culture seems to be receiving little attention from practitioners as well as scholars, which in part is reflected through the Basel II accords, but also can be observed in published work in the field of finance. Bankers all over the world however seem to agree on the fact that corporate credit risks in large part are related to the competencies of management of companies and organizations. The argument was made that the assessment of management capabilities may be hindered in those cases where the culture is little understood. In other words, how do banks evaluate management of another culture for example, if they understand little of it?

This research in the area of banks, credit and culture started off 4 years go more ambitious, where replication of subsequent findings of Hofstede's type of research have not been found and the mere relationship between credit (risks) and culture (differences) had not been studied so far. Instead, the focus of the study needed to be gradually amended into an exploratory research as to being able to answer the key hypothesis of this study whether culture should be a concept to be taken into consideration, according to practitioners in the field of cross border finance.

One of the findings regarding banks and cross border finance was the conclusion that both clients of banks would be benefited, if banks were rated in terms of clients or clients' satisfaction, and that – asked separately - the quality of the banks should also be rated in accordance with client satisfaction. It was argued that these findings are first of all relevant to the marketing side of a bank, which is a complex area. Perhaps transparency of banks could be improved using the tool of providing rating of banks in terms of clients' satisfaction. Secondly these findings perhaps should be relevant for rating agencies – and supervisory institutions – as to consider client satisfaction as an additional factor measuring the quality of a bank.

Although the concept of housebanks may not be universally know (specially refers to findings in North Western European countries) the acceptance of the hypothesis that a housebank (strong relationship bank), is expected to produce positive results and effects on either improved corporate control as well as more competitive credit for the client, suggest that indeed according to Granovetter (1985) transactions are influenced by expectations that are formed by the history of the relationship and that according to these finding it bears a positive influence not only on price, but also on quality of the relationship.

It would be good (for bankers) to be aware of the observation made by Hall (1976) where he argued that the part of man's nervous system that deals with social behaviour is designed according to the principle of negative feedback. One is completely unaware of the fact that there is a system of controls as long as the program is followed (see also Hofstede, 1991 – software of the mind). Ironically – according to Hall (1976) this means that the majority of mankind is denied knowledge of important parts of the self by virtue of the way the control system works. The only time one is aware of the control system is when things do not follow the hidden program. Most cultural exploration however begins with the annoyance of being lost. The control system of the mind signals that something unexpected has arisen, that we are in uncharted water and are going to have to switch off the automatic pilot and man the helm ourselves (Hall, 1976). This was illustrated by a comment from one the speakers at the conference;

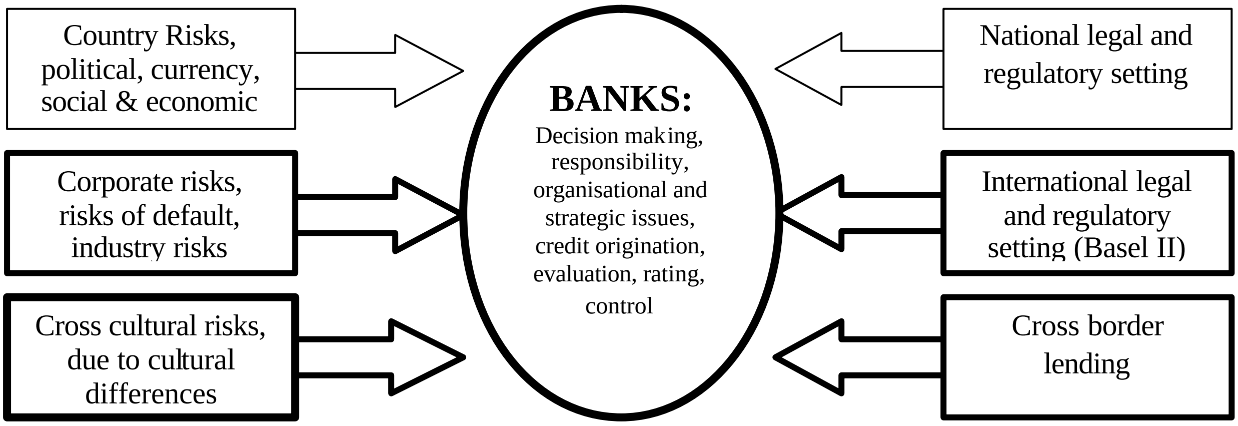
Conference quote Mr. Hans Hanegraaf (page 123); *and cultural differences mainly become apparent when things don't develop as you want or expect……….*

These observations should be applied to this field of research and inevitably raises a number of interesting issues. How for example do banks cope with these processes? Do they actually seek to work in cultures which are different from their own, or – alternatively - does their lending policy implicitly lead to a selection of cultures which seem similar? How much flexibility is needed for uniform regulations (Basel II) to be adequately and meaningful applied in more than 100 countries by 2006? How much understanding of the other culture is needed, in cross border lending, in order to make an informed judgment on the quality of the company, the integrity and capabilities of management and all other aspects relevant to the corporate governance?

“If the bank does not understand the cultural context of a particular country or region, it becomes highly doubtful it will understand the risks, and this has been at the core of this thesis” (Hypothesis H.3.2.). By far the clearest of all responses which confirmed that, whereas there seems to be an agreement on the fact that credit risks in large part are related to the management competencies - effective corporate governance and integrity of management and organization - the argument can be made that the assessment of management capabilities, governance and integrity may be hindered in those cases where the culture is little understood. In other words, if the bank does not understand the cultural context of a particular country or region, it becomes highly doubtful it will understand the risks.

Going back to the original conceptual framework given below, cross border lending is a complex field, which demands careful processes and controls. In this thesis cross border lending was limited to lending by banks to companies across their borders. Given the specific responsibility of banks towards their depositors, their stakeholders, the regulatory authorities and perhaps society at large, due consideration needs to be given as to if credit is being granted and risks are being assumed.

Figure 14 Adjusted conceptual framework



As can be derived from the above figure, cross cultural risks as a result of cultural differences should be considered by regulators and banks. This research explored whether the exclusion of theses risks was considered correct by practitioners and evidence showed that this exclusion was found incorrect. Therefore the implicit views underpinning the Basel II accords are not being shared by the participants in this research.

In conclusion it seemed to be that practitioners acknowledge the relevance of culture in their practice, which is not only confirmed by the findings of the questionnaire, but also illustrated by the comments from the conference, as outlined above as well as in the Chapter 4. It remains therefore to be questioned how regulators – and in particular credit risk managers in banks – will go forward.

It could be argued though that culture in the organization literature still remains the great taboo of today as Hofstede wrote already in 1980, something we are all involved in but not supposed to speak about. This research showed that the subjects in this study in majority realised this.

5.7. Implications of research findings:

Cross cultural risks as a result of cultural differences should be considered by regulators and banks as has been demonstrated in this research. The Basel II regulations as well as current banking practices overemphasize the effects of improved regulations. It is assumed that an enhanced architecture of risks management techniques and practices will produce convincing positive results. Whereas it is undeniable that the new regulations will be rather adequate to better measure the different risks banks undertake, differentiated amongst operational risks, market risks as well as credit risks, and where capital adequacy for each individual bank will be more appropriately aligned to the aggregated risks the particular bank supposedly carries, these improvement in regulations will not improve the quality of cross border lending, given that risk assessment is being done without properly considering soft factors, including cultural differences. It also remains to be seen whether the improved regulations will help banks to improve their assessment of risks in case of very large high profile cases such as Worldcom, Parmalat and the like.

Basel II and the current banking practices are the result of bad banking in recent banking history and the accurate recognition that every bank carries a different risk profile and thus requires capital – adequate - to cover the specific risks of that specific bank. This approach however should not have been a purely technical exercise only, predominantly influenced by the risk management and credit rating areas of financial and capital markets. The marketing side of the financial business has had too little influence on the outcome of Basel II, as was recognised by several participants in this research. It is rather disturbing that according to the research by the CSFI (2005), overregulation already forms the major threat of the financial industry, even one year before Basel II will be officially introduced.

Based on the previous observations and the findings of this research the following specific recommendations could be made;

5.7.1. Implications for banks;

- Management of banks need to recognize that in recent years too much autonomy and decision making power has been with the risk management and internal controls of their banks.
- Marketing and product management of the banks, need to get involved in the interpretation and application of the new Basel II regulations, instead of passively accepting the new rules and restrictions. They have to defend the business side of their banks and need to protect the interests of their customers more adequately. So far new Basel II regulations have been often used as an argument why banks could not provide the kind of services clients requested for. At times these new regulations were used in

negotiations with clients in order to leverage to position of the bank even further.

- A new consensus and equilibrium needs to be established which will reconcile the benefits of good regulation with the marketing opportunities and needs of the banks, including sufficient flexibility for innovation.
- As with any other business, management of banks should put their clients' needs (again) central to their decision making and strategy formulation.
- Banks should consider how to measure their business success in terms of client satisfaction, as was shown in this research.

5.7.2. Implications for regulators and Central Bankers;

- The new Basel II regulations are the result of many years of hard work and an enormous amount of consultation with markets. BIS and Central Banks need to recognize however that their consultation with markets has been too much dependant on risk avoidance and risk measurement and that the business side of the financial market has had little to no voice.
- It is never too late to recognize criticism to the new regulations and some adaptations need to be considered, especially in creating sufficient flexibility for the banks to continue operating successfully in cross border lending and markets. A realisation of the fact that soft factors,

such as cultural differences are relevant risk drivers would be an advisable first step.

- Basel II is a complex change to markets which causes confusion and sometimes sets in fear. This research showed that up to 70% of the banks larger customers did not know much about Basel II and even at operational levels within the banks, confusion is still at large. It would be helpful for Central Banks to assist banks to explain better to the markets the aims and benefits of the new regulations.

5.7.3. Implications for the corporate clients;

- Too much autonomy and decision making power with the risk management of the banks, has not been good for the account managers to defend your business within their organisations. Ensure that your concerns reach management of your main banks, as the consequences of unwanted regulatory changes will affect your relationship with your banks.
- Companies would be benefited according to this research if banks would be rated according to client satisfaction. This observation should be voiced in contacts with your banks and more specifically each individual company should have a clear policy and opinion with regard to rating their own banks and find appropriate ways to communicate both negative as well as positive experiences.

- Be aware of the fact that in accessing the credit risks of your company, foreign bankers have to understand your context, your cultural background; they should be able to understand why you do the things in the way that you do them. Besides, they have enormous problems understanding the cultural background of the country you are operating in. Already by recognizing and talking about these aspects you can be helpful to your banker to do a better job at home, defending your credit.

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