

# LEBANESE BANKS' STATE OF READINESS TO LIFT BANKING SECRECY

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## **ABSTRACT**

This paper aims to explore the level of readiness of Lebanese banks to adapt to a change highlighted by the international financial wave of transparency that oppresses banking secrecy worldwide.

## **Keywords**

Banking secrecy, Lebanon, Environmental Shock, Change, Adaptation, Institutional Theory.

## **INTRODUCTION**

“Change management is like any worthwhile project; it needs to start early and the preparation needs to be done well “(Hanson, 2010).

Many historical and recent scandals gave good reason for international community to implement intensive pressure to reduce the effect of bank secrecy laws. By looking back in the international and local financial history, many scandals reveal. Banking secrecy was directly or indirectly a main cause that lead to financial crimes and eventually to banks' failure. Swiss Wegelin Bank case that was defunct in 2013 for helping its US clients to evade tax obligations of over \$1.2 billion between 2002 and 2010 is just an example. Alike, another Swiss bank, Leu AG Bank, where one of the scandal due to application of strict secrecy law related to insider trading was enough to shut down its operations. The local Lebanese market was also affected and many examples could be stated...The frustrating shockwaves sent by the collapse of Al-Madina bank and more recently the Lebanese Canadian Bank are hard to be healed easily and forgotten due to the negative effect that they cause to the reputation of Lebanon's banking system.

A question worth being inquired pops up: Is the Lebanese financial sector aware of the international pressure regarding lifting worldwide secrecy code and ready for change?

Today's environment is becoming more and more turbulent and organizations are floating in an unstable environment where they are continually faced with the need to implement changes in multidimensional aspect whether in strategy, structure, process, or even the culture itself. Organizational Change is faster than ever and it comes from all directions; the primary motive for change is triggered by forces in the external environment mainly related to societal changes, technological changes and explosion of knowledge which are considered some of the main factors making organizations' change certain. Because even the simplest changes entail risk, anticipating change and get ready to adapt to it mitigates hazard by providing the organization with enough time and expertise to balance the risk and reward of change. For Berneth (2004) "Readiness is more than understanding the change, readiness is more than believing in the change... Readiness is a collection of thoughts and intentions toward the specific change effort."

## **1. THE BANKING INDUSTRY AND BANKING SECRECY**

### **1.1 Evolution of the Banking Sector**

Banks survive nowadays in the most crucial status in the modern world (Agboola, n.d.). In the last few years, the banking sector has passed in a stage of experiencing wide-ranging changes. This phase is not seen to be ending soon; rather many major changes will continue to prevail over the next decade. Many factors have contributed to the current prevailing process of nonstop changes in the banking sector emerging from the facts of Liberalization, Privatization and Globalization (Anjani, 2013). After 2008 worldwide wide financial crisis, many calls and alarms were spread in the financial industry calling for change in conducting banking transaction under the light of transparency. In addition, the global trend to fight terrorism gave a legitimate right for many critics to raise their voices louder toward more financial transparency and therefore abolishing secrecy rights. Customers, regulators and bankers get ready for a new phase of banking highlighted by new trends. On one hand, massive new government regulations, evolving customer demands, fierce competition, innovative products and services, and technological developments all together induce organizations to undertake major changes. On the other hand, global trends toward more transparency and information sharing has notably changed the banking industry worldwide where the time of hiding money is coming to an end and pressure is mounting on financial institutions to share information.

## 1.2 Evolution of Banking Secrecy Code Worldwide

The grandfather of bank secrecy is internationally referred to Switzerland which is well known as the world's largest tax haven. Old and profound roots characterized Swiss banking secrecy. Searching in the history of the world oldest secret regime reveals that in 1713, long before Switzerland existed as a federal state, the Great Council of Geneva implemented a "secret" legislation that prohibit bankers, who were collecting substantial sums from European nobles, from disclosing details about their clients. Later during the First World War many prosperous Europeans escaped their money to Swiss to avoid contributing in the war financing effort which produced the largest ever flow of money into Swiss banks.

2008 was a turning point in Swiss solid banking secrecy history. It is the year when the United States began actively to investigate and prosecute senior Swiss bankers, launching high-profile criminal cases against UBS, Credit Suisse and other banks for being accused helping wealthy Americans evade tax. Swiss could not resist the huge pressure triggered by the 2008 worldwide financial crises.

Since the global financial crisis in 2008, new pressures have emerged for transparency, from societies, media and governments around the world to concentrate their effort on fighting financial dirty actions. In this regard, in February 2013, Switzerland had no choice but to sign the U.S. Foreign Account Tax Compliance Act-FATCA- which requires financial institutions to disclose information on U.S. accounts to the Internal Revenue Service-IRS- a department of the treasury in the United States of America on an ongoing, automatic basis. These changes provided an important proof of Switzerland's inability to face external pressures.

Switzerland being a huge player compared to other secret jurisdictions with a weight scale of more than 5% of the global market for offshore financial services could not resist the global pressure. Many actions were taken that are seen as loophole for this "secrecy" myth which is eventually seen to be eliminated soon. Lebanon weight for less than 0.4% of the offshore financial services making it a small player compared to other jurisdictions and a minor player in the international financial game; could Lebanon resist the international pressure of transparency and keep on preferring secrecy instead? A positive answer to this question is neither obvious nor simple. Hence, the importance to explore the Lebanese banking sector's readiness for a potential change highlighted by the possibility of lifting banking secrecy is very legitimate.

To sum it up, external pressures have succeeded to breach the legend of the unbeatable Swiss banking secrecy. A key lesson from this episode is that countries cannot anymore hide in dark spots and cannot resist international tendencies toward openness, information sharing and collaboration. Globalization and interdependence among countries turns things upside down...what was acceptable and prevailing years ago could be considered a taboo nowadays in conducting banking transactions.

### 1.3 Research Question

Lebanon adopted the banking secrecy law in 1956 in a bid to attract Lebanese and foreign deposits (Elkanj & Zreika, 2011). Since then, the law was never updated or amended despite the sky-high improvements in the banking activities.

What was valid before regarding building an unbeaten competitive advantage for a life time is not valid anymore. Creating the right position and the appropriate competitive advantage is not a simple process but rather a complicated state where many factors jointly get involved and limit even further organizations' capabilities to set the appropriate strategy. "Amid sometimes unpredictable, always uncertain, and highly turbulent business conditions, an organization's capacity to learn as it goes may be the only true source of competitive advantage" (Rowden, 2001). Change readiness along with organizational capabilities to catch change signals and adapt accordingly and quickly become part of the game. "Instead of being really good at doing some particular thing, companies must be really good at learning how to do new things" (Reeves & Deimler, 2011).

The world is running more and more into more stringent rules and compliance matters where secrecy has no more place and the concepts of transparency and access to banking information can hardly be argued against. Under international environmental pressures, highlighted mainly by the coercive force of cross borders legislations, is Lebanon ready to lift banking secrecy?

Hence, this study aims to explore the level of readiness of Lebanese banks for the end of banking secrecy by interpreting the point of view of board of directors' members and middle managers (heads of compliance).

## 2. ORGANIZATIONS AND THE ENVIRONMENT

### 2.1 Changes in Organization

Organization's change is generally too complex and not straightforward and this complexity is what makes the study and practice of organization change so challenging, so meaningful, so exciting, and so worthwhile. According to (Gersick, 1991), having a sense of urgency and crafting a vision for the future to provide clear direction are considered two main focal points to launch successful organizational change.

In financial institutions and mainly in banks, new compliance regulations are taking place in a rapid pace at the international level. Knowing the effects of the new rules ahead of time is opportunistic since the probability to succeed in implementing change is high when we are being prepared ahead of time to change (Kingston & Caballero, 2008). Change process is not easy to be implemented nor adopted since it is extremely difficult to predict the number of variables that will surface once change is to be implemented.

## 2.2 The Environment and the Firm

According to Duncan (1972), organizations operate within an external environment characterized by two main features: level of complexity and level of uncertainty. External environment is defined as forces or variables outside the organization that influence or will shortly influence organizational performance. These forces include variables such as customer behavior and satisfaction, marketplace conditions, political circumstances, government regulations, world financial and economic conditions, and changing technology. With these possible major shifts in the external environment, the organization must change its basic strategy and most of its aspects even its mission statement. If the success of the overall change effort is to be realized, thus changing the vision, mission and strategy of the organization become necessary which by itself could lead to modification in the organization's culture (Burke, 2013). The world seemed to be moving more toward the turbulent type and the reality that for their survival, organizations are dependent on their external environment, and accordingly organization change occurs primarily as a reaction to some change in the environment. Thus, the importance of reading the environment as accurately as possible so that timely and appropriate organizational responses could be made to ensure survival is essential.

In Lebanon, after the 2008 worldwide financial crisis, the Lebanese banking sector has been put under light by the international community as a secret haven jurisdiction due to the prevailing banking secrecy which is considered a main pillar of the sector and its source of competitive advantage. As a result of this serious criticism of banking under secrecy shadow, Lebanese regulators had no choice but to introduce many regulatory frameworks and circulars to ease international fears regarding Lebanese banking sector's main core competency, illustrated by banking secrecy. These amendments are seen jeopardizing the effectiveness of banking secrecy and questioning its destiny. Following the world wide trend for higher financial transparency and information sharing standards, are Lebanese banks ready to adapt to this major environmental change?

## 2.3 Environmental Shocks and Organizational Adaptation

Tybout & Bark (1988) define an environmental shock as a sudden change in macroeconomic conditions. Hence, it is the result of an unpredicted and disturbing change in a firm's external environment (Meyer, Brooks, & Goes, 1990) which by itself could be smooth or severe, and raises the probability of a radical organizational response especially if it was brutal (Miner, Amburgey, & Stearns, 1990; (Romanelli & Tushman, 1994). Organizational shock is not limited to a specific sector, rather it may affect specific organizations (Brege & Brandes, 1993), industrial segments (Sheppard & Chowdhury, 2005), or entire economies (Singh and Yip, 2000).

An environmental shock is considered a stimulus for adaptation; hence having the ability to adapt to unexpected change is necessary especially that adaptation is considered a major factor in assessing organizational performance and survival which is positively related to its ability to adapt to shocks. “In order to adapt, a company must have its antennae tuned to signals of change from the external environment, decode them, and quickly act to refine or reinvent its business model and even reshape the information landscape of its industry” (Reeves & Deimler, 2011).

Studies argue that level of accepting change and reacting accordingly is critical especially when change happens extensively and rapidly (Weitzel and Jonsson, 1989). In order for an organization to stay competitive, it is important to be able to respond quickly to the changes that occur in the concerned business industry (Agboola, n.d.). Strategic speed is considered a rule of thumb to be able to develop a successful strategy that fits the existing turbulent business environment.

### **3. BANKING SECRECY IN LEBANON**

#### **3.1 Secrecy Code in Lebanon**

September 3, 1956 is an important date in the Lebanese banking sector... In this date, the Lebanese famous banking secrecy law, which gave rise to Lebanon’s nickname as “the Switzerland of the Middle East”, was born and it was named accordingly: “Law of September 3, 1956 On Banking Secrecy.” Since then, this code has been considered the heart of the Lebanese banking sector.

The issuance of this decree was considered a major achievement for the Lebanese banking sector in the Middle East area as it promotes foreign capital inflow to the country (Elkanj & Zreika, 2011). This fact highly contributes to the growth of the Lebanese Banking sector, fuels the economic growth of Lebanon as a whole, and pushes the whole sector forward to become a major monetary center in the Middle East and a model for banking services among neighboring countries at a time of flourishing political stability in the country.

The banking secrecy is absolute in Lebanon and limits all financial entities regulated by the Central Bank of Lebanon to complete secrecy regarding clients’ personal and account-related information. Accordingly, banks tend to implement stringent controls to ensure that their staff respects their obligations since violation of banking secrecy is considered as a misdemeanor punished under the Criminal Code. The Law provides that violation of its provisions is punishable by imprisonment of three months to one year as well as civil liability. Moreover, a person charged for this violation is prohibited from performing the profession of a banker or being a bank’s employee.

61 years have passed since the issuance of the code that is still to date in its primitive form without any type of amendments although many things have

change since the promulgation of this Law. Cross-border financial transactions flourished in the country in a time characterized by serious fighting against the criminal and unlawful use of the financial system. This fact put the whole Lebanese sector under close scrutiny by the international system for being an active player in cross-border transactions. As a result, a new chapter of global watching and supervision has shined.

### **3.2 The End of Banking Secrecy in Lebanon**

The main strength of the Lebanese banking sector, illustrated by banking secrecy, is jeopardized in face of the international pressure to tighten secrecy laws. The long-run forecast for the Lebanese financial sector cannot rely solely anymore on the strict secrecy rules; rather adaptation to regulatory changes and fierce competition based on strong pillars become mandatory (Radu, 2014). Eliminating banking secrecy is considered a major change in the Lebanese banking sector which could be facing an identity change since it was always well known for the secrecy law. This fact will create a new state that requires banks' adaptation and call for the board of directors who are responsible of setting long term strategies to introduce necessary amendments and appropriate changes in their strategies to build on new competitive advantage since identifying organizations' core competencies is necessary to achieve organizational goals (Prahalad & Hamel, 1990).

Till now, Lebanon has handled to resist international criticism to eliminate completely the Banking Secrecy Law. However, new laws and regulations have been gradually enacted which have direct effect in decreasing the ultimate power of secrecy.

The US foreign account Tax Compliance Act-FATCA-and the European Common Reporting Standard-CRS- were major changes that were imposed on the Lebanese banking sector by the international world which stimuli banks to change and adapt accordingly without any other choice. These laws go into contradiction with banking secrecy and jeopardize its absolute impact and diminish its influence.

## **4. THEORETICAL FRAMEWORK - THE INSTITUTIONAL THEORY**

The theoretical and empirical support for the research is being influenced by the institutional theory since the choice of organizations in the environment is controlled by many external forces (Oliver, 1991) and these outside pressures have significant effect on the organizations and impact the organizations toward specific behaviors (Pfeffer & Salanick, 2003). Organizations do not operate in a state of isolation rather organizations are viewed as an integrated system that has different aspects and respond differently to diverse situations (Scott, 2003). Coercive, Normative and Mimetic pressures are considered the three main environmental forces that affect organizations (Scott, 2003). The international pressure to eliminate secrecy is nothing but a clear example of coercive pressure

exercised by the international bodies on local Lebanese banks to adapt to international standards. Hence, organizations have no choice but to comply with the requirements to avoid punishment (Hoffman, 1999) and to be accepted by the society that expect organizations to act within the legislations’ requirement that are seen as best practices. In other words, organizations’ behavior is enforced as a result of the costs linked with breaching the regulations (North, 1990).

**5. EMPIRICAL STUDY**

The empirical basis of this study will be to a large extent based on primary data ranging from series of qualitative interviews with practitioners affected by the problem. The primary data in this research was conducted through semi-structured, face to face, in-depth interviews with BOD members and compliance managers. Nine banks were approached and as a result nine BOD members and nine heads of compliance departments contributed with valuable insights regarding the research question at hand. Moreover, Publications and other secondary sources were also used to better mirror the ground along with papers and typologies carried out by international bodies as well as by local financial institutions and regulatory organizations.

	BOD Members	Heads of Compliance
1 : Alpha Banks	5	5
2 : Beta Banks	4	4

Figure 1-Interviewees Targeted based on Banks’ Classification

**5.1 Research Methodology**

An interview guide has been set to assist in the data collection by suggesting clear questions designed based upon the literature review and the researcher’s field knowledge to allow participants to recall specific event and open-ended questions to urge the respondents to communicate detailed and quality information on topics related to the research question at hand.

Data collected from the interviewees were analyzed and narrowed down to find out the meaning of the data collected. Responses were grouped according to the similarity of their content, thus forming themes out of coding the data before moving to the interpretation stage of the coded data and then reach findings and conclusions.

Collected data was coded with high level of integrity and truthfulness. Double coding was used to ensure proper coding and analysis. Computerized software- NVIVO- was used to ensure proper qualitative data analysis.

The below figure presents an overview of the overall methodology approach, design and process followed in this research:



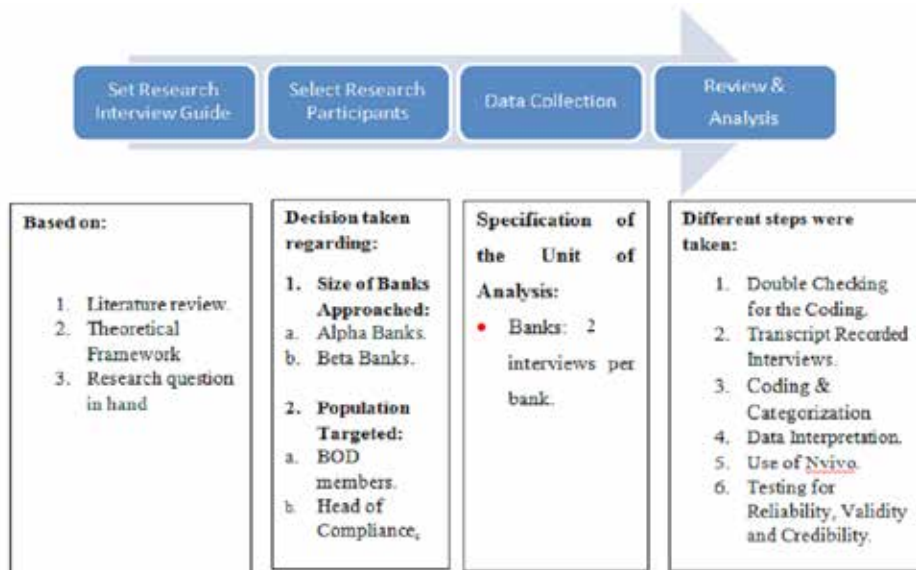


Figure 2- Research Methodology and Process

## 5.2 The Use of BOD Members and Compliance Managers as Informants

BOD members are the primary target for this research since lifting banking secrecy is a strategic change in the Lebanese banking sector and BOD members play the role of evaluating the overall direction and strategy of the business. They assign and hire the general manager of the bank and they are responsible to oversee and manage non executive business units in the banks including the compliance department. They are responsible in setting long term strategies that guarantee shareholders profits while ensuring business sustainability and prosperity.

Compliance managers are considered non executive and they report directly to the BOD. Among other responsibilities, they are appointed to scan the international environment for the best practices to be adopted to ensure banks' survival. Transparency in financial transactions is the name of the game in the international financial sector and because banking secrecy has notably been criticized, it becomes useful to interview compliance managers and understand their points of view toward this phenomenon.

## 5.3 Research Results

Almost 91% of BOD members interviewed state that previous changes adopted in banking sectors were mostly related to the application of international laws (FATCA, CRS, Anti money laundering and counter terrorism financing, compliance culture) and they were smoothly accepted. Moreover, BOD members highly believe that adaptation to change was considered rapid with percentage

exceeding the 70%. According to the majority BOD members interviewed, Lebanon was always ready to change and it was better than Swiss in adaptation and in managing its national and internal duties and the adaptation time span was considered rapid... A BOD member claims that “We are open and ready for any change that is taking place at the international world”.

While middle managers operating as head of compliance in the banks approached consider the previous changes in the Lebanese banking sector as a shock to the banking sector mainly when it comes to applying international rules and regulations. According to this group of interviewees, almost 80% believe that compliance with international regulations, like FATCA and CRS, entails costly compliance process related to screening, identifying and reporting information. More than 90% of compliance managers’ interviewed admits that it took a lot time and effort to adapt to the proposed change and to build the appropriate infrastructure and for customers to accept most proposed changes. Head of compliance state: “we were surprised by some changes... implementing changes was not easy and it required lots of work ..... It took a lot time and effort to adapt.”

Regarding the question related to a specific cross border international requirement that was imposed by the international bodies on local regulators who in their turn had no choice but to issue necessary circulars for local banks to apply, results show that 73% of BOD members believe that “we were ready and we adapt easily to these amendments” and even more “we wanted these laws to take place to avoid being alienated out of the international market” and that “Lebanon adopted positively since we had no choice but to adapt”. On the other hand, 80% of compliance managers announced that “Lebanon was late to introduce the necessary changes to be compliant with the international rules” and that “we have no choice but to adapt.”

To assess interviewees viewpoints regarding the consequences of not obeying to the international standard and prefer secrecy; results show that all interviewees, regardless of their classification, totally agree and to a great extent on the importance of adaptation.

It was necessary for the sake of this research to know the main reason that is behind the change in the Lebanese banking sector... a set of sections were proposed and the interviewees’ answers were coded respectively based on the institutional theory pressures. Results show that 78% of BOD members admit that the main reasons that push Lebanese banks to change is mainly related to coercive pressures related to the issuance of international cross borders laws as well as local regulations that were issued to satisfy international requirements... Tax Evasion, FATCA, CRS, HIPFA, AML/CFT regulations are just recent examples to these coercive forces. In addition, compliance managers do agree that coercive forces are the main reason to change as well as some normative forces imposed by the best international practices and correspondent banks’ norms and requests.

## 5.4 Result Analysis

### Isomorphism in Lebanese Banks' Reactions

Organizations face environmental and social pressures in order to become homogenous. The concept of isomorphism is explained by this homogenization (DiMaggio & Powell, 1983). By taking into consideration the institutional theory reflections, isomorphic behaviors reveal in the Lebanese banking sector based on the similarity between banks' reactions and points of view toward adopting to the environmental coercive pressures applied by the international agencies. The institutional coercive pressures drive the local isomorphism decisions among Lebanese banks. At the end, isomorphism boost banks' legitimacy and grant banks a high level of acceptance by the international environment (DiMaggio & Powell, 1983).

Rather than lifting banking secrecy which is considered by the world as the source of financial darkness, Lebanese banks are preferring another strategic alternative: Currently and once forthrightly requested, the sector struggles to amend and issue new regulations and circulars each and every time an international request is issued. Then, a specific period of time is granted for banks to make necessary changes and adapt... This process of reacting to change is not guaranteed to ensure banks' survival due to the technological advancement, globalization and openness among jurisdictions in conducting their financial transactions. Change process has been accelerated and been spreading more quickly among countries, therefore a rapid isomorphic change shall be rapidly adopted by the Lebanese banks to meet the powerful external pressures and gain sustainability in the international financial market.

Moreover, due to high level of international rules and regulations, coercive isomorphism is most likely to increase in the financial industry through the coercive process. This isomorphism is necessary for the Lebanese banks to gain legitimacy and international presence. Since the rule of the game in banking nowadays favors transparency, getting ready for an inevitable fate is worth a coordination effort among concerned parties to formulate appropriate strategy accordingly.

It is worth mentioning that these isomorphic pressures will make all Lebanese banks much more alike and similar which could lead to inefficiency and ineffectiveness in the whole sector (DiMaggio & Powell, 1983)... hence, banks have to build new competitive advantages to differentiate and properly position themselves in the international financial market.

Due to the isomorphic pressures emitted by the environment and the social forces, different strategic responses are seen appropriate by different decision makers in the organizations to gain legitimacy and ensure proper compliance to these isomorphic three forces: Coercive, Normative and Mimetic; which is considered crucial for survival. This legitimacy justifies organizational behavior to skip being

questioned by the various social structures. To gain this crucial element, legitimacy, compliance managers and BOD members assess the situation from different lenses... compliance managers urge decision makers in the bank to gain legitimacy in the financial industry by operating in the same manner as other international organizations in the same field regardless of effectiveness level that could be resulted out of this change and hence take strategic decisions in building new core competencies aside from banking secrecy while BOD members are hooked under the secrecy veil to ensure profit maximization and banks' effectiveness. As a result, the institutional pressures faced by the banking industry will lead to an agency problem inside the banks among the decision makers. An increase urge by compliance managers in banks calling for organizational compliance towards institutional isomorphism increases the possibility of conflict internally.

## CONCLUSION

The purpose of this research was to explore the level of readiness of Lebanese banks to adapt to environmental pressure and more specifically to a particular phenomenon highlighted by abolishing a core competency from the Lebanese banking sector: Lifting banking secrecy law.

First, the researcher confirmed that the Lebanese banking sector is not totally ready for this major change and hence potential chaos to prevail in the sector is possible. Contradictory assessments regarding adapting to previous change processes in the banking sector, different interpretations regarding necessary time span to adapt to change, diverse effectiveness level of plans that were taken to adopt change elements, various versions regarding strategic alternatives in light of transparency calls, along with the absence of clear vision to prepare to change in order to facilitate implementation will further complicate the change process.

The responsible concerned parties in the Lebanese banking sector are called to professionally skim and scan the external environment, learn from other countries' stories and attentively listen to the importance of getting ready to a change to ameliorate the probability of success. Moreover, reducing conflict among different managerial levels is necessary since the adoption of a successful change process covers different hierarchy level.

Furthermore, it should be clear by now to all involved parties that slow reaction to change could be devastating in this age of globalization and technological advancement. Acting while thinking is mandatory and it's a core condition of organizations' success.

Finally, applying national laws that contradict international standards could not last forever. The efforts taken till now by the Lebanese authorities in adapting to international calls are not sufficient in the presence of the main cause of financial transparency: banking secrecy. Financial institutions and countries that will succeed are those who start looking forward to sport new competitive advantage in the sector to build on it.

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