

# 13 One Regulation, Diverse Banks

*Viktor Elliot and Mikael Cäker*

## Introduction

The post-crisis regulatory framework aims at improving the health of financial systems, but what are the consequences of such regulation? In a recent comment on the Basel III framework, Goodhart and Wagner (2012, p. 1) point to the potential danger of ‘lack of diversity across financial institutions.’ They argue that although the Basel III framework helps to mitigate excessive risk-taking, it may also increase the systemic risk if banks and banking practices become more similar. The present chapter investigates how one small and one large bank have responded to the increasing regulatory pressure (see Crawford et al.’s chapter, this volume, for an extended discussion of regulatory pressure). The contingency literature finds size to be one of the key variables explaining why firms adopt different types of control systems (see Chenhall 2003, for a review), and we elaborate on how the isomorphic pressure of regulation (cf. DiMaggio and Powell 1983) may threaten diversity by undermining the banks’ ability to adapt their business models and control systems in accordance with their specific needs.

There are at least three arguments for preserving diversity in the financial market. First, financial distress and crises will inevitably strike where we least expect them. Remember that it was the ‘safe’ triple-A-rated derivatives that collapsed during the recent crisis and not obscure high-risk investments in dark corners of the world. We cannot anticipate when and where the next crisis will strike, and for that sole reason diversity is an important tool to mitigate systemic risk. During the 2007–09 crisis, it was primarily large and complex banks that failed, whereas small retail banks managed far better (see, for example, Stiroh 2010). However, it was the other way round in the US savings and loans crisis during the 1980s, where small savings and loan associations failed on a massive scale, whereas the commercial banks were largely unharmed (see Dotsey and Kuprianov 1990, for a review). Financial integration and globalization are making the system more interconnected and, therefore, we need a diversity of players in the system.

Second, small retail banks are important for the establishment of new businesses and to prevent financial exclusion in more rural areas. Understanding



the business climate and customers is important for helping organizations and people in such areas to finance their activities, and, as shown by Ayadi et al. (2009), this continues to be important. Even in Sweden this role is still prominent; in her recent thesis, Backman (2013) finds that the presence of local bank offices promotes new business creation.

Third, small retail banks contribute to competition in financial markets, and the regulations are now running the risk of not only drastically raising the entry barriers (Clemens et al. 2008), but also creating an oligopoly situation for the large players. As shown by van der Steen (this volume), these risks are highly relevant, and banks that fall outside the regulatory ‘average’ already experience increasing costs and pressures to deviate from their traditionally successful business models.

Traditionally, retail banking performed by small and local banks has been a main feature of both the US and the European financial systems, but over the past 25 years banks have grown tremendously in terms of both size and complexity (DeYoung 2010; Goddard et al. 2010). This growth, together with the post-crisis restructuring and regulatory pressure aimed at stabilizing the largest banks, has made the environment for locally based small banks increasingly hostile (Miklaszewska 2014). The gradual reduction of small retail banks in Sweden over the past two decades (see Table 13.2) is, according to Olsson (2009), an eloquent testimony to these effects.

In order to understand this concept, follow us on a short visit to a small local bank in Sweden, Virserums Savings Bank (VSB). The bank has eight employees, two offices, and total assets of less than MEUR 100, and it has existed since 1884, when the local citizens of Virserum convinced the municipality that a local bank was needed to handle the vibrant trade. Today, the community of Virserum has fewer than 2,000 inhabitants, and in the 2012 annual report, on page six, we can read:

. . . we [VSB] have been able to contribute to the necessary reconstructions of several local companies. Thanks to the record-high operating income we have generated an operating profit of MSEK 10.9 and a total profit of MSEK 27.1. Accordingly, we have been able to strengthen the capital with an additional MSEK 17.8, which gives us a unique financial strength among Swedish banks. In addition, we have been able to contribute to some local development projects, not least by investing in a digitization of our cinema.

The unique financial strength mentioned above refers, among other things, to the 32-percent equity-to-debt ratio held by VSB; i.e., 10 times more than the 3 percent ratio suggested by the Basel Committee on Banking Supervision (Basel) and strongly opposed by German and French governments, ‘most likely because they know how highly geared their credit institutions are’ (Chorafas 2012, p. 20). However, it is also interesting to note that in parallel with relying on exceptional financial performance in



legitimizing its performance, VSB also refers to its role in the local community (cf. Brunsson, this volume).

Under present regulations, VSB must have both an independent compliance function and an internal audit function (FFFS 2005, p. 1), ensure that its employees meet the competence requirements of financial advisors (FFFS 2004, p. 4), (closely) follow the IFRS rules on accounting (FFFS 2008, p. 25), and report its current capital and liquidity position on a regular basis (FFFS 2010, p. 7; CRR 416–426; see FI Dnr 11–13269 for a detailed description). In total, these (and other) regulations create a burden on small banks with respect to their finances, competence, and daily work.

Still, the regulatory framework actually accounts for diversity to some extent, as manifested both by the availability of different risk-reporting approaches in the Basel framework (see, for example, Blundell-Wignall and Atkinson 2010) and the considerations of size and complexity that should be observed by regulators according to Swedish bank law (Chapter 6 §4a). One expected advantage of this is to allow smaller banks, which have less impact on financial stability, to work with less complex risk-management procedures. However, as noted above, the utilization of such regulatory measures has not been enough to protect the smallest players, indicating that further effort is necessary to develop a regulatory framework that allows for dynamic and diversified financial markets. To further our understanding of how diversity in the financial markets may be threatened by regulatory pressure, we compare a small<sup>1</sup> and a large bank with respect to their responses to this pressure. Thereby, we are able to contribute to the understanding of *how* the present regulatory framework influences risk and control processes, and ultimately the business models of large and small banks, respectively. We mobilize Oliver's (1991) typology of strategic responses to institutional change to fulfill our purpose. Our findings guide our interpretation of the impact of recent regulation on diversity across financial institutions.

### How Do Firms Respond to Regulatory Change?

Research on how firms respond to regulatory change is quite broad, not least in the organizational change literature (see Scott 2008, for a review). From an institutional theory perspective, the coercive pressure of regulation may offer valid incentives for banks to respond uniformly (Deepphouse 1996; DiMaggio and Powell 1983), that is, adopting similar practices to appear legitimate. However, Oliver (1991) notes that firms may respond differently to altering institutional pressures and develops a typology for the potential responses, which facilitates an understanding of how firms may react to regulatory shifts (Canning and O'Dwyer 2013; Shapiro and Matson 2008). Responses (see Table 13.1) range from most passive (*acquiesce*) to most active (*manipulate*).

Oliver's predictions have been tested in several studies (see Canning and O'Dwyer 2013, for a review), and factors that may influence how firms respond include size, goal congruence, uncertainty, and interconnectedness.

Table 13.1 Responses to Regulatory Pressure

<i>Oliver's strategies</i>	<i>Oliver's tactics</i>	<i>Examples</i>	<i>Examples for this study—banks dealing with increasing regulatory pressure</i>
Acquiescence	Habit Imitate Comply	Following invisible, taken-for-granted norms Mimicking institutional models Obeying rules and accepting norms	The bank decides to follow the rules and regulations of government agencies. They also follow international regulations.
Compromise	Balance Pacify Bargain	Balancing the expectations of multiple constituents Placating and accommodating institutional elements Negotiating with institutional stakeholders	The bank negotiates with their regulators to obtain a mutually agreeable solution that meets the intent of the regulations at a reduced cost for the firm.
Avoidance	Conceal Buffer Escape	Disguising non-conformity Loosening institutional attachments Changing goals, activities, or domains	The bank decides that the possibility or the cost of responding to the potential risk management problem is not worth the effort. Thus, the bank only pretends to follow the regulations.
Defiance	Dismiss Challenge Attack	Ignoring explicit norms and values Contesting rules and requirements Assaulting the sources of institutional pressures	The bank decides that regulators do not have the resources or political might to enforce the regulations. The bank fights the regulators with the help of lawyers, which may eventually have to battle with the regulators' lawyers.

(Continued)

Table 13.1 (Continued)

<i>Oliver's strategies</i>	<i>Oliver's tactics</i>	<i>Examples</i>	<i>Examples for this study—banks dealing with increasing regulatory pressure</i>
Manipulation	Co-opt Influence Control	Importing influential constituents Shaping values and criteria Dominating institutional constituents and processes	The bank tries to influence the regulations. This may be done openly through lobbying and/or informal contacts between the bank and the policymakers.

According to Clemens et al. (2008), the majority of studies investigating size support the hypothesis that larger firms adopt more passive levels of response, whereas smaller firms adopt more active levels of response. The intuition is as follows. On the one hand, large firms are both more bureaucratic and more closely scrutinized by regulators, and are therefore more likely to choose a passive response. Smaller firms, on the other hand, are more flexible and regulations are generally more burdensome, giving them the ability and reason to respond more actively. Moreover, as noted by Chilton and Weidenbaum (1982, p. 5), one of the most serious consequences of regulation of business is the threat to the continued existence of the small firm; therefore, regulators face pressure to relax requirements and accept higher levels of response from smaller firms. Finally, as noted by Clemens et al. (2008, p. 496), large firms have the capacity to use complex regulatory regimes as a way of erecting barriers to entry and limiting competition from new market entrants, driving the smaller firms to adopt more aggressive strategies.

On the other hand, Canning and O'Dwyer (2013, p. 174) note that '[t]he capacity of actors to adopt passive or active response strategies is contingent on the resources they can employ as part of their efforts to influence the establishment and interpretation of proposed regulatory rules and associated regulatory boundaries.' The resources include formal (legal) authority, organizational capacity (such as lobbying and professional advice and expertise), control of information, and wealth. Moreover, Clemens and Douglas (2005) found that larger and more visible organizations may prefer active responses when threatened by regulatory change, with far-reaching consequences for their business models. Concerning these aspects, we would expect a large bank to respond more actively to a new regulation, compared



to a small bank. Finally, some studies show that larger organizations may in fact display a variety of responses to regulatory change, originating from different responses chosen among different departments within the same organization (cf. Brignall and Modell 2000; Hyvönen et al. 2009; Modell 2001). Mikes (2009, 2011) offers further support in this direction, in the banking domain, arguing that certain departments tend to engage in boundary-work to develop their own interpretation of institutional change.

Oliver's (1991) claim that consistency between the regulations and the aspirations of the organization (goal congruence) will evoke less active responses has been confirmed in several studies (see Canning and O'Dwyer 2013). For example, Etherington and Richardson (1994) find goal incongruence to be strongly associated with more active responses such as manipulation.

Finally, Oliver (1991) suggests that an organization's context, including environmental uncertainty and interconnectedness, directs organizational response. High uncertainty about the environment is proposed to motivate firms to reduce uncertainty by acquiescing or compromising (for empirical papers in favor of this view, see Clemens et al. 2008). Similarly, high interconnectedness among firms is hypothesized to lead to less active strategic responses, as supported by, for example, Clemens and Douglas (2005), who find acquiescence and compromise to be most common among players that cooperate through trade associations or equivalent organizations (see also Goodstein 1994).

In the following sections, we present our experiences of how these different aspects influence the organizational processes in one small and one large bank, wherein both have to adapt to similar regulatory change.

### *Regulation of the Financial Industry in Sweden*

Swedish banks, which in general seem to have weathered the crisis relatively well (Goddard et al. 2009; Lindblom et al. 2011), have been quick to adapt to changes in the regulatory framework<sup>2</sup> that have practically flooded banks in recent years. Apart from Basel III, the post-crisis regulatory measures include initiatives such as the Packaged Retail Investment Products (PRIPs), the Directive on Alternative Investment Fund Managers (AIFMD), the EU regulations on OTC derivatives (EMIR), and the Dodd–Frank Wall Street Reform and Consumer Protection Act (see Lundberg 2013, for an extended discussion). Furthermore, in 2011 the European Banking Authority (EBA) issued a set of guidelines on internal governance called GL44. GL44 includes far-reaching recommendations on the actions of, and the level of understanding among, the board and top management of banks. In response to GL44, Sweden has decided to update the regulations on internal control, and the Swedish Financial Supervisory Authority (SFSA) agrees with, and includes, many of the aspects in GL44. A recent memorandum issued by the SFSA (2012, no. 11–5610) states: '[t]he SFSA is under the



strong belief that self-regulation is not enough. Governance, risk management and control are areas of too much importance to the financial system to be left without action.<sup>7</sup>

## Method

Our empirical interest is directed toward the Swedish banking industry, the structure of which has changed considerably over recent decades. Table 13.2 shows the number of banks within each segment over this period. In December 2012 there were a total of 117 banks in Sweden: 23 commercial banks, 29 foreign banks, 63 savings banks (14 of which have converted to joint stock banks), and two cooperative banks. Five large banks accounted for more than 80 percent of deposits and lending in Sweden. In the early 1990s Sweden was hit by a severe financial crisis, and the number of banks decreased drastically (Larsson 1998). As shown in Table 13.2, the number of banks started to gradually increase when the conditions stabilized from the mid-1990s. However, over the past decade several of the smallest savings banks have merged in order to cope with the increasing administrative burden resulting from new regulations (Olsson 2009). The gradual reduction of small and locally oriented banks seems to be continuing, as exemplified by the recently announced merger between Sparbanken 1826 and Färs & Frosta Sparbank.

Table 13.2 Banks in Sweden 1992–2012

Type of Bank	1992	1995	1998	2001	2004	2007	2010	2012
<i>Swedish Commercial Banks</i>	9	14	15	25	26	28	33	37
– Large Banks	6	5	4	4	4	4	4	4
– Converted Savings Banks	0	1	4	11	12	11	14	14
– Niche Banks	0	5	5	8	10	13	15	19
– Other Banks	3	3	2	2	0	0	0	0
<i>Foreign Banks</i>	6	11	17	21	22	31	29	29
– Subsidiaries	5	0	2	2	3	4	3	2
– Branches	1	11	15	19	19	27	26	27
<i>Savings Banks</i>	91	90	85	77	76	65	50	49
<i>Cooperative Banks</i>	0	0	0	2	2	2	2	2
<b>Total</b>	<b>106</b>	<b>115</b>	<b>117</b>	<b>125</b>	<b>126</b>	<b>126</b>	<b>114</b>	<b>117</b>

Source: Data received from the Swedish Bankers Association.

*Research Design*

In accordance with Yin (2009), our aim of tracing *how* the present regulatory framework influences risk and control processes of banks calls for a qualitative research approach. Not only are we searching for the experiences made by decision-makers, but, in order to compare how these experiences are interpreted and integrated into the two banks, we need a deep understanding of their specific contextual situations. This is enabled by a qualitative approach. Moreover, since the overall research design aims to discover how external pressures influence internal processes, we need to carry out our investigation at both the strategic and operational levels. Together, these circumstances point at two qualitative case studies as a suitable research design.

As case studies, we have chosen two banks (referred to here as Small Bank and Big Bank) that share similar values and business models but differ in terms of size. This allows us to somewhat isolate the effects of imposing big-bank regulations on all banks. Through earlier work, the two authors of this paper have found that Big Bank and Small Bank both work with a long-term mindset concerning profitability, customers, and employees, and prudence in and local anchoring of business. The business models of both banks rely on flexibility and responsiveness in the customer interface. As regulations tend to limit such ambitions, we find these two banks suitable for exploring concerns with regulations. Big Bank was studied by one of the authors during 2009–11. The study was on management control, with a special interest in the credit-assessment process under the influence of increased regulation, and has earlier been reported in Cäker and Siverbo (2013). The documentation of this study is the basis for the presentation of Big Bank, and has also been complemented by additional contacts and documents during the write-up of this chapter. Through his previous studies of Swedish savings banks (SSBs), one of the authors has acquired a broad knowledge of the differences and similarities among these banks. Moreover, in 2013 he was involved in executive education for the SSBs that consisted of five three-day meetings, which allowed him to further his understanding of these banks. Small Bank was chosen primarily for three reasons: Its size, level of complexity, and

Table 13.3 Overview of Case Banks

	<i>Small Bank</i>	<i>Big Bank</i>
<i>No. of employees (2012)</i>	<50	11192
<i>No. of offices in Sweden (2012)</i>	<5	461
<i>Total assets 2012</i>	<BSEK 5	BSEK 2400
<i>Average credit losses 1997–2012 divided by total assets</i>	0.002	0.0003

level of credit losses. Although all SSBs differ to some extent, the findings related to Small Bank can be considered representative of most SSBs.

Table 13.3 illustrates the difference in size between the two banks, whereas the average credit losses illustrate the low-risk approach of both banks. The banks have been anonymized in this study as per Small Bank's request.

### *Empirical Work and Analysis*

Qualitative, semi-structured interviews served as the main source of information for our case descriptions. In total, 21 interviews were performed in Big Bank, on central, regional, and branch levels within the Swedish organization. In our analysis, we draw on interviews with managers at the central level to understand how the bank interacts with regulatory authorities and adjusts its internal processes to new regulations. We rely on interviews on regional and, especially, branch levels to understand how central intentions influence work in the bank as a way of checking whether intentions are met. The presentation of Small Bank is based on four formal interviews, meetings with the board of directors, as well as public and internal documentation received from respondents. The top management in Small Bank is much more involved in the operative work, and, as we present later in the paper, the same actors decide how to handle the regulatory pressure and manage the consequences of their decisions when performing risk and control work. Therefore, interviews in Small Bank contain questions on both how the respondents choose to handle new regulations and the consequences for day-to-day work at the bank.

The interviews with Big Bank were conducted prior to those in Small Bank and thus affected the information we sought from Small Bank. Based on this knowledge, and our basic understanding of Small Bank, we expected Small Bank to experience more problems related to regulatory issues than Big Bank. In order to mitigate the influence of our own predispositions, we initially wrote about the two banks as separate cases. In the next step, we decided to depart from the problems experienced by Small Bank and compare how Big Bank handled similar problems. The final step in our interpretation included writing the discussion, in which our theoretical framework guided us on how to structure our interpretations. An admitted weakness concerns the time difference between the two data collections. However, later contacts with representatives of Big Bank have convinced us that the previous findings are still relevant. Importantly, we do not claim to trace the two banks' reactions to a specific regulation, but rather to the general regulatory pressure.

## **Case Narrative**

### *Introduction to the Banks*

As mentioned above, Small Bank is a savings bank, which in Sweden is a separate legal form, regulated under the Savings Banks Act (1987, p. 619). SSBs share a number of distinctive characteristics. First, they do not have

any owners, but are instead governed by a trustee consisting of politicians and businesspeople from the local community. Second, SSBs have limited operations outside their local community. Third, the profits that SSBs generate are either used to capitalize the bank (through retained earnings) or distributed to local projects by means of sponsoring, for instance. Fourth, most SSBs have a close and historically grounded relationship with Swedbank (one of the four largest banks in Sweden) and cooperate with each other and through the Swedish Savings Banks Association (see Olsson 2009, for an extended discussion). The business model of Small Bank relies on retail banking, where almost 80 percent of the bank's income stems from interest and most of its lending is financed through deposits. As in all SSBs, long-term customer relationships are essential to Small Bank, and credit losses have remained at very low levels since the bank was founded in the early 20th century. Small Bank only conducts business within the community in which it is located, and the 'church spire principle' (i.e., lending to those who can be observed from atop the church spire) has traditionally guided their lending activities. Internally, the business is characterized by a pervasive and historically grounded thrift in which investments are only made after careful consideration and with cost-consciousness as an important guide. Small Bank prides itself on its high level of service and ability to make quick credit decisions based on the small size of the organization, which eliminates bureaucratic credit processes. The credit processes are fairly simple and primarily collateral-based, both within the private and the business segment.

Big Bank is one of the four largest commercial banks in Sweden. Similar to Small Bank, the business model relies on a strong local presence and the building of long-term relationships with customers. The bank has a long history of low levels of credit losses, which the respondents claim can be explained by an attempt to avoid high-risk customers. This is enabled by a management model that builds on a number of core values, including customer focus, prudence and cost efficiency, in combination with a highly decentralized organizational structure, an HRM policy of long-term employment and heavy reliance on internal promotion of managers. The importance of decentralization is manifested through the rights and responsibility for each credit assessor. Not only are credit assessors in Big Bank allowed higher credit levels in comparison to its competitors, but the individual assessor always makes the final call, even if approval from higher levels is required.

A second feature illustrating decentralization in Big Bank concerns branch autonomy. Each branch should be managed, as far as possible, as a free-standing bank, where regional and national activities are seen as support functions for the branches. Branch autonomy is to some extent restricted by, for example, central information systems, communication of core values, education, career development, and other HRM aspects. However, bank representatives consistently confirm that these are primarily support functions to the branches, which are seen as the most important part of Big Bank. The core business of Big Bank is based on the net interest income, which

accounted for about 75 percent of the bank's income in 2012. The credit process is based on an individual examination of each credit instrument. Small credit instruments, such as private loans, are granted based primarily on a standardized IT-based credit-scoring model. For larger loans, a credit assessor makes an individual evaluation of the borrower, which, together with the IT-based credit-scoring model, is used to decide on credit issuance. Although decentralization is enforced throughout the loan process, risk management is handled centrally to assist loan officers in making decisions that are in the bank's interests. With each credit issue, risks are accumulated, including credit risk, interest-rate risk, liquidity risk, and market risk, and a key objective of the people managing these risks is to ensure that branches can maintain a 'business-as-usual' approach when meeting with customers.

To highlight how the changing regulatory framework affects these two banks, the next section outlines how Small Bank has handled some of the major challenges imposed by the new regulations, and compares this with processes initiated in Big Bank.

#### *Relation to Regulatory Authorities*

In order to understand the responses, it is helpful to first juxtapose the relationship that each of the two banks has with the regulatory authorities, which respondents describe as being completely different. Small Bank seems to try to stay out of the spotlight, whereas Big Bank appears to seek frequent contact and maintain an active dialogue with the regulator. None of the respondents from Small Bank has had any direct contact with the regulatory authorities, and the limited interaction they have had has been through mail correspondence.

We get the instructions via mail but unfortunately the instructions are rarely explicit but instead we are asked to fill out a form, without knowing what they [the SFSA] expect, and then we just have to wait and see if what we have done is sufficient or not.

(CEO, Small Bank)

The SFSA is thought of as a disciplinary agency with limited interest in helping Small bank through discussions on common ground, and rather gives instructions based on prescriptive measures and regulations. The CEO of Small Bank has expressed hopes for better future cooperation, primarily via the Savings Banks Association, in which the SFSA would make better use of the proportionality principle.

Today we really don't know how the SFSA interprets the issue of proportionality, if we take GL44 [ . . . ], optimally some bank would test it but let us hope it is someone else that does that.

(CEO, Small Bank)



For Big Bank, the relation to Swedish regulatory authorities is based on communication. As one of the major banks in Sweden, the respondents find it natural that they can influence how regulations should be interpreted. The work on developing solutions regarding how the bank should handle requirements from new regulations has been based on continuous contact with the authorities. They see themselves as having a strong position in this relationship, based on Big Bank's long and successful history of low credit losses. The communication is facilitated by the expertise that Big Bank has developed on the central level.

We work with building systems to evaluate risks. Every new product must be analyzed concerning how it affects our long-term risk position [see further below]. This builds a competence on risk, which can be used to show others that we have the right competence to analyze risks and suggest our own ways of accounting for risks that the external regulators want.

(Top management (Risks), Big Bank)

The history of building competence to evaluate risks has prepared Big Bank to handle contact with the authorities, and, in adapting to the new regulatory demands, the bank maintains active dialogue with the regulator, in which the key personnel of the bank engage in physical meetings and discuss regulatory consequences. Communication with the regulator is important to protect the bank's credit process, and, according to several respondents, the successful history of Big Bank has been helpful in persuading regulators to accept their models.

Our relation to the SFSA is good; they usually appreciate what we do. They would like us to base our evaluations more on statistics, but when we point at our successful history, they do not have that much to say. The general direction is to 'score' more segments of the customer base, but we refuse.

(Top manager, Big Bank)

However, Big Bank has not always been successful in its ambitions to influence the regulatory bodies. For example, when adapting to Basel II, Big Bank argued that it was unnecessary for every credit assessor to have in-depth knowledge of the regulation, but the regulator still forced the bank to provide this training for its employees. It is quite clear, however, that the two banks have fundamentally different relationships with the regulatory authorities, and this is further materialized in their different responses to the regulatory pressure.



***Responses to New Regulations***

Consistent with its aim to stay out of trouble, Small Bank has focused on complying with the new regulations. The bank does not consider itself to have the resources to keep up with all the new regulatory requirements, nor to actively resist them; instead, it has gradually adapted its business after the implications and actual impact became clear. Therefore, each new regulation is analyzed with the aim of understanding what the bank needs to do, and when, in order to stay out of trouble. Although Small Bank seeks to do only what is necessary, the new regulations have still had consequences for Small Bank when it comes to the customer interface. This interface is considered far more complex today, with the customer having to answer many more questions. Earlier, in cases where the customer did not have a favorable financial status, the bank could still choose to grant credit based on a qualitative understanding of the customer being trustworthy and having good future prospects. Nowadays, all credit must be defensible based on formal numbers and liabilities. It is evident that Small Bank has had to adapt to the regulations, indicating a rather passive response, and although the respondents claim that it is often possible to find solutions, they maintain that credit processes have become more time-consuming and involve a large amount of formal communication with the customer.

Small Bank's passivity is further reflected in how the respondents think about recruitment within the new regulatory context. Several respondents explained that they find it increasingly difficult to locate people with enough knowledge and experience to meet the demands of the regulator. Perhaps the most salient example of this problem can be attributed to the recruitment of new board members, and the CEO gave several examples of how this process is becoming increasingly problematic:

In a small community like [X] it is difficult, if not impossible, to find people that fulfill all the requirements of the new regulations, and both our bank and several other SSBs have had some trouble convincing the FSA that our proposed candidates are suitable.

(CEO, Small Bank)

Eventually, Small Bank may need to recruit board members outside its local community, at the risk of undermining the bank's local character—a solution that may, in fact, be in conflict with the Savings Bank Act (1987).

Big Bank is far more active here, and in analyzing new regulations it strives for alignment between the regulations and its current internal processes. Three parallel processes can be identified. First, one aspect of recent regulations is to have models to support a formal account for risk. Banks are allowed to select a credit-evaluation model that is either based on the regulators' recommendation, or developed by the banks themselves and approved by the authorities. The management of Big Bank claimed to often



take the opportunity to develop its own models in order to enable a better match with the bank's internal processes.

Second, new regulations are analyzed in relation to how the central organization can ensure that Big Bank meets the regulatory requirements without influencing the bank's core credit assessment process (as further discussed below). Increased external regulation is seen as a potential threat to their management model, and

. . . it is important not to let regulations from the outside affect the internal work with running a solid financial business.

(Top manager, Big Bank)

On a general level, the idea in Big Bank is to set systems and procedures on the central level to ensure compliance, and to make the regional level responsible for providing these systems with information. In doing so, the bank can minimize the influence at the branch level, which merely has to make specific adjustments to the already-existing credit-process instructions. The respondents' experience from the first decade of increased regulations is that they usually find ways of documenting and informing about procedures that the bank already has. Therefore, the impact of regulations on how business is conducted can be kept low.

Statistics and models are becoming increasingly important, not least when communicating with regulators because . . . they love statistics . . . So far we have largely been able to resist this trend on the credit level, but on an aggregate risk-management level this has become increasingly important.

(Top Manager (Risks), Big Bank)

Third, when developing new products the process is similar, that is, the central organization is responsible for analyzing the new products to make sure that Big Bank is compliant with the regulatory requirements. However, the regulatory pressure has altered this process to some extent, and today the evaluation resembles that suggested by the regulations. Thus, products that would previously have made it to market may be stopped, and the pricing of those products that actually reach the market is adapted according to the regulations. Thus, Big Bank's response has been far more active; however, in most cases the bank has not tried to actively resist the regulatory measures.

### *Discrepancies in Handling the Regulatory-Driven Workload*

The management of both banks claimed that the increased regulatory pressure was met with skepticism. Over the years, however, this skepticism has become more nuanced. Whereas still reflecting on the high complexity of the regulations and the banks' intense workload, managers in both



organizations have also expressed more positive views in terms of how the regulations have forced the banks to formalize and work more systematically with risk management. The formalization is expressed through improved documentation and reporting of, for example, credit and liquidity risk, and the continuous reporting of various risks to the SFSA helps the banks to systematize their risk-management processes. In this respect, the two banks have actually shared similar experiences, although their reactions to the increased workload have taken a very different form.

Although the employees in Small Bank recognize the increasing workload, they have not hired any new personnel to assist in handling these additional tasks. Instead, the overall responsibility for adapting the organization to the new circumstances has fallen to the different functional specialists. The bank's lawyer has taken on the role of compliance manager, and the credit manager handles the new routines concerning credit assessments. The latter described that it is not only the specific new tasks, including incorporating the new regulations into the bank's processes and designing the reports to the CEO, the board, and external recipients, that have been added to her daily job. She also emphasized her increased involvement in discussions about different credit decisions that used to be dealt with by individual loan officers. Due to the regulations, more decisions are considered complicated and require professional support from the credit manager. The credit manager recognized that this, of course, has implications for her job, but when asked about what activities receive less attention, she could not provide an answer, explaining that the new tasks just have to be fitted into her daily workload. In order not to lose touch with the business, and to keep up to date with the credit assessment process, the credit manager tries to find time to take care of some customers herself. However, she recognized that she is gradually reducing the time spent with customers, and stated that this development will continue; this trend was also echoed by the CEO:

Today, the focus is primarily on regulation, and the downside is that we lose focus on the customer. Regulatory issues dominate the discussions held by both the management and the board, and a large share of our time is devoted to these issues, which unfortunately means less time to discuss things with the employees.

(CEO, Small Bank)

In Big Bank, the new regulations have resulted in the appointment of a number of new roles. The bank now has a compliance function, and statistical experts working with risk models. Furthermore, the internal control has expanded. These functions are required as a consequence of new regulations. However, the resources allocated to these functions are based not only on a judgment of what is necessary to comply with the new regulations; it is also considered important that these functions analyze regulations and develop processes that enable the bank to comply with regulations without



harming internal, operative processes. The management model of the bank rests heavily on the belief that the primary task of the bank's central organization is to protect its branches. In terms of the effect of the regulations on the credit assessment, the 'protection approach' means that every new regulation that may have implications for credit decisions should be carefully analyzed and broken down into what needs to influence the local level and what can be handled at the central level. Aspects in which the local branch needs to be involved are carefully planned and analyzed in terms of how they affect the credit assessment process, with the aim of 'disturbing' it as little as possible. Credit officers in the bank describe these ambitions as successful.

We all have regulations to follow, but to us it is the [internal] credit instruction that is the key to follow; it is enough for us.

(Credit assessor, Big Bank)

The central functions, such as credit experts, compliance, and internal control, should also assist branches when ambiguity arises as to how to implement the internal instructions. In Big Bank, the respondents emphasized that internal experts should have operational experience; that is, everyone working in support functions should have started their careers in a branch, working with credit assessments.

If you are uncertain, then you call someone. It is of great importance that they [internal experts] have long experience within the bank so that they know how we think.

(Branch manager, Big Bank)

Although employees in Big Bank have experienced an increased demand for documentation as a consequence of new regulations, the credit process still follows the same logic. Throughout the interviews, the respondents maintained that the bulk of new regulatory-related tasks are handled by the central organization, whereas change and increased workload at the operational level are kept to a minimum.

In Small Bank, the respondents recognized that simply increasing the workload on the bank's current management staff is not sustainable. New tasks are constantly added, and the recent regulation even requires certain tasks to be handled by employees who are independent of the bank's operational activities. However, recruiting new personnel is not a viable alternative, since the bank is simply too small to carry the cost of a full-time internal auditor or a compliance manager. Instead, the bank cooperates with other banks to share the cost of new specialists, or to buy these services from consultancy firms that specialize in regulatory services. Although outsourcing appears to be a financially more attractive solution, the respondents stressed the potential danger in implementing new processes with uncertain effects



on the bank's business. Furthermore, external experts cannot be expected to have the same understanding of how a specific bank operates in relation to its customers. This should be compared to Big Bank, whose representatives emphasized that they are reluctant to hire external consultants; they want to build the competence in-house rather than lose their grip on the bank's own processes.

To summarize the empirical section of our chapter, we have two banks that were initially skeptical about the new regulatory pressure. One reason behind this skepticism is the calculative approach to management incorporated under the regulations, which conflicts, and may be hard to combine, with the two banks' business models. These are based on a strong local anchoring and knowledge of local differences. Over time, the management in both banks seems to have developed a more positive attitude toward the new regulations and particularly the more systematic risk-management practices that the regulations require. However, concerns still exist, especially related to the resources required to handle regulations and, particularly in Small Bank, the future implications for the company. The differences between Big Bank and Small Bank are clearly visible in terms of how they have related to the increased need for resources, both in terms of their responses to regulations and in their contacts with the regulators. Big Bank has invested resources up front in order to protect and preserve its business model, whereas Small Bank has handled these questions reactively, doing as little as possible. This could explain why Small Bank has experienced a more pronounced impact on its business model. The following section analyzes these differences from a theoretical perspective and outlines the possible implications for diversity.

## Discussion

### *Strategic Responses to Regulatory Change*

Based on Oliver's (1991) predictions, we would expect Small Bank to utilize an active response, such as trying to defy or even manipulate the regulator, whereas Big Bank would respond by acquiescing or trying to compromise (see also Clemens et al. 2008). However, our study delivers quite a different story, in which Small Bank has responded passively by acquiescing in a way that would best be described as isomorphic (DiMaggio and Powell 1983). There has been some resistance in terms of 'wait and see,' but for the most part Small Bank has adapted to the regulators' expectations. The passive response displayed by Small Bank could possibly be explained by the coercive pressure of regulations, which was hypothesized by Oliver (1991) to constrain the scope for active resistance (see also Modell 2001). However, considering the importance of the regulations for the bank's business model (Clemens and Douglas 2005; Goodstein 1994), we would have expected some resistance. We find Canning and O'Dwyer's (2013) resource argument

fits well with our case, and the limited resources available to Small Bank has constrained it to rely on others, such as the Savings Banks Association, larger SSBs, and politicians, to fight for its cause (see also Clemens and Douglas 2005; Goodstein 1994).

Big Bank, on the other hand, is more difficult to classify, since it seems to have utilized a number of different responses. There is evidence of both compromises, such as the development of alternative models for reporting and evaluating risk, and even manipulation illustrated by the respondents' frequent contact with the regulators, in which they seem to have a strong idea about how to impact regulation, not least by referring to Big Bank's importance in the Swedish financial sector and successful history. Nevertheless, acquiescence has also been part of their response, sometimes as a consequence of failure to influence the regulatory authorities, exemplified by the internal training of all employees on the Basel II framework, and sometimes as an active choice to accept the new regulations without resistance. Other researchers have identified the utilization of a variety of responses in large organizations (such as Brignall and Modell 2000; Hyvönen et al. 2009; Mikes 2009, 2011; Modell 2001) to stem from the fact that different departments respond differently to regulatory pressure. However, consistent with the argument about goal congruence (Canning and O'Dwyer 2013; Etherington and Richardson 1994; Oliver 1991), and based on our experiences from Big Bank, we would emphasize the analysis of how regulations impact operational processes. Where regulations can be responded to without interfering with basic ideas of how credit processes should be handled, the respondents appeared to be more passive than otherwise. This is rather intuitive, but it also requires that the organization have the resources to actually choose when to respond and when to actively comply.

Thus, the interesting difference between the two banks relates to how their acquiescence strategies have materialized. Big Bank has adapted to the regulations by adding resources to the central level in order to protect the operational level. This has been done in various ways—for example, by building reporting systems, providing operational support, rewriting credit assessment instructions, and analyzing the consequences of new regulations for operational credit decisions. Although the response is passive in terms of Oliver's (1991) typology, it represents, in comparison to Small Bank, a very active means of acquiescence that could help us better understand results from earlier studies suggesting that large organizations show high degrees of acquiescence (cf. Clemens et al. 2008; Goodstein 1994; Ingram and Simons 1995). Clemens et al. (2008:504) specifically conclude that '[l]arger firms simply have the capability to comply with regulations.' This chapter agrees with, and extends, this point. In fact, our findings indicate that larger firms have the capability and resources to make an active choice of whether or not to comply, which also helps to explain why some of the prior work has reached the opposite conclusion, namely that larger firms adopt more active strategic responses, such as defiance or manipulation (cf. Clemens and

Douglas 2005; Milliken et al. 1998). Organizations with enough resources to adapt the instructions of new regulations to internal processes may find the acquiescence strategy more acceptable, unless the regulations are seriously threatening their business models. The importance of size in our study, that is, what the Big Bank can do that the Small Bank cannot do, thereby materializes both through the ability to influence the institutional milieu (compromise and manipulate) and through the resources available to actively comply with regulations (acquiesce).

### *The Consequences of Acquiescence for Small Bank*

As illustrated in the above discussion, the respondents from Small Bank view the regulations as coercive (DiMaggio and Powell 1983; Oliver 1991; Scott 2008); there are simply no other options than to comply. This coercion has several implications for the bank's business model, not least in terms of threatening its main competitive advantage, and legal obligation, of locality. Although Small Bank is still able to issue credit, from a regulatory perspective, to 'non-prudential' customers, it has gradually become more difficult for it to do so. The bank is under pressure to become more similar to the bank described by Öhman (this volume); i.e., relying more on hard information and allowing Type I errors, in which potential earning opportunities are missed. Formal routines, documentary requirements, and more systematized information-gathering require more complicated and time-consuming client meetings, which, we argue, point at a development where Small Bank runs the risk of being perceived as overly bureaucratic and distanced by its customers. Moreover, regulatory issues have increasingly occupied the management in Small Bank, leaving it less time to engage in the daily activities and operations. However, it is not only in the customer interface that the coercive pressures of the regulations have threatened the locality of Small Bank. The regulations have also limited the bank's freedom to choose board members based on local motivations, and the regulatory emphasis on independent functions has forced the bank to consider alternatives with less understanding of local concerns.

For more than a century, Small Bank has shown steady growth, good profits, and negligible credit losses. With the current and historically low risk-related losses, the cost of the regulatory pressure is bound to have a negative effect on the financial performance of Small Bank if it cannot successfully transfer the costs to its customers. In fact, the same is true for Big Bank, with the major difference being that Big Bank has the resources to protect its business model. This brings us to the central question of our discussion: What are the implications of the increasing regulatory pressure on diversity for the financial markets?

### *The Implications of Regulations for Diversity*

Our study contributes to the larger debate on the cost of regulation by investigating potential threats to diversity in financial markets. Specifically, the

intended isomorphic pressure of regulation may threaten diversity by (1) reducing the number of small banks, (2) forcing the banks to adapt progressively more coherent risk-management practices, and (3) limiting the differences in their product offerings. The following paragraphs discuss how our results can be interpreted with regard to these threats.

The SSBs account for approximately 10 percent of the market for deposit and lending in Sweden ([www.swedishbankers.se](http://www.swedishbankers.se)); however, as illustrated in Table 13.2, the number of SSBs has gradually decreased over the past decade. Olsson (2009) concludes that one of the main reasons for this decrease is the increasing regulatory pressure, and the board of Small Bank uniformly agreed that all banks with fewer than 50 employees must at least consider the possibility of a merger. As we have shown, the burden of regulatory work has required investments that are difficult for Small Bank to handle, and posed a serious threat to the bank's survival. The situation in Big Bank is quite different. Big Bank has been able to use its successful history and extensive resources to maintain a 'business-as-usual' approach, at least at the branch level, over the past decade of increasing regulatory pressure. Consequently, we expect concentration and large bank dominance in the banking market to increase over the coming years.

As illustrated in our case discussions, both banks are gradually formalizing and systematizing their risk-management processes. Although Big Bank is better equipped for 'protecting' its core processes, the bank has had to adapt to the regulatory framework. This has forced aspects of centralization and statistics-based risk-management on the bank. However, locally based risk management originates from an understanding of local business, and we have seen that Small Bank has been gradually forced to deviate from its successful business model, whereas Big Bank has managed, to a greater extent, to preserve its locality. An important aspect of the 'locality' of Small Bank is its ability to fund local projects based on an informal understanding and flexibility. However, this ability has been challenged by the regulatory pressure; hence, even if small banks survive, their role in local communities might change.

Finally, the formalization and systematization of risk management makes it considerably more resource-intensive to develop new products—a process that has been highly influential in both banks. The respondents in Big Bank described that much more effort has been put into the process of analyzing new products from a regulatory perspective. The respondents in Small Bank even reported that the bank has had to remove some products and does not have the resources to develop new ones. This lack of resources may be a problem for the banking market in general, but it is particularly important for small retail banks that are highly dependent on deposit funding. If products aimed at attracting depositors are considered too costly or too complex to develop, banks without access to the interbank market will find it even more difficult to survive in the future. Furthermore, their ability to be a flexible partner to local actors will be further hampered by this development.

### Conclusion and Implications

This chapter set out to further our understanding of how the isomorphic pressure of regulation may threaten diversity in financial markets. To this end, we mobilized Oliver's (1991) typology of strategic responses to explore how increasing regulatory pressure has influenced the risk and control processes, and ultimately the business models of one large and one small bank. We found that our two banks, which have similar business models, differ substantially in terms of how they have acted and reacted in relation to the regulatory pressure. The small bank responded to new regulations via acquiescence, a strategy that has threatened its financial strength and position as an understanding and flexible business partner to local businesses by accepting a more formalized and systematic approach to business. The risk in challenging the regulatory authorities is perceived as high, and the bank lacks the resources to do so. The benefits related to regulation are attributed to a strengthened sense of security. However, with the historically low credit losses, there is little financial gain to be expected.

The big bank, on the other hand, has provided multiple responses to the regulatory pressure, which were largely chosen depending on the regulations' presumed influence on operations. This flexibility has been enabled by the bank's ability to use resources at the central level to preserve the existing business model, that is, a more active form of acquiescence compared to the small bank. The big bank's ability to use different strategies depending on the situation is also key to understanding the differences between small and big banks. This finding supports Canning and O'Dwyer's (2013, p. 174) argument that the capacity of actors to adopt passive or active responses is contingent on the resources available to them. However, we suggest that future research use the resource argument not only to explain *which* strategy a firm chooses, but also to explain *why* the different choices are perceived as active or passive from the actor's perspective. In our case, the big bank made an active choice as to when to acquiesce, whereas the small bank had to passively acquiesce, even to regulations that threatened its survival. Hence, our intentional selection of banks with flexible and responsive business models, which are much at odds with the specialized and formal regulatory specifications, points to an important difference in the interpretation of the two banks' responses. Through its ability to analyze the consequences of regulations for the business model, the big bank has ensured goal congruence (Oliver 1991) by choosing its responses depending on the perceived threat of the regulations to its business model.

A limitation of this study is the omission of the regulator perspective, and we highly recommend that future studies include both perspectives in order to better explain regulatory creation. Specifically, we expect that the big bank's accrued relationship with the regulator has given it the opportunity not only to influence the regulator, but also to enact a regulatory framework that has been developed gradually, taking into consideration the big-bank business context.

The practical considerations of the chapter relate to the trade-off between diversity and transparency. As we have shown, diversity in the Swedish banking market has been threatened by the regulatory pressure in several ways. This observation is, in itself, not surprising, since one of the main purposes of regulation is to reduce information asymmetry by enforcing comparable evaluation criteria among the market participants (e.g., Haan et al. 2009). However, transparency must be valued against the other two regulatory purposes, namely the maintenance of stability in the financial system and the protection of customers against monopolistic exploitation (Haan et al. 2009). Based on our findings, we argue that both of these purposes are at risk if there is less diversity in the market. In line with contingency theory, we therefore maintain that banks of different sizes, and with different business models, need different control systems, including different regulatory frameworks. Several of the chapters in this book study banks with business models that fall outside the regulatory ‘average.’ Clearly, banks’ business models based on social values and collectivity (Brunsson, this volume; van der Steen, this volume), as well as flexibility and responsiveness, have a long and successful history. It is possible that such business models can survive if the banks are large enough to protect them; however, as shown by van der Steen (this volume), it will come at considerable cost. This should not be seen as a critique of regulation per se, but as a critique of the idea of placing the same regulations on all banks. It may very well be that small retail banks need stricter regulations, but of a different kind compared to those for large banks.

## Notes

- 1 The small bank is not Virserum Bank.
- 2 For instance, a recent report from the Swedish Financial Supervisory Authority (SFS) shows that Swedish banks are already largely compliant with the increased capital and liquidity requirements covered by Basel III (SFS 2012).

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