Transparency and standards: evaluating the effect of institutions

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Chapter One: Introduction

This dissertation explores transparency and standards in the financial world, and the impact that different forms of institutions have on the quality and scope of those two factors. The key institutions that are explored within this dissertation are governmental and financial regulatory agencies, at both world and micro level, with a balance being struck between them in terms of analysis. Many of the issues explored within the dissertation are examined within the context of the 2007-2010 financial crisis which resulted in record falls in the world stock markets, the collapse of large financial institutions and the bail out of large banks by government-funded rescue packages. The financial crisis has been chosen as the most appropriate context for this dissertation because it did much to highlight issues with many of the financial regulatory institutions; indeed, as discussed later in this dissertation, much of the negative repercussions that stemmed from the crisis have been attributed to failings in regulatory institutions, both in terms of their failure to foresee the crisis and in their inability to limit its effects.

One of the most obvious areas in which transparency and standards are informed by the roles and activities of different institutions is in terms of governmental activity and its effects upon practices and, in particular, the question of corruption. A study such as that by Lederman, Loayza and Soares (2005), for instance, explores the question of governmental institutional involvement through a complex cross-country panel that assesses different forms of data to make general conclusions and considerations about the nature of corruption and governmental activity, with the broad view that democracies, parliamentary systems, political

stability and freedom of the press are crucial determinants of generally lowered levels of corruption and, by definition, higher levels of transparency and standards within market and financial systems.

The relationship between governments, regulatory agencies such as central banks, and markets has been one of profound importance. This importance has become paramount in the recent economic crises around the world, because questions over the validity of regulatory decision-making or over the validity of asset appraisal by ratings agencies have been at the very centre of the debates that have been taking place. This is not, of course, a new phenomenon. As noted in Adams and Mathieson (1998, p.74), for instance, the world has been witnessing both increased interdependence of financial and capital markets on the one hand along with increasing complexity of financial operations on the other. The latter development has been one that has in large part been driven by computerisation and automation, which have massively and drastically altered the nature and scope of the kind of financial transactions and operations that have been formulated, and at the same time accelerated the processes of interconnection and interdependence that have been one of the central features of globalisation.

These questions of interdependence and interconnection have been heightened and amplified by the development and proliferation of a shadow banking system that has raised important and urgent questions about the ways in which such a system has been regulated. This dissertation will, therefore, explore such a development and the extent to which a shadow banking system has developed in parallel to mainstream institutional structures or, alternatively, the degree to which it has built up as part and parcel of existing institutions and structures. An example of the analysis of the shadow banking system and its effects on

mainstream or more visible structures, is that of Zandi (2009). The growth of off-balance sheet operations has also raised profound and vital questions about the extent of transparency on the one hand and the ways in which financial and economic institutions either contribute to it or attempt to limit it for their own private purposes, with potentially large risks for the integrated and globalised systems as a whole.

The dissertation will begin by considering the extent to which there is only one definition of a concept such as transparency or, alternatively, the way in which an idea such as transparency has been adopted and applied in different contexts to further different ends, and the extent to which there is confusion over its basic meaning and how that meaning is applied within the wider financial world.

Another central element within the analysis of this dissertation is the question of the nature and scope of institutions within the financial field themselves. Throughout the period that is often referred to as that of globalisation there have been many different forms of financial and economic deregulation, which have also had effects such as the spawning of a whole new range of institutions. Along with these developments, there have also been vast and significant changes in the kind of financial instruments that have been used in international operations, such as collateralised debt obligations (CDOs), special investment vehicles (SIVs) or credit default swaps. The extent and scale of the use of such instruments has grown enormously, once again in large part as a result of the development of widespread computerisation which has facilitated a far greater complexity than is possible without the use of computers. The effects of these developments have been massive, and raise important questions about the quality of such developments, as well as related questions about the transparency and openness, as well as the accountability, of such developments as well.

Linked in to the development of such new institutions and instruments, this dissertation will also examine the relationship between different organisations and agencies and the degree to which there is an effective separation of powers between them, or, alternatively, the degree to which there have been both unethical and inefficient blurring of the boundaries between separate entities and their jurisdictions which have led to problems in terms of both transparency on the one hand and the maintenance of proper standards of operations on the other. An example of an approach which explores these concerns is that of Kopits and Craig (1998, p.15) who discuss the nature of accountability and transparency between public and private sector. One of the problems in recent times in the financial markets has been apparent collusion between ratings agencies and other entities which has arguably led to a devaluation of the information provided to markets about the quality of certain institutions and their underlying structures. Once again, this has raised important questions about how well markets are functioning in terms of the flows of information that lead into them. This dissertation will, therefore, examine the nature of that financial and economic information, which institutions provide them, and to what extent they are accurate and produced in a clear and transparent fashion rather than one which is obfuscated, unclear and prone to tampering by entities with vested interests in certain market outcomes that may be produced to a large extent by various processes that are basically unethical or immoral.

Another aspect that will be tackled in the dissertation involves the question of whether or not the debate over transparency and requisite standards of quality in financial transactions and operations is one that is voluble enough at all times, or, alternatively, one that tends to be raised after periods of problems or scandals which then lead to short-term attempts to heighten levels of transparency and standards. If it is the case that the tendency and

trajectory of the discussion is one that is basically reactive rather than proactive, and one that follows the existence of deep-seated problems in the economic system rather than one that anticipates problems and hence prevents them before they start, this is clearly a matter that has profound and important ramifications and one that requires improved financial and institutional architecture both in terms of external regulatory systems and also the internal regulation that is conducted by firms and corporations themselves. An example of the kind of reactive process is that encapsulated in the analysis of Vishwanath and Kaufmann (2001) who argued for heightened levels of transparency and improved institutional practices and processes out of the flawed example of the Asian financial crisis in the late 1990s. It is the case that in this particular analysis it is argued that there are profound limits to transparency, and that therefore more piecemeal ways of improving it (such as limits on credit expansion) may be preferable, particularly in the case of developing countries. Nonetheless, the wider substantive point holds true, that it is preferable to anticipate problems and curtail them early rather than acting in a way that responds to their existence in the first place.

A final element within this dissertation will be to assess not only the effects of current international financial and economic institutions in terms of transparency and standards, but also the degree to which there is a moral or ethical imperative on institutions and organisations to act and behave in a fashion that is transparent. This point is examined, for instance, in Rosenthal and Berry (2009) who argue that there are various ethical and moral imperatives that by definition act as a framework within which the activities of international institutions are arranged and conducted. This is, of course, debateable, and is part of the current argument over the various reforms and transitions that are required in the way that major organisations around the world, such as the World Bank or the International Monetary Fund, operate and conduct themselves, and also how international governments act,

particularly in relation to each other. This dissertation will, therefore, examine the extent not only to which such institutions and organisations are effective, but also the moral and ethical underpinning of their activities and to what extent they should be expended to operate in ways that benefit the wider collective rather than merely furthering their own interests (often at the cost of those of others).

To summarise, therefore, the key aim of this dissertation is to examine the effectiveness of the various government and regulatory institutions which affect the financial sector in terms of their level of independence and transparency and to assess the way in which these factors assisted or hindered these institutions in dealing with the recent financial crisis. A number of secondary objectives are also addressed within the dissertation; these include a detailed exploration of the nature of the different institutions which influence the financial sector and the way in which the structure of such institutions has been affected by financial deregulation, and an exploration of the development of the shadow banking system together with an analysis of the extent to which it is integrated with mainstream financial infrastructure.

Chapter Two: Literature Review

The importance of financial transparency

One of the most important initial observations, asserted clearly in Garsten and De Montoya (2008, pp.98-100), is that of an increasing ‘polysemy’ in terms of the word 'transparency' and its uses. In financial terms, however, they argue that the dominant meaning of the term 'transparency' is that of the disclosure of market information, across a range that encompasses

everything from “price of executed trades [to] quantities, bid or ask price for standing orders, [and] market depth”. Another important element within a discourse of transparency is also that of the question of the anonymity, or otherwise, of market actors. A key example in terms of the latter was the advent of the Euronext market model in 2001, which attempted to enforce full anonymity in the trading system (p.106).

Brigham and Daves (2010, p.15) do not spend the same amount of energy exploring the question of what constitutes transparency in terms of precise definitions and the use of language, but instead argue that transparency is a central part of the process of healthy and successful financial markets and systems. They cite a number of different institutional safeguards that have been created in order to ensure the integrity of financial information and to minimise corruption and false information, such as the fact that publicly owned firms are supposed to follow the same set of accounting rules, called generally accepted accountability principles or GAAP. These standards are laid down by an institution such as the Financial Accounting Standards Bureau (FASB) whose remit also includes amending and changing the rules where necessary. There are also major institutions whose role is to monitor functioning, such as the Securities and Exchange Commission (SEC).

Brigham and Daves point out, however, that such processes have periodically failed to function properly, such as in the financial scandals of the late 1990s, early 2000s, and the recent systemic problems where institutional failures and a lack of proper safeguards were key elements of the problems that have been experienced. One of the major corollaries of such problems have been periodic changes in legislation and in governmental forms of regulation, such as the Sarbanes-Oxley Act of 2002 that emerged as a result of the damage caused by scandals such as Enron and WorldCom (p.16).

These scandals and problems have heightened debate and awareness over the kinds of changes that need to be made in the institutional architecture and regulatory frameworks that govern the flows of markets and financial systems around the world. Transparency is, therefore, at the heart of the requirements of organisations such as the World Bank or the International Monetary Fund. As asserted in Adams and Mathieson (1998, p.74), for instance, "without information [on the degree of concentration of exposures within specific markets and the linkages across markets] it is difficult for those in charge of official market surveillance and systemic risk management to know where all of the risks and vulnerabilities reside within the international financial system and where and how they might be concentrated." This has been particularly evident in the subprime mortgage crisis and its aftermath, given the ways in which the economic systems of the world have been interconnected.

As discussed in the section earlier, the shadow banking system has raised profound questions about the nature and extent of transparency and the ways in which it has been functioning within the world economic system. Zandi (2009, p.121) observes that banks had offloaded a great deal of their riskier functions and operations to the shadow system, while "policymakers took comfort in the notion that risk seemed to be spreading widely around the globe and thought that any problem in the shadow banking system wasn't theirs to worry about." This, of course, ultimately proved to be an erroneous belief system and one that was not based upon a proper appraisal of the underlying fundamentals. An example cited by Zandi is that of the structured investment vehicles or SIVs, which were established and formulated by a number of large scale banks in order to essentially make bets upon securitized loans: "At their peak in mid-2007, SIVs held $1.4 trillion in subprime RMBs and CDOs. Banks

generated handsome profits from their SIVs, earning fees for creating and managing them. Making them particularly attractive, SIVs could be structured so that their investments didn't sit on the banks' balance sheets; thus, banks faced no requirement to hold capital to protect against the SIVs' risks." This is, of course, the key vulnerability and weakness of such exotic instruments that have been relatively recently created and have been distributed on a large scale with huge ramifications for the economy as a whole. The problem of off-balance sheet operations has been at the centre of the wider troubles in the world economic system and raises the central question of the extent to which transparency and high standards have been enforced or, alternatively, bypassed in the interests of short-termism.

This view is corroborated in other analyses, for instance that of Draghi, Giavazzi and Merton (2003, p.1) who raised concerns about the rise of derivatives and the increased risks, as well as potential declines in transparency and accurate and accountable creation of information for the market as a whole: "the general point is that risk diversification through derivative instruments is more flexible than diversification through the transfer of assets. Interest rate swaps, for instance allow banks to service both their borrowers, who want fixed-interest rate, long-dated loans, and their depositor lenders, who do not wish to be exposed to interest rate risk, without the bank taking interest rate exposure itself". The whole question at the centre of the rise of derivatives in the wider economy has, therefore, related to subsidiary questions of risk and its relationship with the long and the short term. As mentioned earlier, it has also been related to the rise of off-balance sheet operations and attempts to place more risky elements on to a less visible footing.

Acharya and Richardson (2009, p.165) also examine the question of institutions and transparency, as well as that of the standards of financial operations, particularly in the case

of hedge funds: “a lack of transparency of hedge fund positions can make it difficult to assess how leveraged and exposed hedge funds are. It can also make it difficult to assess the magnitude of the counterparty risk being generated by hedge funds. Since systemic crises are characterized by investor panic and extreme flights to quality, this lack of transparency will most likely lead to more extreme reactions on the part of investors and ensuing liquidity runs on the system.” This has, therefore, been a generalised problem which has risen in tandem with the development of more complex, decentralised organisations such as hedge funds - a process that has been accelerated through the rise of computerisation which has also occurred together with various processes of deregulation (such as the Big Bang in the UK in 1986) which have allowed for more rapid and less controlled exchanges and flows of capital on an internationalised basis. Another class of institutional entity that has been at the centre of recent problems, along with hedge funds, has been that of money market funds: “After Lehman Brothers declared bankruptcy over the weekend of September 13 and 14, 2008, one of the largest money market funds, the Reserve Primary Fund, announced that it had 'broken the buck' (I.e. its net asset value had fallen below par value) because of its ownership of a significant portion of Lehman Brothers' short-term debt.” Once again, these organisations and structures required significant help and bailouts from governments, and, once again, the problems that arose within them were in part the result of a lack of transparency of operations that was systemic and therefore had not been properly regulated or controlled over a long period of time.

The correlation between increased financial deregulation and financial transparency is corroborated by Wyplosz (1998) who contends that financial markets are characterised by extensive information asymmetries and inefficiency, which in turn result in moral hazard and market failures, namely, the inefficient *ex post* enforcement of sanctions and excessive *ex*

ante risk taking. Such inefficiencies mean that there is a significant lack of transparency which can lead to the enforcement of inappropriate macroeconomic policies and, according to Wyplosz, can exacerbate market failures. The Mexican economic crisis in 1994 is used as a case in point where Mexican authorities exacerbated the negative effects of the crisis by replacing the country's peso-denominated debt with dollar-denominated debt. Evidence of the link between poor transparency and financial crises can be seen in a study conducted by Calvo and Mendoza (1998) which demonstrates that costly information about international investments can result in herding and contagion effects, while a study by Zeira (1997) posits that poor financial transparency can result in informational overshooting in the stockmarket. According to Mehrez and Kaufmann (1999), when financial markets are first deregulated, banks have limited information on specific borrowers and therefore resort to credit rationing by lending only small amounts to borrowers. However, as time passes, further information on borrowers is available, enabling banks to update their credit and to increase credit to projects with high productivity and decrease credit to projects with low productivity. If there is a high level of transparency in the economy, a solid banking system will evolve; however, if there is poor transparency, the learning process will be inefficient and credit will be incorrectly allocated such that a series of positive shocks or non-transparent policy would increase the level of exposure and vulnerability faced by banks. Thus, Mehrez posits that an increase in transparency such as an increase in the transparency of fiscal or monetary policies or of macroeconomic data would reduce the probability that financial liberalisation would lead to a crisis given that better transparency decreases the probability of banks confusing transitory shock or policy with firms' specific fundamentals. An empirical study conducted by Mehrez reveals that the increase in the probability of a crisis is much higher in countries with poor transparency. These findings are confirmed in a study conducted by Rajan et al (2007), default models for securitised subprime mortgages during the 2007-2008 financial crisis

failed due to a large extent to a lack of transparency since information 'such as time since last bankruptcy, time on the job etc. ... are not disclosed on a term sheet ... investors seldom have access to that information'. Such problems were intensified in the case of CDOs that held tranches of many different pools of mortgages. Furthermore, financial transparency actually decreased further during the crisis since regulators relaxed accounting rules for consolidating special purpose vehicles onto balance sheets, for documentation of the 'fair value' of positions in turbulent markets and for loss provisioning and measurement of stated capital, all of which increased the inefficiency of financial markets and exacerbated the effects of the financial crisis.

As mentioned earlier, one of the key effects of financial deregulation has been on the transparency and independence of credit ratings agencies. Indeed, within the US and Europe, faulty credit ratings and flawed ratings processes are perceived as being one of the key contributors to the financial crisis. In particular, they are criticised for their role in funding the growth of the asset-backed structured finance debt market which is believed to have triggered the financial crisis. Within the structured debt market, there was heavy reliance by investors on the ratings provided by rating agencies given the opacity and complexity of many debt instruments (Katz et al, 2009). The reliance on credit agencies meant that the significant growth in the market for non-traditional debt offerings led to a corresponding increase in the profitability and revenue stream of many ratings agencies. The flawed ratings process undertaken by many agencies is reflected in the fact that many ratings agencies awarded high ratings to sub-prime mortgage loans (such loans followed the "originate to distribute" model, whereby lenders originated such loans with the sole purpose of securitising them) despite the fact that increases in the defaults of the underlying assets meant that many of them were substantially downgraded. The failure of credit rating agencies to adequately

predict structured debt defaults has led to increased scrutiny into the transparency and independence of such rating agencies. Indeed, closer scrutiny reveals that there is a significant lack of financial transparency in many ratings agencies especially within the structured debt market. According to Katz et al (2009), while corporate debt ratings are based on publicly available, audited financial statements, credit debt ratings are based on non-public, nonstandard and unaudited information which is supplied by the originator. Many credit rating agencies are not under government oversight and in many cases, decisions as to credit ratings are not based on any due diligence; they 'often relied on representations and warranties from the issuers about the quality of the data which later proved to be inadequate' (Katz et al, 2009). Furthermore, given that many structured debt assets such as subprime mortgages were highly innovative and previously untested, credit rating agencies lacked sufficient historical experience to be able to provide an adequate rating and, in many cases, relied on inappropriate tools and assumptions to determine the risk of default, in many cases, relying on market assumptions which proved to be incorrect. The lack of transparency in credit ratings agencies resulted in significant deviation from standard assumptions when rating agencies were rating unique structures and the majority of rating agencies failed to disclose these changes or the assumptions on which their decisions were made. An example of such faulty assumptions can be seen in the fact that ratings agencies failed to appreciate default correlation within and across pools of assets due to common underlying economic factors such as the housing market.

According to the Katz et al (2009), many ratings agencies lack independence when formulating ratings decisions and there are significant conflicts of interest which arise principally from the 'issuer pays' business model. Given that the banks whose securities are being rated pay the ratings agency, many investment banks shop around for the highest rating

on their issuance deals, playing ratings agency against another in an attempt to achieve the highest ratings, an activity which devalued the ratings provided by agencies and helped to contribute to the recent crisis.

An overview of the financial markets

The global financial system has undergone significant change in the last few decades, which can be attributed principally to the forces of technology, globalisation and financial deregulation. Evidence of systematic financial deregulation can be clearly traced back to the 1980s (Sampson, 2010) but has its roots in the first half of the twentieth century. In 1933, the Glass-Steagall Act was passed by the US Congress in response to the Wall Street Crash of 1929 in an attempt to prevent speculative activities by commercial banks which were largely deemed responsible for the crash. The act stated that there should be a wall of separation between commercial and investment banks in order to prevent conflicts of interest. Prior to this, many commercial banks had been behaving more like investment banks in that they were engaging in risky stock trading and were issuing speculative loans to unstable companies, as well as encouraging their regular commercial customers to invest their money in risky companies without providing them with adequate information about the associated risks. The Glass-Steagall Act also decreed that banks should be divided into categories according to the type of business they conducted since it was believed that different levels of protection should be accorded to different investors. One of the key components of regulatory reform which followed the Wall Street Crash was the introduction of the Federal Deposit Insurance Corporation which continues to provide deposit insurance for bank holders, as well as supervising financial institutions within the US to ensure that they are maintaining adequate standards of financial transparency and corporate governance.

However, since the 1980s, the principles of the Glass-Steagall Act have gradually been eroded. Indeed, the systematic dismantling of the provisions of the act can be traced most clearly to the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St Germain Depository Institutions Act of 1982 which were passed in response to the 1970s recession. The passing of these acts can be seen as the precursor to future financial deregulation; they significantly relaxed the regulatory requirements imposed on financial institutions by, for example, allowing them to expand their range of services, to merge with each other and to independently increase their interest rates as well as relaxing accounting requirements, thus allowing banks to produce more favourable financial reports. As a result of such loosening, by the 1990s, banks were taking greater risks and had begun to group together loans and to sell them on to other institutions as mortgage-backed securities. Many of these securities were highly risky and consisted of loans to people who typically had low income, poor credit score and financial history and would usually not qualify for a loan in a stricter banking environment. In view of the level of risk associated with them, such loans were considered 'sub-prime'. The wave of financial deregulation also resulted in a fall in the transparency of stock and bond ratings agencies such as Moody's and Standard and Poor. Deregulation meant that such agencies were no longer subject to any government oversight which meant that any ratings that they assigned might not be truly reflective of the true potential of a security, and agencies were not required to adhere to strict regulatory requirements. In addition, in many cases, significant conflicts of interest arose since many ratings agencies were actually paid by the financial institutions whose stocks, bonds and securities were being assessed, thus leading to inflation in the values placed on securities far beyond their actual intrinsic value. The effects of deregulation were further intensified in 1999 when President Clinton signed the Gramm-Leach-Billey Act which completely

dismantled the provisions of the Glass-Steagall Act and made it possible for commercial banking operations and investment banking operations to be held within the same institution.

The most common financial institutions that accomplish resource allocation are commercial banks, mutual funds, pension funds and insurance companies (Johnson, 2000). As a result of the moves towards deregulation outlined above, many banks now offering an increasing range of securities-related products and the securitisation of traditional loans has resulted in the creation of a highly active secondary market between banks and securities firms. Financial deregulation has resulted in a plethora of complex financial instruments with a concomitant increase in the importance of market valuation by financial instruments in order to maintain transparency in the market. The formation of various regional trade agreements (namely, the EU, NAFTA, ASEAN and Mercosur) have affected the capabilities of financial firms and the scope for expansion, while increasing globalisation has led to a rise in the number of cross-border transactions which have been occurring, with the purchase of MG Rover by Tata of India being one of the most high-profile examples of this. Furthermore, a wave of mergers and acquisitions has resulted in consolidation of the banking industry, with the number of US banks falling from 15,000 in the mid-1980s to less than 9,000 ten years later (Johnson, 2000). In addition, the traditional separation between commercial banking and investment banking is now almost completely redundant with the success of 'one-stop shops' such as Citigroup. The influence of technology has been revolutionary within the financial markets with the delivery of financial products being adapted to a widening range of technological channels such as the telephone and, more recently, the Internet. 24 hour electronic trading is now a commonplace.

Although financial deregulation has gathered pace in the last couple of decades, the

desirability of such moves are increasingly coming under scrutiny, especially in light of the recent financial crisis. Some analysts argue that the free market theory that financial markets would regulate and correct themselves in the event of a shock has been resolutely disproved by the effects of the crisis, since financial deregulation means that there are now many institutions whose financial liabilities are so great that their insolvency led to several catastrophic effects for the rest of the industry. This can be reflected in the number of government bail-outs of banks which occurred during the last couple of years, with many governments effectively subverting free market principles by bailing out banks such as Northern Rock in order to prevent further negative effects on the rest of the economy. However, despite the widespread vilification that financial deregulation has received in the press, its role in contributing to financial crisis is not unambiguous. Various studies suggest that the role of financial deregulation in the financial crisis has been overstated and that certain aspects of financial deregulation actually helped to stabilise markets during the crash. According to Gattuso (2008), for example, the relaxation of rules constituted by deregulation meant that banks were enabled to operate in multiple states within the US which would enable them to better spread risk by offsetting risky transactions in one state with safer transactions in another. Furthermore, another study conducted by Gokhale et al (2009) argues that, in actual fact, the role that financial deregulation played in the crash was not significant – rather, the negative effects of the crisis can be largely attributed to the failure by financial analysts to accurately predict market bubbles in real time and the lack of pressure by political leaders. Despite the plethora of conflicting viewpoints, consensus exists on the fact that financial deregulation has led to an increasing amount of risky liabilities being assumed by banks and a decreasing level of financial transparency, and great emphasis is now being placed on the importance of regulatory reform.

The link between the effectiveness of institutions and multicultural employees

The ubiquity of the term 'multiculturalism' in the context of organisations has stressed the importance of multicultural employees in increasing the overall effectiveness of organisations. However, it is unclear whether the presence of multicultural employees can contribute to the effectiveness of international institutions. A review of the literature reveals that there can be a number of disadvantages associated with having a high proportion of multicultural employees; firstly, while the greater diversity of employees may be perceived as a good thing, it can also hinder effective interaction between employees within the institution. Employees from different cultures are likely to approach any decisions with very different predefined notions about how a given task should be approached, with many cultural values and norms being deeply and implicitly held. Such cultural differences between employees may serve to hinder smooth interaction (DiStefano & Maznevski, 2000).

However, a number of other studies have revealed a positive correlation between multicultural employees and the effectiveness of institutions. According to Seidenberg (1999), diversity of employees leads to 'more diversity of thinking', which means that better decisions are likely to be taken. This would therefore imply that greater multiculturalism of employees could result in better decisions being taken by institutions and hence in greater transparency to external stakeholders. Indeed, the link between greater multiculturalism of employees and more creative thinking has been highlighted by a number of academics; according to Goleman (1993), a high proportion of employees from diverse backgrounds within an international institution can result in 'heightened collective creativity and entrepreneurial energy'. Furthermore, Senge (1999) posits that diversity is an important asset in any institution and can form a strong basis for more cohesive teamwork and performance.

Indeed, when analysed within the context of the resource-based theory of the firm, a firm's growth and competitive advantage are modelled as functions of the unique bundle of resources that it possesses (Carpenters, Sanders & Gregersen, 2001) – this would imply that having a multicultural workforce could be seen as a competitive advantage which would help to improve the performance of the firm. This is reflected in the experience of many large corporations such as Lucent's CEO McGinn (Colvin, 1999) who avers that 'diversity is a competitive advantage. Different people approach similar problems in different ways'. In summary, therefore, it would appear that having a high proportion of multicultural employees is likely to have a positive effect on the effectiveness and overall transparency of institutions, since it will arguably lead to greater diversity of thinking and more creative approaches to existing problems which should result in more prudent decisions being taken.

Chapter Three: Research Methodology

According to Sprinz et al (2004), the research methodology used within a dissertation is a systematically structured or codified way of testing a hypothesis. Saunders et al (2007) posit that one of the most effective ways in which to formulate an appropriate research methodology to use within a dissertation is to model's one's decisions in terms of an onion consisting of six layers, each of which represents a different methodological issue that needs to be addressed. The layers consist of the research philosophy, research approach, research strategy, research choices, time horizons and data collection techniques and data analysis procedures.

One's research philosophy which constitutes the first layer of the research onion alludes to the assumptions that underpin the research which is conducted and which inform the way in

which data is collected and interpreted (Johnson & Clark, 2006). The philosophical approach which has been adopted within this dissertation is that of an interpretivist/social constructionist context. This was chosen in favour of the alternative ontological perspective which advocates a methodology which is more akin to that of natural science. My decision to adopt an interpretivist/social constructionist perspective in conducting the research for this dissertation is due to the fact that there is no absolute truth concerning the research subject at hand. In other words, the effectiveness of institutions in terms of their transparency is essentially determined by the decisions of particular individuals within a particular historical and cultural moment – given the inherent irrationality of human beings, relying on an ontological framework to adopt a scientific approach to this issue would be clearly inadequate.

The research approach to be adopted represents the second layer of the onion. The approach that is used within this dissertation is a deductive approach which is typified by an emphasis on the collation of qualitative data; this is usually more flexible than the alternative scientific approach which places greater emphasis on the collection of quantitative data and on the formulation of causal relationships between different variables. My decision to rely on the use of qualitative data in this area rests on the fact that there exists a significant body of qualitative studies and literature which address the subject of this dissertation. Furthermore, as discussed above, given the fact that an interpretivist/social constructionist perspective is being adopted in this dissertation, relying on quantitative data to explore the effectiveness of institutions would be overly reductive since a large proportion of this subject matter is a result of the decisions of individuals and hence it would be problematic to model this accurately using quantitative data.

The third layer of the onion is the research strategy to be used. The strategy being used within this paper is that of archival research. In other words, a range of records, documents and academic studies will be used to enable me to explore the subject. As mentioned above, a significant body of studies and research into this subject area exists which can yield useful insights into the subject of this research. One of the issues with relying on archival research, of course, is that the researcher is essentially limited to using the results that have been collected by other researchers based on their research topics which may differ slightly from my own, and therefore, the studies that are analysed may not be truly relevant to the subject of this dissertation. However, given the amount of literature available in this area, this is unlikely to be a significant problem; furthermore, given the constraints imposed by this dissertation in terms of time and cost, it would be more useful to examine the conclusions which have been drawn relating to the effectiveness of institutions by pre-existing studies rather than carrying out a primary study.

One's research choices, or the decision of whether to use quantitative or qualitative data, form the fourth layer of the onion. Each form of data inevitably has its own weaknesses and thus it would be prudent to rely on an amalgamation of quantitative and qualitative data within one's dissertation (Saunders et al, 2007). However, as described above, the nature of the research subject would imply that the use of quantitative data would not be truly representative of the subject being explored, and, furthermore, the greater availability of qualitative data compared to quantitative data has informed the decision to rely on qualitative data. One way to resolve this issue would be to carry out my own primary research study which carries out statistical analysis on quantitative data in this area, but this would be limited by the constraints imposed by the dissertation.

The time horizons within this dissertation, or the fifth layer of the onion, focus principally on the effectiveness of institutions during the recent 2007 to 2010 financial crisis, although the effects of the financial deregulation of the 1980s on institutions are also examined. My decision to focus on the 2007 to 2010 financial crisis is due to the fact that this episode highlighted a number of weaknesses in the prevailing institutional infrastructure and, given the recent date of the crisis, it is most likely to be more representative of the current state of institutions than the overview of any previous financial crises would be.

Finally, the sixth layer of the onion consists of one's data choices and research techniques. As discussed above, the research technique utilised within this dissertation is that of secondary research, with a particular focus on studies which have been conducted into the role played by government, political institutions and regulatory institutions into maintaining financial transparency and standards, as well as an analysis of the development of the shadow banking system and the ethical imperatives associated with financial transparency. The outcome of a study which was conducted into analysing the relationship between the effectiveness of institutions and the presence of a high proportion of multicultural employees is also examined.

Chapter Four: Findings

The role played by government and political institutions in financial transparency and standards

Arguably, the entity with the most significant role in affecting levels of transparency in the financial markets is the government, given that it wields most power in deciding regulatory

requirements. According to Banerjee (1997), the government typically intervenes in the case of market failures where private provision is not a suitable alternative. Financial corruption exists as a consequence of the existence of rents and monitoring failures; thus, the level of financial corruption depends on the political institutions present which in turn determine the incentives facing individuals with and within the state. According to Lederman, Loayza and Soares (2001), political institutions exercise control on financial corruption and on ensuring financial transparency and standards in general by two mechanisms. The first mechanism is political accountability; the study conducted by Lederman, Loayza and Soares posits that the presence of mechanisms which increase political accountability, either by encouraging the punishment of corrupt individuals or by reducing the informational problem related to government activities, leads to a reduction in the level of corruption. The degree of political accountability is in turn determined by the specific features and structure of the prevailing political system and depends, in particular, on the degree of competition in the political system, the existence of checks and balances mechanisms throughout government and the overall transparency of the system. According to Linz and Stepan (1996), the existence of fair elections within a country ensures that politicians who engage in inappropriate policies can be held to account by the electorate and, therefore, institutions which increase the potential punishment of politicians who engage in inappropriate policies will enhance the strength of this mechanism in controlling politicians' behaviour. Another possible mechanism which could increase political accountability within a system is any rule or institution which lengthens politicians' time horizons – this would encourage politicians to focus further on long-term goals thus incentivising them to adhere to strong governance principles. The corollary of political systems which allow for executive re-elections is therefore less corruption and greater financial transparency (Bailey and Valenzula, 1997). Furthermore, as mentioned earlier, the presence of adequate checks and balances throughout government can

ensure the presence of adequate incentives to prevent abuses of power and to encourage government to act in the interest of citizens (Laffont and Meleu, 2001). Adequate separation of powers within government should deter government branches from colluding with each other, as well as enabling the creation of mechanisms to punish government officials that misbehave, thus reducing the level of corruption. According to this definition, parliamentary governmental systems are preferable since they encompass sufficient separation of powers and enable closer monitoring of the executive by the legislature which helps to increase accountability and thus reduce corruption. It is clear, therefore, that political stability is an important prerequisite in ensuring adequate separation of powers and monitoring of government branches. According to Fackler and Lin (2001), another key requirement in political institutions to ensure a low level of financial corruption is a high degree of transparency which depends in turn on issues such as freedom of the press, freedom of expression and the level of centralisation in the government. Such freedom of expression ensures that any wrong-doing by government officials is openly published, thus increasing the flow of information between government and citizens and thus acting as a further punishment mechanism to curtail opportunistic behaviour by government. Furthermore, decentralisation ensures that any problems with information asymmetry are smaller which enables easier monitoring since the presence of smaller constituencies means that it is easier for the performance of government officials to be monitored as well as reducing the risk of collective action problems related to political participation which can be an issue with centralised government, thus indicating that decentralised political systems are more likely to result in lower levels of financial corruption (Nas et al, 1986).

The second mechanism by which political institutions affect financial standards is through the structure of provision of public goods – if the government creates a competitive environment

in the provision of a public service, this reduces the capacity of government officials to extract rents from citizens and thus reduces corruption by simply increasing the level of economic competition. Increased competition among different government agencies providing the same goods increases competition among agencies and thus reduces corruption. According to Shleifer and Vishny (1993), financial corruption is most likely to arise under a political system in which different government agencies provide complementary services rather than substitutes – this can be clearly seen in a situation where different licences need to be obtained in order to perform the same job, for example, and this results in a system where power is shared among different government agencies which extract rents from a single source. This situation typically occurs in cases where government is decentralised such that different branches of government can impose additional legislation on areas already legislated by other branches, thus increasing the number of bureaucracies that citizens have to deal with in order to obtain a single product or service. Therefore, although decentralisation is deemed to have a positive effect on reducing the risk of financial corruption, it is clear that government needs to be decentralised into units that can compete effectively with each other, rather than into units which have overlapping responsibilities. Empirical analysis conducted by Lederman, Loayza and Soares (2005) on a cross-country panel found that financial corruption is significantly negatively correlated with parliamentary systems, political stability and freedom of the press. Furthermore, their analysis indicates that political decentralisation whereby expenditures are more decentralised through different levels of government lead to a reduction in financial corruption and a higher level of financial transparency. It is clear, therefore, that political institutions play a very influential role in reducing the level of financial corruption and ensuring high standards, and also suggests that anti-corruption efforts are more likely to succeed in certain political systems than others.

The role played by regulatory agencies in financial transparency and standards

A financial regulatory agency is an organisation which is responsible for ensuring the safe and sound operation of financial institutions. According to the Monetary and Financial Policies (MFP) Code, the key purpose of any regulatory agency is to instil independence, accountability, transparency and integrity into financial institutions. The role of financial regulatory agencies in ensuring financial transparency and high financial standards has come under intense scrutiny recently due to their perceived failure in predicting or in preventing the 2007-2008 financial crisis. Although their principal aim is to ensure good financial governance among companies, the recent dislocation of the financial markets has highlighted various characteristics of regulatory agencies which limit their effectiveness in monitoring governance in today's financially deregulated markets, and there have been increasing calls for regulatory reform. According to the Committee on Capital Markets Regulation (2009), the financial crisis was largely due to a lack of effective regulation.

Although the structure and scope of the financial regulatory agencies which govern the financial institutions in each country varies from country to country, the key regulatory agencies which are responsible for overseeing global financial standards are the International Monetary Fund (IMF) and the World Bank. Given that these regulatory agencies have the largest scope and thus arguably play have the most influential role in determining the financial transparency and standards of the global financial markets, this dissertation will focus on examining the ways in which these agencies affect global financial standards and financial transparency. The IMF's role is to promote good regulatory governance by providing advice and technical assistance to policy-making institutions such as central banks; strengthening the integrity and transparency of financial transactions; and evaluating the anti-

money laundering supervisory regime. Various studies have suggested a range of factors which can affect the level of effectiveness that a regulatory agency has in ensuring high levels of financial transparency. According to Das and Quintyn (2002), the effectiveness of financial regulation and the level of transparency and standards within a financial institution depend to a large extent on the level of the operational independence of the regulatory agency. The independence of regulatory agencies will ensure that all objectives are pursued free from interference from political powers. Furthermore, the MFP Code stipulates that the regulatory agencies should maintain open communication with the regulated entities and markets. Good governance also requires the regulatory agency to be fully transparent such that, if conflicts arise between or within government units, transparency in the mandate and clear rules and procedures in the operations of the agencies can contribute towards a resolution. In other words, regulatory agencies should be fully accountable for their actions through the implementation of mechanisms such as reports to the legislature, annual reports and audited financial accounts. A high level of transparency on the part of the regulatory agencies will increase its credibility in the eyes of the market and thus increase the effectiveness of its policies. This can also reduce the risk of moral hazard. The MFP Code stipulates that there should be significant clarity and transparency of the regulatory process which is an important element of good regulatory governance – in other words, regulators should adopt clear policy making processes, and all regulatory practices should be transparent in an understandable manner to interested individuals.

However, although the determinants of financial transparency in regulatory agencies is clear, it is equally clear that, in many cases, regulatory agencies have failed to adhere to the stipulations for good governance to be found in the MFP Code. Indeed, many analysts argue that the 2007-2008 financial crisis can be attributed to poor regulation and poor oversight

from regulatory agencies. The lack of transparency in the financial markets and among regulatory agencies themselves meant that agencies were not able to respond quickly enough to prevent the cycle of growing leverage and rising house prices which preceded the financial crisis. Furthermore, there appears to have been significant deficiencies in the regulatory framework in the Basel I framework which enabled banks to create off balance sheet instruments which eventually contributed to the subprime crisis (*Financial Times*, 2009). In fact, it was only after the massive insolvency of Lehman Brothers that there was systematic action taken by the regulatory agencies to address the financial crisis. As discussed later in the dissertation, this could be attributed to the fact that many regulatory agencies act in a reactive, rather than a proactive way, in taking action and introducing new regulatory legislation to prevent crises (Brunnermeier et al, 2009).

Overview of the shadow banking system

As mentioned earlier, the loosening regulatory requirements which accompanied the widespread financial deregulation of the past few decades have led to the development of a shadow banking system which operates in parallel to the key banking system. According to Cecchetti (2009), the shadow banking system refers to those intermediaries which provide services which compete with or substitute those supplied by commercial banks. Such institutions include brokerages, consumer and mortgage finance firms, insurers, investment organisations (such as hedge funds and private equity firms), money market mutual funds (MMMFs) and bank-created asset management firms. One of the key differences between financial institutions within the shadow banking system and commercial banks is that the liabilities in commercial banks consist of deposits made by customers, whereas this is not the

case within the shadow banking system. Furthermore, the amount of leverage and risk-taking which is conducted within the shadow banking system is much less transparent than within commercial banks.

The development of the shadow banking system can be traced to the first wave of financial innovation and the development of new financial instruments in the 1970s (Cecchetti, 2009) and the broadening of securities markets which lowered the cost of direct finance compared to traditional bank loans. Falling information costs in the 1980s and 1990s also enabled more investors to inform themselves about the risks of particular borrowers, thus enabling greater risk taking. Furthermore, the majority of financial regulation focused on commercial banks, leaving the shadow banking system relatively free from government oversight. Government policy which encouraged further financial innovation also benefited the shadow banking system which can be clearly seen in the emergence of MMFs in the 1970s. At this time, rising inflation led to an increase in market interest rates although federal law capped the interest rate that banks could pay on deposits, thus encouraging depositors to shift their funds from the large commercial banks to more competitive MMFs within the shadow banking system. The development of the shadow banking system was also spurred on by the availability of various profit opportunities in the 2000s such as the global housing boom and the flow of capital from countries with excess savings such as China to the United States.

The growing significance of the shadow banking system and the lack of regulatory oversight coupled with the lack of transparency meant that there was a sizeable increase of leverage in the financial system, making it particularly vulnerable to shocks. According to Cecchetti (2009), the leverage ratios in some brokerages exceeded thirty, compared to a ratio of just ten or twelve in commercial banks. Given the faster growth in the shadow banking system

relative to the commercial banking system, overall leverage in the financial system as a whole increased significantly. This was exacerbated by government regulations, such as the ruling in 2004 by the Securities and Exchange Commission which authorised an increase in broker leverage. This served to increase the lack of transparency within the financial systems by encouraging commercial banks to compete by utilising Special Investment Vehicles (SIVs) to shift assets from their balance sheets and thus avoid regulatory requirements, thus making it much harder to monitor the actual level of leverage prevalent in the financial system. Furthermore, the rapid proliferation of new, over-the-counter (OTC) financial instruments such as derivatives enabled greater risk-taking by highly leveraged institutions within the shadow banking system which were not apparent to investors, other institutions or financial regulators. It is clear therefore, that the lack of transparency engendered by the growth and dominance of the shadow banking system helped to accelerate the trajectory towards financial crisis.

Since the 2008 financial crisis, there has been a significant transformation of many institutions within the shadow banking system, with the volume of assets held within this system plunging. Many of the largest brokerages within the system failed, merged or converted themselves into commercial banks as a result of the crisis, and many investors lost confidence in MMFs which led to mass withdrawals. Many hedge funds also closed as a result of the crisis. Tighter rules and proposed regulatory reform suggests that there will be a significant reduction in the size and dominance of the shadow banking system in the future; the US Treasury is encouraging Congress to increase supervision of any financial institutions that could pose a threat to the financial system through their risk taking, the US government has tightened rules for off-balance sheet activities by banks and the US Treasury is intending to standardise many OTC derivatives and to shift trading to public exchanges where they can

be easily monitored and higher levels of transparency can be ensured.

Further regulations which have been proposed in order to limit the influence of the shadow banking system includes the introduction of an explicit leverage ratio bound that restricts the growth of leverage at the peak of business cycles, the introduction of forward-looking provisioning by banks whereby a provision is created at the time that a bank makes a loan which goes through the income statement of the bank (New York Fed, DATE), the introduction of countercyclical capital rules and explicitly basing capital adequacy rules on measures of systemic risk of particular institutions (Adrian and Brunnermeier, 2009). More specifically, the New York Fed recommends the establishment of a macroprudential systemic regulator who would be responsible for gathering, analysing and reporting systemic information which will require reporting from a broader range of financial institutions from within the shadow banking system such as hedge funds. The regulator should also be responsible for operating capital rules with a systemic focus. In short, therefore, the key emphasis of regulatory reform appears to be on restricting the role of securitisation through the imposition of stricter financial regulation and on preventing excessive leverage and maturity mismatch within the shadow banking system.

The nature of financial regulation

As mentioned earlier in this dissertation, there is some debate about whether the passing of new pieces of financial legislation is proactive or reactive. In other words, is the passing of new legislation a reaction to deep-rooted economic problems which have been identified and is it intended to prevent future crises from happening which could be triggered by such problems, or is it merely a reaction to crises which have already happened and an attempt to

prevent similar crises from happening again? More importantly, perhaps, is the question of which approach is preferable.

According to Brunnermeier et al (2009), the majority of financial regulation is extended incrementally rather than in discrete steps and in the majority of cases, new regulation is passed to close a loophole which has been exposed by an earlier fraud or financial crisis. Even the passing of the Basel I Accord in 1988 which was perceived by some to be a discrete jump in the passing of financial regulation was, according to Brunnermeier, merely a consolidation of 'pre-existing best practices in the key nation states, without much overt attempt to rationalise them against fundamental principles, or underlying theory'. In fact, the only situations in which a significantly new piece of legislation is passed is in reaction to large financial crises such as the passing of the Glass-Steagall Act and the introduction of deposit insurance for banking customers after the 1923 Wall Street Crash. According to Brunnermeier, the adoption of such an incremental approach in the passing of financial legislation has its benefits since it is generally 'practicable, do-able and commonsensical'. This view would appear to be corroborated by Vishwanath and Kaufmann (2001) who argue that there are limits to transparency and, in certain cases, the introduction of new proactive legislation could cause speculation and result in greater market volatility – indeed, a study conducted by Bushee and Noe (2000) reveals that improvements in disclosure practices are correlated with subsequent increases in stock market volatility. However, the failure of financial regulation to prevent the 2007 financial crisis and its failure to stem the cycle of leverage, credit expansion and housing prices which resulted in this debacle suggests that this approach may be erroneous and, rather, it is necessary for government and regulatory agencies to frequently examine the underlying principles of financial regulation to assess whether or not the existing regulations are appropriate. In fact, the case of the recent

economic crisis would appear to confirm the contention that financial regulation is mainly reactive rather than proactive since no proactive action was taken prior to the crisis; no regulation was drafted to prevent banks and other firms from pursuing short-term profit maximisation, nor were regulations regarding capital, liquidity or remuneration tightened. A further example of the way in which financial legislation fails to identify deep-seated economic problems and prevent future crises can be seen in the gradual dismantling of the Glass-Steagall Act after the 1970s recession. The passing of the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St Germain Depository Institutions Act of 1982 was arguably a reaction to the recession of the past few years but failed to foresee the potential detrimental effects that could arise as a result of such financial deregulation.

It would appear, therefore, that a proactive approach with regards to financial regulation is desirable. This is evidently the attitude which has been adopted by the Financial Services Authority (FSA) which is hiring 460 new staff in an attempt to improve its supervision of the financial sector and assume a new 'proactive' approach (*Times Online*, 2010). The FSA states that such a move can be attributed to its decision to adopt a more 'confrontational and risky' approach to regulation after admitting that it had not been proactive enough in talking mis-sold financial products. According to Hector Sants, Chief Executive of the FSA, 'this proactive approach to supervision requires significantly more people than the old reactive model'. However, while this is clearly the case, it is important to bear in mind that ,in practice, the complexity of the financial markets and of the economic environment means that it is often difficult to foresee any economic issues that may arise in the future and considerable disagreement and uncertainty usually exists over the potential repercussions of new pieces of legislation. Furthermore, the passing of any proactive pieces of legislation is

likely to face a greater level of objections when being passed and, even if successful, is likely to encounter a significant time lag before it is actually in force.

Financial transparency as an ethical imperative

In today's corporate environment, financial transparency is perceived as a prerequisite for any large corporation. Indeed, the emphasis on financial transparency would seem to suggest that it is almost an ethical imperative for companies to ensure that they meet certain standards of financial transparency and, in instances in which it is clear that companies have not adhered to this standard, management is often criticised by the press for being selfish, opportunistic and greedy. This strongly suggests that the requirement for corporations to be financially transparent is much more than simply a condition to ensure the efficient functioning of the market – rather, it is an important value to which all ethical corporations should adhere.

The perception of financial transparency as an ethical imperative is explored by Rosenthal and Berry (2009) who posit that legitimate global governance institutions should possess three epistemic virtues. Firstly, they should generate and provide reliable information about coordination points; secondly, they must be narrowly transparent – in other words, they should be accountable to the extent that it is possible for third parties to determine whether the institution is in fact performing their current coordinating functions efficiently and effectively; and thirdly, they must be broadly transparent – in other words, they must have the capacity to revise the current terms of their accountability and should allow frequent contestation of their current terms of accountability.

However, despite the desirability of such conditions, the recent financial crisis made it clear that very few institutions actually adhere to such conditions. For example, the bail out of Lehman Brothers in 2008 revealed a fundamental lack of transparency and clarity in their previous financial dealings. It is clear that, in order to ensure that organisations actually adhere to these principles, an appropriate form of regulatory architecture needs to be present. Various suggestions as to how to increase financial transparency within institutions have been encompassed in a number of calls for financial reform. According to the Capital Markets Report (2009), for example, greater transparency in the financial market is necessary in order to ensure greater protection of investors. The report suggests that this can be achieved through a thorough reform of the securitisation process. The report posits that originators need stronger incentives to originate loans that conform with what they have promised, thus improving the alignment of economic interests between originators and investors which can be achieved by strengthening representations, warranties and repurchase obligations as well as requiring increased disclosure of originators' interests in securitised offerings. A reform of this process would include the outright prohibition of high-risk practices such as 'no doc' loans. Transparency would be further increased by increasing loan-level disclosures and encouraging regulators to analyse ways of improving the standardised public disclosure package. Furthermore, the report also calls for thorough reforms to be made to the operations of credit ratings agencies, developing globally consistent standards to restore confidence in the integrity of credit ratings, ensuring unitary systems of enforcement, avoiding governmental interference in the ratings process, reviewing references to credit ratings in regulatory frameworks and increasing disclosure regarding ratings of structured finance and other securities.

In addition, the report also states that a thorough review of the fair value methodology used in

accounting procedures needs to be conducted in order to encourage companies to meet the requirements of financial transparency and suggests, instead, using market prices and fundamental credit analysis as more accurate measures. The report concludes by emphasising the importance of separating regulatory and financial reporting accounting, subject to a check that regulators are not using accounting rules to avoid the recognition of clear losses.

The correlation between multiculturalism and the effectiveness of institutions

A study conducted by Banutai and Bizjak (2009) explored the correlation between multiculturalism and institutional effectiveness by focusing on a sample of 284 public administration managers from the European Commission. Their hypothesis was that public administration managers with a higher possession of multicultural skills would make a positive contribution to the organisational outcomes of their institution and that this would consequently result in greater openness and transparency, higher levels of stakeholder satisfaction and support, productivity and successful change leadership. While the study which was conducted did not focus specifically on the case of a public institution operating within the financial sector, the outcomes of the study should prove useful in providing an overview of the correlation between multiculturalism and the effectiveness of institutions in general, the results of which could be extrapolated to apply to any regulatory or governmental institutions.

The results of the study indicated that the presence of multicultural skills were not significantly correlated to organisational outcomes related to managing internal transactions such as relationship quality, decentralisation, employee motivation and satisfaction. It would appear, therefore, that the possession of multicultural skills by employees does not

significantly increase the success with which internal transactions are managed within institutions. However, the results of the study did indicate that the possession of multicultural skills did result in benefits related to the management of external transactions. This is due to the fact that multicultural skills were bundled with other competencies – in other words, managers with a higher level of multicultural skills were more likely to also have a range of other competencies. Thus, according to Banutai and Bisjak (2009), higher levels of multicultural skills among employees are more likely to result in greater levels of transparency and more stakeholder satisfaction. This suggests that the transparency and standards by which institutions related to the financial sector operate could be improved by the recruitment of employees who are in possession of higher levels of multicultural skills.

Chapter 5: Conclusions & Discussion

As this dissertation has demonstrated, it is clear that there are a range of different factors which can affect financial transparency and standards. One of the key factors is the quality and effectiveness of related institutions: namely, the prevailing system of government, the quality and transparency of financial regulatory agencies and credit rating agencies. It would appear that any lack of transparency, insufficient oversight or general misgovernance in either of these institutions can have a significant negative effect on the level of financial transparency in the market and on financial institutions as a whole, something which was clearly demonstrated in the recent financial crisis when a failure to intervene by regulatory institutions together with a lack of pressure from government and conflict of interests among credit rating agencies helped to trigger a widespread dislocation in the financial markets. Arguably, the vulnerability of markets to financial crises has been exacerbated by the rapid financial deregulation of recent decades which has in turn increased the extent to which

misgovernance in any of the aforementioned institutions can result in financial crises. Another key development which has contributed greatly to a reduction in financial transparency and a general obfuscation in the provision of key financial information is the development of a shadow banking system which has resulted in a parallel system of highly speculative, unregulated institutions which have significantly increased the level of risk in the financial system.

One of the benefits of the recent financial crisis has been the way in which it has forced governments to acknowledge that regulatory reform is necessary, and the foundations are being laid for the construction of a new regulatory architecture which will hopefully address the issues mentioned above and reduce the vulnerability of the financial system to any future shocks. However, a more deep-seated paradigm shift in the way in which pieces of financial regulation are introduced may be required in order to effect the necessary changes. As has been discussed earlier in this dissertation, the majority of financial regulation tends to be passed in a very reactive, rather than proactive, way. While there are benefits to such an approach, arguably, a more proactive approach which tackles deep-seated economic problems and anticipates economic crises is preferable. Given the FSA's recently publicised commitment to adopting a new approach to financial regulation, I am hopeful that a more proactive approach to financial regulation will be widely adopted. One way of improving the transparency and effectiveness of institutions could be through the recruitment of employees with higher levels of multicultural skills who could contribute greater diversity of thinking and hence result in more effective decisions being taken.

However, despite the fact that a significant amount of research has been conducted for this dissertation, it is clear that further, more rigorous research needs to be performed before any

meaningful theories can be extrapolated. Given further time and resources, I would be keen to examine the ways in which institutions and financial deregulation have affected transparency in developing countries. This dissertation has focused very much on the Anglo-American model and it would be of great interest to evaluate whether countries such as India have had a similar experience. Furthermore, it would be valuable to examine whether there is a similar negative correlation between financial deregulation and financial transparency in countries with a state economy such as China, where arguably, state-imposed restrictions mean that the effect of financial deregulation is not as strongly felt.

In summary, the financial scandals of the 1990s and 2000s highlighted a number of systemic problems with the way in which regulatory and governmental institutions operate, as indicated by the frequent changes in regulatory legislation. This was epitomised in the recent 2007 financial crisis which reflected the institutional failures and lack of proper safeguards inherent in many institutions. Many studies attribute the lack of transparency and issues with the way in which the crisis was dealt with by such institutions to the financial deregulation which took place in the 1980s and the onset of globalisation. This led to the emergence of the shadow banking system which encompassed a range of financial institutions which were not regulated and lacked sufficient oversight, a situation which was exacerbated by the passing of the Gramm-Leach-Billey Act.

As discussed in the dissertation, government and political institutions typically exercise their influence over the transparency and standards of financial institutions through the mechanism of political accountability i.e. by the punishment of corrupt individuals or by the presence of rules or systems which lengthen politicians' time horizons. Political institutions can also reduce the risk of any corporate malfeasance among financial institutions by ensuring a high

level of governmental transparency by ensuring the freedom of the press, for example. The studies discussed within this paper also suggest that issues of corporate malfeasance and financial corruption are most likely to arise within political system where different government agencies provide complementary services rather than substitutes.

Regulatory agencies typically provide advice and technical assistance to financial institutions in order to ensure a high level of transparency and standards within the financial market. The effectiveness of regulatory agencies is determined by the level of operational independence and full transparency with which they operate. The presence of these conditions serves to increase their credibility, to reduce moral hazard and to ensure clear policy making processes. Indeed, the recent financial crisis has been attributed to the lack of transparency among these agencies and a lack of governmental oversight which epitomises the fact that the majority of agencies and institutions tend to act in a reactive, rather than a proactive, way.

The findings of the dissertation also indicate that high levels of multiculturalism within institutions are likely to have positive effects in terms of ensuring greater success in managing external transactions, which implies that the presence of employees within institutions with greater multicultural skills is likely to result in greater transparency of the institution and higher levels of satisfaction from external stakeholders.

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