CONTROL MECHANISMS FOR RISK-TAKING: EVIDENCE FROM THE UK FINANCIAL SERVICES INDUSTRY

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DECLARATION

I certify that the work contained in this thesis, or any part of it, has not been accepted in substance for any previous degree awarded to me, and is not concurrently being submitted for any degree other than that of Doctor of Philosophy being studied at the University of Greenwich. I also declare that this work is the result of my own investigations, except where otherwise identified by references and that the contents are not the outcome of any form of research misconduct.

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ABSTRACT

The significance of institutional traits when incorporating risk metrics into performance management systems (PMSs) in the financial services sector have been under investigated in the management accounting literature. This thesis explores attempts by UK and European regulators to impose controls on the PMSs of a number of regulated employees (material risk takers (MRTs)) in the UK financial services sector, in order to modify risk-taking behaviour. Additionally, the thesis investigates banks' responses to regulatory pressures; exploring the effectiveness of controls, and initial steps, to identify the guiding principles underlying changes to the risk-taking behaviours of MRTs. It reports on illuminating differences in how new controls were implemented across various banks following the 2008 financial crisis, and how this variability impacted their effectiveness. Finally, the thesis queries the assumption that incentives are a driving force of MRTs' risk-taking behaviour, by investigating the significant role of banks' risk-taking cultures.

The middle-range approach taken in the study draws on Oliver's (1991) typology of strategic responses to institutional processes and management control systems theories. It does not aim to test Oliver's theory, but rather to use her framework as a theoretical 'skeleton' to be 'fleshed' out with empirical data. Evidence was found to support several of Oliver's ideas, including escaping from institutional pressures through concealment, and identifying areas requiring conceptual refinement. For example, the prediction that local regulators would acquiesce to demands from EU regulators is largely unsupported. Similarly, a middle-range approach is adopted when implementing management control systems theories, and used as a tool to provide theoretically informed explanations of the empirical findings.

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ABBREVIATIONS AND ACRONYMS

BoE	Bank of England
BPU	Business Prevention Unit
CRD	Capital Requirements Directive
EBA	European Banking Authority
ECB	European Central Bank
EMEA	Europe, Middle East and Africa
EU	European Union
EY	Ernst and Young
FCA	Financial Conduct Authority
FSA	Financial Services Authority
IMF	International Monetary Fund
IRM	Institute of Risk Management
IR	Interpretative Research
ISO	International Organisation for Standardisation
MCS	Management Control System
MRTs	Material Risk Takers
NIS	New Institutional Sociology
OIE	Old Institutional Economics
PAB	Professional Accounting Body
PCBS	Parliamentary Commission on Banking Standards
PMS	Performance Management System
PRA	Prudential Regulation Authority
RQ	Research Question
RO	Research Objective
SMR	Senior Managers' Regime
TLOD	Three Lines of Defence
UK	United Kingdom
USA	United States of America

1. INTRODUCTION

1.1 Background

The fallout from the 2008 financial crisis demonstrated the systemic importance of the financial services industry to the global economy. The crisis was largely attributed to behaviour encouraged by inappropriate incentive structures operating within the industry, although the poor risk culture was also cited (Turner, 2009; Walker, 2009). Consequently, industry regulators have since introduced several codes of conduct concerning remuneration, to ensure that compensation arrangements are contingent on observance of sound risk management practices (PRA[1], 2015).

In view of the above, the most prominent changes within the financial services industry to-date have been to compensation arrangements and the risk culture itself (PRA, 2015; Turner, 2009). In 2009, the UK Prudential Regulation Authority (PRA) imposed a Remuneration Code linking long-term incentive plans to performance and risk management. Its intention was to mitigate employees' propensity for excessive risk-taking. The code was only applicable to financial institutions, and primarily to those individuals whose work had a significant effect on the firm's risk profile: labelled 'material risk takers' by the PRA. The predominant features of the Remuneration Code were that a portion of the MRTs' remuneration had to be paid in the form of deferred equity[2], and that bonuses (both vested[3] and unvested[4]) should be subject to clawback provisions. Clawback refers to the right of the banks to recover bonuses previously awarded to an employee. The triggers for a clawback are: serious individual misconduct, risk failure, or the firm or business unit suffering a significant decline in its financial performance. Furthermore, the 2014 Capital Requirements Directive[5] (CRD) IV, required bankers' bonuses be restricted to one hundred per cent of their fixed pay, or to two hundred per cent of their fixed pay with shareholders' permission. In summary, three new control mechanisms were introduced into the MRTs' compensation packages to reduce their propensity for excessive

[1] Prudential Regulation Authority, UK
[2] At least 50% of any variable remuneration had to be paid in shares or share-linked instruments.
[3] A financial incentive where the employee is entitled to the full amount immediately.
[4] A financial incentive that has been awarded, but where the employee is not yet entitled to the full amount.
[5] The Capital Requirements Directive is an EU legislative package that covers prudential rules for banks, building societies and investment firms.

risk-taking: bonus deferrals, bonus clawback clauses, and a bonus cap. Added to these three controls mechanisms was a requirement that risk metrics be included in MRTs' PMS.

The introduction of these new controls on compensation was unwelcome among banks; with the first proposal made in the Remuneration Code receiving unprecedented negative feedback from the industry. The introduction of the European Union directed CRD IV bonus cap rule caused even greater tension in the industry and beyond, resulting in the then UK Chancellor of the Exchequer, George Osborne, legally challenging the rule in the European courts (BBC, 2014).

This thesis investigates and details attempts by European and UK regulators to change the risk-taking behaviour of MRTs working in investment banks after the 2008 financial crisis, through the introduction of new regulatory mechanisms to govern PMSs. It explores not only *whether* the new control measures changed risk-taking behaviour, but if so, *how* and *why*. It specifically examines the Remuneration Code, whilst also considering the European directed CRD IV bonus cap, to ascertain how it was translated at a local level in the UK.

The term 'excessive' risk-taking is central to the debate on this topic, yet surprisingly there is a dearth of both academic and practitioner literature explaining what the term 'excessive' risk-taking actually means in the context of the financial services sector. The concept of 'excessive' risk-taking is a complex phenomenon, yet one that is often taken-for-granted or deemed self-evident in many academic papers, practitioner reports and policy documents. As such, this thesis will attempt to firmly grasp the concept of 'excessive' risk-taking as understood by those working in the financial services industry.

1.2 Motivation for the study

Several years have passed since the introduction of the first Remuneration Code in 2009, yet the continued scandals highlight how frequently things can and do go wrong in this sector. Post-2008, banks spent vast sums of money implementing numerous regulatory change initiatives, concerning both incentive arrangements and their risk culture. Nevertheless, these initiatives failed to prevent subsequent banking scandals; the most audacious example demonstrating that reckless risk-taking continues to thrive in the industry is the so-called 'London Whale,' involving Bruno Iksil, a trader from JPMorgan Chase who lost the bank $6 billion in 2012 (FT.com, 2015a). What is noteworthy about this case is that, ironically, JPMorgan Chase had a reputation for 'best-in-class' risk

management and the loss arose in a part of the bank responsible for suppressing risk. The bank's CEO and Chairman, James Dimon, admitted that the failing occurred because traders did not have the '*requisite understanding*' of the risks they were taking; the risk limits were not specified; the risk control functions failed to adequately challenge the traders' judgment; there was weak risk governance; and further, there was poor scrutiny from senior management of firmwide risk (Dimon, 2012). The Permanent Subcommittee on Investigations (2013, p.7) found the failure in the risk culture was a critical factor in the case, citing:

> [A] bank culture in which risk limit breaches were routinely disregarded, risk metrics were frequently criticised or downplayed, and risk evaluation models were targeted by bank personnel seeking to produce artificially lower capital requirements.

Similar examples include that given by Kweku Adoboli, a London-based UBS trader who lost UBS $2.25bn on unauthorised trades in 2011, and the foreign exchange rate rigging scandal, which cost six banks $5.6bn in fines from the regulators in May 2015 (FT.com, 2015b).

The recurring banking scandals prompted the managing director of the International Monetary Fund (IMF), Christine Lagarde, to call for another change to bankers' pay arrangements. In conversation with the Chair of the Board of Governors of the Federal Reserve System in May 2015, Lagarde stated that risks to financial stability were continuing to arise, largely due to the incentive arrangements and culture of the industry. She stated that regulation alone would not be sufficient to solve the problem: '*What is needed is a culture that induces bankers to do the right thing even if nobody is watching*' (IMF, 2015). Elsewhere, the UK Financial Conduct Authority (FCA), in their 2015/2016 risk outlook, cited poor culture and controls at banks among the most important areas for future focus, linking these dangers to the design of their incentive structures. They stated:

> [F]irms must ensure that all of their processes support and reinforce the culture they want to promote. Some examples include firms' remuneration, hiring, performance management and promotion decisions, as well as how they treat internal reporting of concerns…We consider that there is a continued need for firms to consider the impact their incentive structures and other performance management tools may have on behaviour and the steps they need to take to adjust these. (FCA, 2015, p.18)

This raises two questions: What changes have been implemented over the past seven years? And, why are there still calls for more changes to be made to the industry?

It is important to contextualise the changes in incentive arrangements, as in many banks they have been implemented alongside numerous other initiatives intended to address banks' risk culture. The most prominent cultural change initiatives to ameliorate risk management at banks to date focus on: compliance with risk functions; adherence to risk limits; clarity of a firm's risk appetite; timely responses to control queries; and ensuring performance management and reward systems are linked with risk management. As the CEO of Barclays, Anthony Jenkins, explained to the FT:

> We have developed a system at Barclays to measure both what people have to deliver – based on our balanced scorecard – and how they deliver it. Overall compensation is a composite of the two and importantly if someone achieves their goals but does it in a way that is not compatible with our culture then they will fail to hit their target. (FT.com, 2014)

A significant proportion of the new control measures require that MRTs receive equity in the bank as part of their bonus award, with the requirement that fifty percent of any variable award be paid in shares or share-linked instruments. This measure is intended to reduce excessive risk-taking and enhance performance. A study by Ittner *et al*. (2003a), however, found that companies in which the top five executives have lower equity holdings than the industry benchmark actually performed better. Furthermore, Gregg *et al*. (2012) studied whether bankers' incentives were to blame for the 2008 crisis, and found the greater the proportion of incentive pay the less likely the bank was to fail. This held true for banks before and after the crisis. These findings question the regulators' insistence that high incentives were a contributory factor to the crisis, and more worryingly, whether their solution of forcing MRTs to hold more equity to prevent another crisis, is an appropriate solution. Another study by Murphy and Jensen (2011) also questions the regulators' policies, arguing there is little or no evidence to prove that bankers' bonuses were a contributory factor to the crisis. In fact they believe cultural and performance issues were the biggest contributors, arguing that post-crisis, widespread misinterpretation of compensation arrangements were responsible for '*erroneous criticisms*' by politicians and the media. Nonetheless, widespread support for changes to compensation arrangements amongst policy makers and others outside the financial services industry continues; despite the distinct lack of theoretical and empirical evidence to demonstrate that these changes will achieve the desired result of reducing excessive risk-taking (Yermack, 2013). In fact, recent evidence suggests certain elements of these new control schemes will conflict with their purported aim to reduce excessive risk-taking (Ayadi *et al*., 2012; Fahlenbrach &

Stulz, 2011; Gregg *et al*., 2012; Hartmann & Slapničar, 2015)[6]. Undeniably, these studies highlight that academic theory and reality appear to contradict the efficacy of the regulators' policies.

In recent years, there have been many calls for research in this area by prominent management accounting scholars. For example, Lim *et al*. (2017) argue that detailed studies of practice, particularly in the financial services sector concerning risk, are '*rare*' and necessary. Van der Stede (2011, 2015) calls for research on incentives and risk management that considers the organisational design (both structure and culture). Finally, Hartmann and Slapničar (2015) call for an empirical investigation to complement their experimental study into the effects of the new incentive measures on risk-taking behaviour.

The research described herein answers these calls using a middle-range thinking approach (Laughlin, 1995). First, by exploring the banks' responses to the new control mechanisms, and second, by investigating *whether* the new incentive controls have altered traders' risk-taking behaviour, and if so, *how?* And *why?*. The thesis uses an institutional theory lens in a middle-range theory way[7], to shed light on the processes by which the investment banks have adopted the new control mechanisms and the controls imposed, and a systems theory lens to explore the effectiveness of the new control mechanisms on MRTs' risk-taking behaviour.

This unique study introduces evidence obtained in interviews with: MRTs (traders), their control functions, regulators, and other industry experts, to assess if the new control measures have had the desired effect of curbing excessive risk-taking. As a study like this had not been done before, it contributes to: the literature on control mechanisms for risk-taking in the UK financial services sector; the literature on the bonus system design in the financial services sector and the institutional theory literature, policy makers' understanding of the impact of their policies, and the practitioner literature on controls and risk-taking and bonus system design.

Following this introduction to the background and motivation for this thesis, the following section discusses the conceptual approach taken, detailing the theories, methodology and methods employed within it.

[6] See literature section for more detail on these studies.
[7] A middle-range approach allows for more than one theoretical framework to be utilised in a study (Laughlin, 1995, 2004).

1.3 Theories, methodology and methods

As previously mentioned, a middle-range thinking approach was used as the theoretical lens for this thesis, because it provided '*[A] basis for meaningful theoretical engagement with organisations*' (Broadbent & Laughlin, 2014, p.267) under conditions of uncertainty. The use of a middle-range approach allowed for more than one theoretical framework to be utilised (Laughlin, 1995, 2004). Thus, a '*skeletal*' framework of both methodology and theory informs the research design, and can be '*fleshed*' out and guided by the empirical data collected.

The context within which this thesis rests includes two main areas: the investment banks' responses to new remuneration regulations (institutional pressures), and the impact of those remuneration regulations (incentive controls) on the risk-taking behaviour of traders in the UK financial services sector. To acquire evidence from these two areas, both a management controls systems theory perspective, and an institutional theory perspective were adopted. The institutional perspective contributed a further conceptual viewpoint to the question of what the investment banks' responses to the new remuneration regulations were, highlighting the institutional factors at play in the banks' remuneration policies. Meanwhile, the management control systems' perspective provided a framework to help assess the impact of new incentive controls on the risk-taking behaviour of traders in the UK financial services sector.

Investigating the impact of the compensation control mechanism on risk-taking from the perspective of the actors within the industry provided an opportunity to examine it within an organisational and institutional context. The institutional perspective was selected as it affords valuable insights into how organisational environments influence the behaviour of organisations, and more specifically how organisations respond to environmental pressures (Deephouse, 1996; DiMaggio & Powel, 1983; Oliver, 1991). The relevance of adopting an institutional perspective in this study can be understood when recognising that the process of remunerating staff in the corporate sector is a highly institutionalised activity (Westphal & Zajac, 1994). New institutionalism will be used to help explain the strategies, rationales, and resources that investment banks based in the UK utilised to achieve their agendas. How the institutional factors that shape the responses of individual banks' in this study to novel control mechanisms will also be explored. Oliver's (1991) typology of strategic responses to institutional processes will also be used to help explain the differences found

in the interpretation and adoption of new control mechanisms by the investment banks included in this study.

Whilst only a limited number of the studies in the management accounting literature have explored the link between compensation arrangements and risk-taking behaviour, those that exist have favoured a positivistic approach: as will be discussed in detail in Chapter 2. It is noteworthy at this point that no studies conducted to date have spoken directly to those actors affected by the new control mechanisms.

The chosen method for the thesis was a qualitative field study; the primary data source being face-to-face semi-structured interviews with thirty-four bankers from ten large UK based investment banks, two regulators, one partner at an accountancy firm that provides tax advice to the banks on their remuneration policies, and one Head of Corporate Governance at a large asset management firm, whose firm is a majority shareholder in many investment banks and plays a key role on voting on the remuneration policies of the investment banks. The richness of the qualitative study methodology allowed for an in-depth assessment of what was happening in the industry, helping to reveal facts that would not have emerged under a quantitative framework. Further data was collected in the form of four types of documentary evidence: (1) regulatory documents, (2) banks' annual reports, (3) internal compensation contracts of employees, and (4) media reports on new regulations.

1.4 Thesis design

The thesis design is derived from a methodology based on Lukka and Modell's (2010) adaption of Interpretative Research (IR). It adopts a pragmatist philosophy, which integrates social constructivism with moderate forms of realism. As the combination of control mechanisms under review in this study is relatively new, very little has been written about their effectiveness (or lack thereof) in either academic or practitioner literature. This led the researcher to choose an abductive approach to the study, as she was not convinced that existing management accounting theories could adequately capture all the relevant factors in play.

As will be discussed in greater detail in Chapter 3, the design of the thesis developed in a non-linear manner. There were frequent iterations between the theory and the empirical data to establish which theory or theories best explained the observed phenomena; a process described by Shepherd and Suddaby (2016) as 'Pragmatic Empirical Theorising'.

The thesis was initially designed to reveal real issues facing the UK financial services industry; in particular, to assess how best to curb traders' excessive risk-taking behaviour. However, it was conducted through an academic lens, involving theorising the problem the industry faced as well as collecting empirical data. Vaivio (2008) supports the need to balance practical and theoretical aspects of a research study to ensure that the research reflects the world from which it originates. He argues that too much focus on theoretical aspects results in research that is only interesting to small niche communities; whereas too much emphasis on practical aspects can result in a consultancy type project, thereby rendering it less relevant to academic communities. Therefore, it was very important to the researcher to strike an appropriate balance between practice and theory in this study.

1.5 The research aim and objectives

The primary aim of this thesis was to clarify the processes by which UK-based investment banks interpreted and adopted the new compensation controls imposed on them by UK and European regulators, whilst also assessing if these new control mechanisms changed traders' risk-taking behaviour. Its intention in doing so is to reduce the gap between theory and practice.

The thesis, therefore, aimed to address the following overarching research question (RQ):

> What were the banks' responses to the new control mechanisms, and have the new control mechanisms changed the risk-taking behaviour of traders in the UK financial services sector? If so, *how* and *why*?

This overarching question leads to the following subsidiary questions:

> RQ1: What were banks' responses to the new control mechanisms?
>
> RQ2: What can be theoretically observed about banks' responses to the new control mechanisms?
>
> RQ3: Did the new control mechanisms change the risk-taking behaviour of traders?

These sub-questions will be used as the basis for structuring the thesis; each sub-question will then direct the analysis phases later in the thesis.

To meet the overall research aim, the research objectives (ROs) are specified as follows:

RO1: To examine the literature on institutional theory to comprehend a firm's reaction to institutional pressures.

RO2: To review the literature on management controls and risk-taking, to gain an understanding of what is currently known about the topic.

RO3: To review policy documents, banks' annual reports and newspaper reports regarding the new regulations, to understand the context in which they were conceived.

RO4: To qualitatively analyse data drawn from semi-structured interviews with financial services personnel, to gain insight into their perceptions of the effectiveness of the new control mechanisms.

RO5: To qualitatively analyse data drawn from the archival sources, to gain insight into the views of actors at the time of the study.

RO6: To use the insight gained from the analysis of the semi-structured interviews and archival data to contribute to the literature on institutional theory, control mechanisms and risk-taking.

1.6 Synopsis of the research journey

For ease of reading and understanding, this thesis is laid out in a traditional format, with the research questions and theory upfront, and the findings presented thereafter. However, this thesis was not conducted in any traditional sense, rather it is the result of a developmental approach. The section that follows describes the evolution of the research project chronologically.

The initial aim of the research was to focus on one area: did the new control mechanisms imposed by the regulators change the risk-taking behaviour of traders in the UK financial services sector? If so, *how* and *why*? This later became the focus of RQ3, as listed above. With this primary question in mind, and using a middle-range thinking type approach, the pilot study was conducted. Three theories, namely agency theory, prospect theory and management control systems theory, helped establish the semi-structured questions for the pilot study. From the analysis of the data in the pilot study two factors became evident. The first observation was that the incentive controls alone appear to be having little or no impact on shaping the risk-taking behaviour of the traders involved in the study. Culture, on the other hand, and as discovered later in the process specifically risk culture, was

having a huge impact on how the traders in the study viewed and responded to the incentive controls imposed on them. Second, even at such an early stage in the data collection process, the researcher could see that a split in the data was starting to emerge, which was entirely unanticipated. This split will be discussed in detail in Chapter 6, and is referred to as a split between type A and type B banks. It was at this point the management control systems theories started to provide strong theoretical explanations to explain the behaviour observed in the interviews.

The remaining interviews were conducted with these observations in mind. After analysis of all the interview data, it was observed that many of the behavioural differences observed depended upon which bank type the respondent worked in. The differences were too large to ignore and led the researcher to question why individuals who work in similar roles, operating under the same controls and the same environment, have markedly different responses and behaviour to similar individuals working in another bank type. This prompted the researcher to investigate what was happening at bank level to gain a better understanding of what she was observing at the individual level. It was at this point that research questions one and two were added to the study, and it was found that an institutional lens, and specifically Oliver's (1991) typology of strategic responses to institutional processes offered the researcher theoretically informed explanations to the phenomena she was observing. The findings to RQ1 and RQ2 were presented before the original research question (RQ3), because in order to understand the findings about RQ3, the findings from RQ1 and RQ2 must first be understood.

In order to explore what was happening at bank level, the researcher analysed numerous secondary data sources, such as those from banks' annual reports, white papers, regulatory reports and consultations, and media reports on banks' reactions to the new regulations. Data from the interviews was also used to assess the validity of the findings from the secondary data. Additionally, a discussion took place with the regulators to confirm that no misunderstandings had occurred, although this cannot be reported in detail as it took place under Chatham House Rules. The findings, conclusions and recommendations from this thesis were also discussed and validated with the Head of Corporate Governance at a large asset management firm, whose company is a large shareholder in some of the banks in the study. Finally, due to the unique nature[8] of the study, the researcher was invited to the

[8] No other study to date has interviewed MRTs and their support departments to gauge how the newly introduced controls are working out.

Bank of England (BoE) on two[9] occasions to present the results of her findings and make recommendations to policy makers from the Remuneration[10] division and the Senior Managers Regime[11] division.

1.7 Overview of thesis

Chapter 2 will provide a critical review of the literature, mainly focusing on RQ3, and the link between compensation controls and risk-taking. It will analyse the different methods and theories used in existing studies on the topic of control and risk-taking, and identify the gaps in the literature this study aims to address.

Chapter 3 introduces the methodological approach of pragmatic constructivism utilised for the thesis. It also explains the rationale for adopting a middle-range thinking approach when conducting the study. Furthermore, it explains the rationale for choosing an interpretative methodology for the study, rather than the mainstream methodological position adopted by the majority of studies previously conducted in this area. The chapter will explain how an interpretive methodology was used in this study, and discuss how field-based qualitative methods of data collection were analysed and used. Finally, this chapter explains why an institutional theory approach is compatible with the chosen methodology, methods and data presented in this thesis.

Chapter 4 discusses the additional theoretical framework added to this thesis, to assist with answering research questions one and two. As previously mentioned, institutional arguments provide the lens through which these research questions will be investigated and interpreted. As such, this chapter will provide a brief critical review of the institutional literature from its inception to the present day. Moreover, as Oliver's (1991) typology of strategic responses to institutional processes provides the guiding framework for this part of the research, it will be explored in more detail in this chapter. Also included in this chapter will be a discussion of how institutional theory has been used in previous management accounting studies. The chapter concludes by explaining how institutional theory is used in the thesis, whilst also clarifying how the theory served to refine the research questions and refocus the data analysis.

[9] First meeting took place in April 2017 and second meeting in October 2017.
[10] Responsible for the Remuneration Code.
[11] A policy introduced in March 2016. For further information see section 7.7.3.

Chapter 5 sets out the motivation for the thesis and the history and context regarding the new remuneration regulations. As the design of this thesis is based on Lukka and Modell's (2010) approach to interpretative research, the history and context of the remuneration regulations are critical to constructing interpretations of the data in it.

Chapter 6 presents the findings of the thesis based on the three sub-research questions presented in Chapter 1.

Chapter 7 provides the conclusion to the overarching research question. It also discusses the findings of the thesis from a theoretical perspective. Flaws in the current PMSs used in the UK financial services industry are identified, along with suggestions to enhance existing PMSs to control MRTs and senior managers[12] at investment banks.

Chapter 8 concludes the thesis and presents a summary of the conclusions drawn concerning the original research questions. The contributions of the thesis are also outlined in this section, as are the limitations of the thesis, and suggestions for future research.

The following chapter presents an overview of the literature on management control systems and risk-taking from a management control perspective.

[12] 'Senior managers' describes members of the board and senior managers as defined by the PRA Remuneration Code, and under the Senior Managers Regime.

2. LITERATURE REVIEW

2.1 Introduction

As discussed in Chapter 1, the international financial services sector is of vital importance to the stability of the global economy. The UK financial services sector alone contributed almost 12% of the UK's GDP in 2014 (TheCityUK, 2016), indicating its major importance to the UK economy. The near-worldwide financial turmoil that erupted following the 2008 financial crisis revealed the importance of the stability of this sector to the global economy. To prevent another crisis of this kind, many regulatory bodies have focused their attention on the remuneration arrangements of investment bankers, believing these arrangements were a primary contributor to the crisis. Controls have now been put in place to govern remuneration arrangements in an attempt to prevent bankers from taking excessive risks.

The primary aim of this thesis is to clarify the processes by which the banks adopted these new controls, and to explore any consequences of these control mechanisms on the risk-taking behaviour of traders in the UK financial services sector. It will gather evidence directly from involved participants, an approach never before taken in academic studies of this topic.

As noted in Chapter 1, at the outset of the study, the combination of new incentive control mechanisms were a new phenomenon in the UK financial services industry, and there had been very little empirical work on their effectiveness as a means to curb excessive risk-taking. The exceptions were experimental studies using students as test subjects; such as that conducted by Hartmann and Slapničar in 2015, and a quantitative study that looked at *overall* bank risk carried out by Kleymenova and Tuna in 2016. These studies will be discussed in detail later in the chapter. The new control mechanisms were introduced to change *individuals*' risk-taking behaviour, and not to *reduce* overall bank risk, and this is the first study that interviews the individuals directly affected by these new controls.

As a key aim of the study was to explore whether the new incentive controls changed the risk-taking behaviour of traders in the UK financial services industry, exploring what was already known about compensation control mechanisms in general, understanding their effectiveness in curbing excessive risk-taking was important. As will be shown in the literature review that follows, very little empirical research has been conducted into the

link between compensation control systems and risk-taking, and none of this provides empirical evidence from a real-world field study in the UK financial services sector. The primary research question enquired about risk-taking in the UK financial services sector, as exploring what was already known about risk in the UK financial services sector was also pertinent within the context of the overall thesis.

The section that follows critically analyses the relevant literature streams mentioned above, identifies the gaps in the literature, and concludes by establishing how this study can help to close some of the gaps identified.

2.2 Risk-taking literature

As 'risk' is a central tenet of this research, it is important to discuss what risk is and how it is conceived of in the financial services industry. There is a wealth of both academic and practitioner literature on the topic of risk in the financial services industry (Ayadi *et al*., 2012; Belkhir & Boubaker, 2013; Chen *et al*., 2006; Hagendorff *et al*., 2016; Hartmann & Slapničar, 2015; Kleymenova & Tuna, 2016; Mikes, 2009, 2011; Power *et al.*, 2013; Soin & Scheytt, 2009; Soin & Huber, 2012; Wahlström, 2009; Willman *et al*., 2002). However, attaining a consensus about what constitutes risk is understandably problematic, as there are many varying and often contradictory definitions. The 2009 International Organisation for Standardisation (ISO) on Risk Management, ISO31000, defines risk as '*the effect of uncertainty on objectives*'. An academic definition of risk given by Sanders and Hambrick (2007) is '*[T]he degree to which potential outcomes associated with a decision are consequential, vary widely, and include the possibility of extreme loss*' (p. 1057). To the man in the street, however, a more commonly held view of risk is one associated with negative undertones, that is, a potential for future losses, due to action or inaction that has already taken place. It is not just the man in the street who holds this negative view of risk: March and Shapira (1987) in a field study of managers, reported that managers also think of risk in terms of the possibility of large losses, rather than other more widespread probabilities as the official definition suggests.

Over the years, the importance of managing risk in organisations has grown immensely, particularly in the financial services industry, with the result that now all large financial services firms have dedicated risk management departments. Risk management, as defined by Collier *et al*. (2006), '*[I]s the process by which organisations methodically address the*

risks attaching to their activities in pursuit of organisational objectives and across the portfolio of all their activities' (p. 2).

Establishing categorically what risk is and/or is not falls outside the scope of this thesis. However, for the purpose of this thesis it is important to loosely define what the term means in the context of this study. In the financial services industry, five broad categories of risk are identified and 'managed':

1) *Market risk* is financial risk due to the price volatility of trading positions in the market.
2) *Credit risk* is the financial risk that customers will not be able to fulfil their contractual obligations.
3) *Liquidity and Funding risk* is the risk of having insufficient capital and liquidity resources.
4) *Operational risk* –is risk proceeding from inadequate internal processes and/or systems failures, and from external events.
5) *Conduct/Behavioural risk* is the risk that individuals will exhibit poor judgment and/or act fraudulently.

As can be seen from the broad categories of risk listed above, some are easily quantifiable and measurable and thus managed (market, credit and liquidity risk). However, other risks, like operational and conduct risk are more subjective and difficult to quantify, measure, and manage. The use of robust internal controls; such as the new remuneration regulations for example, are often used as tools to attempt to mitigate some of the behavioural type risks, however their effectiveness is still unknown. In practice, the tools used to manage behavioural risks include: compliance with the other categories of risk mentioned above; regular mandatory training on risk related topics; investigations on employee breaches of risk metrics; level of compliance with risk and other control functions; and the timeliness of responses to issues. This thesis is concerned primarily with conduct/behavioural risk, and takes the first steps towards understanding the relationship between incentives and risk-taking controls in real-world settings.

As the primary aim of the new remuneration regulations was to alter the risk-taking behaviour of MRTs, other factors that are known to change risk-taking behaviour must also be mentioned at this stage (although these are not the primary focus of this thesis). In addition to incentives (Agrawal & Mandelker, 1987; Ayadi *et al*., 2012; Bebchuck &

Spamann, 2010; Belkhir & Boubaker, 2013; Chen *et al*., 2006; Hartmann & Slapničar, 2015; Sanders & Hambrick, 2007), other factors commonly known to influence risk-taking behaviour are: controls (Hartmann & Slapničar, 2015; Kleymenova & Tuna, 2016), environment (McAlvanah, 2009), gender (McAlvanah, 2009; Powell & Ansic, 1997), personality (Hagendorff *et al*., 2016), emotions (Lerner *et al.*, 2014), and perception (Hartmann & Slapničar, 2015; Kahneman & Tversky, 1979; Kahneman & Lovallo, 1993).

At this stage in the evolution of the topic of risk, it can be argued that the concept of risk is understood to be a multi-layered phenomenon and theoretically infinite. There are different perceptions of what constitutes risk; for example, the Collier *et al*. (2006) study argues that risk is a socially constructed phenomena, as it better reflects how risk is viewed and managed in organisations. As will be explained in Chapter 6, the findings from this thesis support a view of risk as socially constructed. Furthermore, it is believed that the regulators' and banks' responses to risks similarly reflect the supposition that risk is a social construct (Collier *et al.,* 2006).

2.3 Risk culture

As discussed in Chapter 1, inappropriate incentives combined with a poor risk culture were identified as the principal causes of the 2008 financial crisis (Walker, 2009). Consequently, efforts to alter the risk-taking behaviour of banks after the crisis focused on addressing and altering their risk culture. When developing this study by applying a management controls systems lens, it emerged as important to establish that new incentive controls would not be viewed in isolation from other controls that might also contribute to changes in behaviour, one of these other controls being the risk culture at banks. Thus, understanding the concept of risk culture in the context of changes made in the UK financial services sector is also pertinent to this study.

Emphasis on the phrase 'risk culture' has increased within the financial services sector since the 2008 financial crisis, and is often cited as the reason for the failure of other control measures. However, the call for organisations to embed a 'risk management culture' into their business operations is not a new phenomenon, prior to the crisis academics such as Collier *et al*. (2006) advocated the benefits of employing risk management practices in organisations.

The Institute of Risk Management (IRM) defines a risk culture as:

> A term describing the values, beliefs, knowledge, attitudes and understanding about risk shared by a group of people with a common purpose, in particular, the employees of an organisation. (IRM, 2012)

Arguably, a risk culture is not distinct from culture in general, rather it frames the culture problem by focusing attention on key risk-taking activities (IRM, 2012; Power *et al*., 2013). Power *et al.*'*s* (2013) post-crisis study of risk culture offers the most comprehensive report on the subject to-date. It revealed that whilst there are commonalities as to what constitutes a 'strong' or a 'weak' risk culture, there is no precise agreement. They argue that the concept of risk culture is socially constructed and subjective, making distinguishing between a strong or weak risk culture difficult. Whilst agreeing with this sentiment, in practice at least, banks have defined what they consider to be indicators of a strong risk culture. Using Barclays Bank as an example, they identified four key elements believed to demonstrate a strong risk culture: tone from the top; accountability; effective communication and challenge; and incentives (Barclays, 2015, p.99).

Reviews in academic (Power *et al.*, 2013) and practitioner (EY, 2013) literature, and analyses of banks' annual reports revealed the main areas targeted in risk cultural change initiatives post-crisis to be: change in tone from the top; clarity and enforcement of trading limits; clarification of the firms' risk appetite; compliance with risk and control functions; and ensuring that performance management and reward systems are linked to risk metrics. Regulation is deemed the main driver of risk cultural change programmes in the financial services sector, with organic change playing a lesser role (Power *et al.*, 2013).

In terms of the risk control frameworks adopted by the banks post-crisis, many banks used a 'Three Lines of Defence (TLOD)' approach as a control framework for monitoring risk (PCBS, 2013). In the first line of defence is front office staff who take responsibility for day to day risk; the second line comprises control functions, such as risk management, compliance, and product control functions; and the last line of defence is the internal audit function. However, as evidenced by the numerous banking scandals after the 2008 crisis, there is evidence that this control framework is failing in some banks. Lim *et al*. (2017), in their post-crisis study of risk management in ten global financial institutions based in Singapore, found the TLOD model appears to have been '*adopted in principle but not in spirit*' (p.88); thus failing to provide effective risk management. They found front office staff often game the regulations, and '*engage in grey market practices*' (p.88). Moreover, they argue that there is a '*critical imbalance of power*' between traders who are given

privileged status, and risk and control functions. They concluded from their study that these risk control functions lack the authority to '*effectively challenge*' front office staff, further weakening the TLOD model. A limitation of the study, acknowledged by the authors themselves, was the sample size of thirteen interviewees; this is a concern, not because of its small size per se, but because the rationale for using such a small sample was not explained. In particular, it is important to ask, how, without any theoretical saturation, could the researchers ensure the views they were eliciting were widely held within the industry? However, this researcher believes that a more concerning unacknowledged limitation of their study was that the sample contained just one interviewee holding a front office revenue generating role or 'front line of defence' as described under the TLOD model: thereby their conclusions were based largely on one sided arguments only, without any understanding of how front line of defence staff view their relationship with second and third line of defence staff.

Furthermore, some of the conclusions drawn from the study are questionable, as they are based on hearsay and not first-hand accounts. For example, the study is littered with examples of second and third line of defence staff commenting on how the front office takes risks and what drives their behaviour: '*[T]hey were careful to take on (only) good risk*' (p.82), '*The Basel capital rules and macro regulatory environment put a curb on trader risk-taking and made them more risk averse… in some banks*' (p.84), '*The front office sales people are driven by sales revenue targets*' (p.83), '*Profitability measurement drives behaviour*' (p.84). *''The bankers*' *view is if it doesn*'*t affect me personally; who cares?* (p.85), '*Traders always come up with even more complex products to avoid the regulation*' (p.85). All these comments are hearsay and cannot be taken as valid evidence; they only convey the interviewees' perception of the situation. This research will address the limitations of the above study by considering the views of a broader range of interviewees, including front office revenue generating staff.

Now the concept of risk has been clarified in the context of this thesis, the section that follows will review what is known about the connection between incentive controls and risk-taking.

2.4 Incentive controls and risk-taking

Management accounting research has found linking monetary incentives to performance metrics results in greater employee effort, and as a consequence increased performance (Bonner & Sprinkle, 2002); at least in terms of the measured dimensions of performance. Thus, many organisations have implemented pay-per-performance arrangements when attempting to improve performance. However, as previously discussed, since the crisis of 2008, such pay-per-performance arrangements have negative connotations, as they have been blamed for excessive risk-taking. This is particularly true for traders in financial institutions whose public image is that of casino bankers gambling large sums in the pursuit of personal gain with a '*heads I win, tails: you lose*' mentality. To address the perceived deficiencies of such pay-per-performance arrangements, the regulators introduced new control mechanisms into incentive arrangements for individuals deemed to be the MRTs within financial institutions; i.e. bonus deferrals, a bonus cap, and clawback provisions on bonuses.

Multiple theories and streams of literature explore the connection between incentives and risk-taking, the mostly prominent one's of relevance to this area are agency theory and behavioural economics theories, and so these are discussed in greater detail in the following sections.

2.4.1 Agency theory

Agency theory presents strong arguments regarding the implications of *how* people are paid effects their behaviour and motivation. Traders (in the context of this thesis) trade on behalf of the banks (principals) that employ them, making them agents of the banks. The underlying premise of agency theory is that managers (agents) are self-interested and risk averse, making their goals incompatible with those of the company or shareholders (principals) (Jensen & Meckling, 1976). Agency theory posits that the way to resolve issues that arise from the separation of ownership and control in organisations is to align employees' compensation contracts with shareholders' interests by introducing equity shares into their incentive arrangements (Agrawal & Mandelker, 1987).

The problem with linking employees' incentives with equity is that it subjects them to the whims of the stock market, which are often beyond their control. This is especially true for employees further down the command chain whose individual actions have little impact on

the company's share price (Jensen & Murphy, 2010). A further issue with the use of long-term incentives as a tool to align the interests of agents with principals is that they may not motivate them in the constructive way that short-term incentives can (Hedesstrom *et al*., 2012). This could lead to the unintended consequence of making managers less inclined to seek out good investment opportunities, and consequently shareholders could suffer from receiving lower returns on their investments (Larcker & Tayan, 2011).

Adams (1995) as cited in Collier *et al*. (2006), argues that all individuals have the propensity to take risk with varying degrees. However, this propensity is influenced by the rewards on offer for risk-taking. Agrawal and Mandelker (1987) claim that agency theory predicts the vested equity that would make agents risk averse in order to protect their existing holdings; whereas, unvested shares and options would increase appetite for risk in order to grow wealth. When investigating traders specifically, agency theory predicts that they are likely to be risk averse, in order to protect their personal wealth (Willman *et al*., 2002); that wealth being their bonuses, which are deferred or subject to clawbacks. Whereas, according to Agrawal and Mandelker (1987), as traders also hold unvested shares and options, that makes them risk seeking. As a result of the new control mechanisms, predicting how traders (agents) might react becomes complicated, because on the one hand, the clawback mechanism should make them risk averse in order to protect their existing wealth, but on the other, the deferral mechanism (if it contains options and unvested shares, as it usually does) would make them risk-seeking in order to grow their wealth.

Over the years, many researchers have investigated this agency issue, specifically in the domain of CEOs' performance and the use of long-term incentive plans which include an equity portion (Faulkender *et al*., 2010; Jensen & Murphy, 1990; Ittner *et al*., 2003a). The results of this research are mixed; i.e. some academics argue that equity-based compensation tied to long-term results diverts managers' attention from the short-term, and as a result increases the company's performance (Bebchuck & Fried, 2010; Hartmann, 2012), and others arguing the opposite is true. For example, Ittner *et al*. (2003a) found that companies where the top 5 executives had lower equity holdings than the industry benchmark actually had higher performance; Belkhir and Boubaker (2013) argued that stock options[13] can, in fact, promote short-termist behaviour. However, it has been argued

[13] Stock options are often awarded as part of long-term incentive plans.

that under traditional compensation arrangements there was a strong link between a manager's risk preference and his compensation structure, due to the fact that the principal-agent conflict between banks shareholders (principals) and managers (agents) was externalised to taxpayers as a result of government bailouts during the crisis (Acrey *et al*., 2011; Bebchuk & Spamann, 2010). Thus, a further apparent limitation of the traditional compensation scheme was that there appeared to be no real down side to risky decisions: if substantial losses arose then the tax payer would pick up the bill; whereas, if profits materialised then the banks benefitted.

Whilst agency theory contributes greatly to accounting research and theory it is not without its limitations. The primary limitation of agency theory as a theoretical framework for use within this thesis is that its origin is in economic theory, which is concerned with rationality and equilibrium. The ontological position of the researcher is that the world is subjective, and this is in contrast with the view commonly held in neo-economic theory that the world is objective and socially controllable. Additionally, agency theory mostly assumes risk aversion on the part of the agents who act on behalf of principals (Willman *et al*., 2002), whereas in this study, the regulators view traders (agents) as risk-seeking, which prompted them to introduce new controls mechanisms to curb this behaviour. An important contribution of this thesis lies in the fact that it interviews real life risk-takers who work in complex institutional environments, and whose bonuses are impacted by these new regulations. Agency theory makes no attempts to assess these complex institutional forms, and whilst it may provide answers to part of the primary research question: i.e., *what* is happening as a result of the new control mechanisms, it would fail to assess *why*, and *how* new control mechanisms are/are not changing behaviour as it does not provide literal descriptions of practice (Lambert, 2006).

As will be discussed in greater detail in this chapter, the behavioural economics literature and specifically prospect theory, was initially considered in the early stages of this thesis as a means to understanding individuals' risk-taking behaviour and their reactions to incentives. However as discovered, as the thesis progressed, with regard to the link between risk-taking and incentives, the behavioural economics literature advanced well beyond prospect theory. A recent example of this is given in a study conducted in 2016 by Hagendorff *et al*. who found interventions in the form of compensation arrangements were unlikely to make any significant impact on banks' business models, and hence bank risk-taking. They studied more than 1,500 top United States (US) bankers, and found

personality and talent were deemed more significant than pay, bonuses, or education with regard to how much they shaped risk-taking behaviour. They identified six managerial styles, which they believed could explain some individuals' preference for risk. The styles they identified were: (1) the aggressive innovator, (2) the cautious innovator, (3) the aggressive traditionalist, (4) the cautious traditionalist, (5) the prudent manager, and (6) the extremely prudent manager, with the aggressive innovator being the most prone to risk taking and the extremely prudent manager favouring risk the least (Hagendorff *et al*., 2016, p.28). These labels for managerial style were developed by the researchers to denote empirical clusters, achieved through the use of a k-means clustering algorithm, and the Calinski and Harabasz (1974) index (Hagendorff *et al*., 2016).

Whilst the individual traits identified above could shape risk-taking behaviour, Collier *et al*. (2006) argue that national cultures can also play a part. They claim that risk perception is a cultural process, whereby each culture and its supporting institution shows bias when emphasising some risks and 'downplaying' others. They believe that this socially constructed view of risk highlights the subjectivity of risk perceptions and preferences more accurately than text book rationales modelling so-called organisational risk.

Contemporary sources focused on the link between incentives and risk-taking are varied and often conflicting. Many authors argue that traditional compensation arrangements promote risk-taking behaviour (Ayadi *et al*., 2012; Bebchuck & Spamann, 2010; Belkhir & Boubaker, 2013; Chen *et al*., 2006; Sanders & Hambrick, 2007). However, in contrast, Fahlenbrach and Stulz (2011) and Hagendorff *et al*. (2016) found traditional compensation arrangements have no impact on banks' attitudes to risk-taking. The first thing to note about all these studies is the differences in how they measure bank risk (see section 2.4.2). They also differ in their understanding of how traditional compensation arrangements promote risk-taking when offering a long range review of compensation and risk data, dating as far back as far 1992 (as in Chen *et al.*, 2006). Focus also differs, as for example a study conducted by Fahlenbrach and Stulz (2011) focused on data immediately prior to (2006) and during the crisis (2008); this study also focused solely on investment banking data, whereas other studies have assessed data from a range of firms (Sanders & Hambrick, 2007), as well as data from banks, including commercial banks (Chen *et al*., 2006).

2.4.2 Incentive mechanisms and risk-taking

As explained in Chapter 1, the incentive mechanisms brought in by the new control mechanism and thus discussed in this thesis are: bonus deferrals, bonus clawback provisions and a bonus cap. The practice of bonus deferrals in the form of equity-based pay was in place in investment banks for many years, and their effect on risk-taking behaviour has been discussed widely in quantitative research, with mixed results. Deferral schemes can be implemented in many ways: some banks defer cash bonuses, whilst others opt to defer bonuses in the form of shares, stock options, other equity-based derivatives, or a mixture of all/some of these. Academic research has found that how such schemes are implemented produces differing results in terms of risk-taking.

The bonus cap and bonus clawback controls in the form advocated by the current regulations are relatively new controls, and as such, no studies have to date investigated their impact on risk-taking as standalone controls. It is noteworthy that the Stern Stewart & Co Economic Value Added (EVA) literature in the late 1990s examined the notion of clawback provisions in the form of bonuses, although not to the same extent as they are being applied today. The key difference noted is that under the new control mechanisms, bonuses *already paid out* can be clawed back, which was not the case advocated by Stern Stewart & Co. The EVA literature describes the concept of a bonus bank: an internal account where deferred bonuses were kept and whose value can decrease (even becoming a negative bonus carried forward to the following period). Bonus banks were introduced to deal with the shortcomings of EVA where accounting numbers could be manipulated inter-period for the benefit of managers, using bonus banks meant that the EVA bonus award was separate from the actual payment (O'Hanlon & Peasnell, 1998). The bonus bank concept was used in many companies for decades (Byrnes, 2009); nevertheless, the researcher could not find any empirical data that discussed the link between using bonus banks and risk-taking behaviours.

In contrast, bonus deferrals of executive compensation was a practice implemented for many years in the banking industry (Belkhir & Boubaker, 2013). Indeed, many studies investigated the impact on risk-taking of bonus deferrals as a standalone control. The results of these studies were varied with many conflicting results, mostly arising from the methods employed in the research design, the dataset used and the classification of bank risk.

Two quantitative studies: Ayadi *et al*. (2012), and Belkhir and Boubaker (2013), found deferrals can promote risk-taking behaviour. The study by Ayadi *et al*. (2012) used data from European banks covering the period from 1999 – 2009 and measuring bank risk as a function of the total daily variation of bank stock returns[14] and presenting a two-index model to consider systematic risk[15], interest rate risk, and idiosyncratic[16] risks. Belkhir and Boubaker's (2013) study, however, used data from the largest US banks, which are more aligned with the period of the 2008 financial crisis, covering the period from 2006 – 2010, and using the hedging of the banks' interest rate risk as a marker to determine whether CEOs with more deferrals took greater risk than CEOs with fewer deferrals.

Two additional quantitative studies: Acrey *et al*. (2011) and Fahlenbrach and Stulz (2011) found deferrals have no impact on risk-taking. Acrey *et al*. (2011) investigated the compensation data of the largest US banks during the period 2004 – 2008. Their measures of risk included those employed by the Federal Reserve to estimate the probability of bank failure; market-based measures of bank default risk; and dependent variables for banks heavily involved in risky activities[17]. The Fahlenbrach and Stulz (2011) study focused on data collected from US investment banks over the period 2006-2008. Their measure of risk was stock volatility.

To date[18], only two studies, Hartmann and Slapničar (2015) and Kleymenova and Tuna (2016), have investigated the implications of all three of the new control mechanisms on risk-taking behaviour. The results of these studies are discussed in the sections below.

2.5 Studies that investigated the new control mechanisms

Kleymenova and Tuna (2016) investigated the implications of the combined effects of the UK Remuneration Code and the Capital Requirements Directive IV bonus cap, and found that overall risk portfolios for UK Banks were reduced. They measured the banks' risk levels using three proxies: (i) idiosyncratic volatility; (ii) total volatility, which measures the overall risk exposure; and (iii) leverage, and found reduced risk across all three measures (Kleymenova & Tuna, 2016, pp. 25-26). A limitation of their study is that the Remuneration Code and CRD IV were intended to reduce *individuals*' propensity for

[14] Ayadi *et al*. (2012) recognise the limitation of this method in that it does not take account of risks outside the banks control, like market and environment risks.
[15] Macro level risk applicable to all assets, for example interest rate risk.
[16] Risk that is specific to a particular asset for example stock, and not the entire investment portfolio.
[17] See p.461 of the Acrey *et al.*'*s* paper for a detailed breakdown of the risk measures used.
[18] No further reviews were conducted after January 2017.

excessive risk-taking, not overall bank risk, which was the unit of analysis they employed. A further limitation was that their quantitative methodology did not enable them to speak to the actors involved in the study. This meant they were unable to assess whether there were any unobservable factors driving risk reduction across the portfolios, and which, if any, of the individual elements each control mechanism played in risk reduction. This thesis will focus on the MRTs' risk-taking as a unit of analysis and not as a component of the banks' overall risk. Furthermore, it will interview the actors impacted by these new control mechanisms to assess which of the individual elements of the control mechanisms had an observable impact on their risk-taking behaviour. As apparent from the different methods, datasets, timeframes, and risk measures, employed in the studies above, it is not surprising that no consensus has emerged regarding the impact of deferrals on risk-taking behaviour. The second study mentioned above, which considered all three of the new controls mechanisms, was an experimental study by Hartmann and Slapničar (2015), which found that deferrals can, in fact, lower risk-taking. This study will be discussed in detail in the section that follows.

2.6 Behavioural economics literature

Many studies have utilised behavioural economics theories to investigate the effect of incentives on risk-taking behaviour (Barberis *et al*., 2006; Hartmann & Slapničar, 2015; Kahneman & Tversky, 1979; Kahneman & Lovallo, 1993; Thaler, 1981; Willman *et al*., 2002). As such, behavioural economics, specifically prospect theory were explored in a middle-range thinking type way in the early stages of this thesis.

Prospect theory is a major theory in behavioural economics, one that shows if alternatives are shown as gains, decision makers usually opt for safer options, thereby exhibiting risk-averse behaviour, but they reverse their choice when the alternatives are shown as losses (Kahneman & Tversky, 1979). Prospect theory posits that individuals do not always behave consistently; indeed, it argues that individuals behave according to their preferences/reference point when faced with gains or losses. The general consensus among authors is that individuals are risk averse when faced with gains, and risk seeking when faced with losses (Kahneman & Lovallo, 1993; Kahneman & Tversky, 1979). In terms of this research, this is an important finding, because the deferral and clawback elements of the new control mechanism could put an individual's compensation in a loss domain, which might then result in an increase in their propensity for risk-taking, rather than

reducing it (Kahneman & Lovallo, 1993). The prospect of an employee being penalised through the malus or clawback clause of the new control mechanism could mean they no longer see their incentive contract as just a bonus, but also as a penalty. If that is the case, then Luft (1994) argues that the employer would then have to offer a higher set of payoffs to entice employees to accept the incentive contract. This is consistent with Deloitte's (2010) findings that post-crisis, bankers now receive higher base salaries with less variable pay and more long-term incentives in the form of equity-based pay. Similarly, DeHaan *et al*. (2012) found that where staff contracts contained clawback clauses, staff expected to be compensated financially for the extra risk.

The equity portion of an employee's compensation contains an element of uncertain gains and losses. Under the new compensation controls, in addition to facing the uncertainty of the equity portion of compensation, employees encounter further uncertainty in that their bonus (both vested and unvested) could also be clawed back. Prospect theory argues that individuals have a greater attachment to what is already theirs and dislike losses more than they like equivalent gains. As such, employees will take *less* risk to avoid losing what is already theirs. The way in which the new remuneration regulations are set up with complex and multifaceted factors, makes pre-determining *how* any one employee will react to them almost impossible, at least from a theoretical standpoint. Therefore, it can be argued that the effect of equity incentives on risk taking behaviour is dependent on both prospects and the probability of those prospects, which is contingent on each individual's circumstance (Chapman *et al.*, 2007). This is important here, as it recognises that an individual's propensity to take risk is also contingent upon their personal circumstances and market conditions; it is not solely a consequence of the incentive structure.

Prospect theory was ruled out as a main theoretical frame for this thesis when data collected from the pilot study highlighted its limitations (assessing the interviewees' reference point, and capturing the other factors that influenced their risk-taking behaviour) and pointed towards more suitable theories to address the observed phenomena. These theories will be discussed in greater detail in Chapter 4.

As previously mentioned earlier in this chapter, Hartmann and Slapničar's (2015) study explored the implications of all three new control measures on risk-taking. Their study provided experimental evidence relating to the effectiveness of the new measures on risk-taking behaviour from a behavioural economics perspective. They used one hundred and

fifty-three undergraduate students as research participants; the students were given an investment task over two periods. They were rewarded small sums of money (€13 being the maximum reward payable) if the investment decisions went in their favour. In the study there were two types of bonus schemes: high variance and low variance. With the high variance scheme, there was the potential for high bonuses, but also negative awards in the form of clawbacks of deferred bonuses. In the low variance scheme, bonuses were capped at an upper and lower amount. They found that the high variance bonus scheme containing a negative bonus actually increased the probability of higher risk-taking. In terms of deferred bonuses, they concluded that there was no initial effect on risk-taking, with the effect in the second period dependent upon the results of the first period. If the first period produced a positive bonus, then the participants became more risk-taking in the second period, whereas if the first period produced a negative bonus, then participants became more risk-averse in the second period. They found no such effect when the bonuses were paid immediately.

In the Hartmann and Slapničar (2015) study, participants were protected against the negative outcomes of their investment choices, which is not the case in real-life settings under the new measures. In contrast to the interviewees in this thesis, the participants in the Hartmann and Slapničar experiment would have had a complete contract (i.e. one where there are explicit terms set by the principal to provide monetary rewards to the agent in return for agreed performance outcomes (Christ *et al*., 2012)). However, complete contracts of this nature are rare in practice (Bailey *et al*., 2011; Banker *et al*., 2000; Ittner *et al*., 2003b). The participants in this thesis have incomplete contracts (i.e. one where there is discretion in the monetary payout (Christ *et al*., 2012)).

An important contribution of this thesis is that it has been conducted in communication with real-life risk-takers, who have found their substantial bonuses subject to the new incentive measures, meaning they are no longer protected against the adverse outcomes of their decisions. Moreover, traders, by the very nature of their role, are risk 'seeking' individuals. Therefore, it would be interesting to ascertain if the same results would be found if replicating the Hartmann and Slapničar (2015) study experiment with traders rather than undergraduates. Furthermore, Hartmann and Slapničar's (2015) study examined the implications of incentive controls on risk-taking behaviour in isolation from other controls that might influence behaviour. However, today, it is widely accepted in the management control literature that organisations rely on a multitude of control

mechanisms to elicit desired employee behaviour (Abernethy & Brownell, 1997; Ittner *et al*., 2003b; Simons 1995). Moreover, by researching individual controls in isolation from other controls, only limited conclusions can be drawn (Ferreira & Otley, 2009; Grabner & Moers, 2013; Malmi & Brown, 2008; Otley, 1980; Simons, 1995). Therefore, an empirical investigation that considers the implications of these new incentives controls on those actors directly affected by them will provide a considerable contribution to both practice and academic literature.

2.7 Control systems literature

Otley (1999) described management control systems (MCSs) as providing '*[I]nformation that is intended to be useful to managers in performing their jobs and to assist organisations in developing and maintaining viable patterns of behaviour*' (p.364). In 2009, Ferreira and Otley, believing the term 'MCS' had become more restrictive than originally intended, mentioned the term performance management systems (PMSs). They defined PMSs as: '*[F]ormal mechanisms, processes, systems, and networks used by organisations, and also the more subtle, yet important, informal controls that are used*' (Ferreira & Otley, 2009, p.264) to facilitate the achievement of organisational goals.

The control systems literature has an abundance of research designed to explore the impact of incentives as standalone controls on employee behaviour and/or performance, and hence, risk-taking (Ayadi *et al*., 2012; Bonner & Sprinkle, 2002; Faulkender *et al*., 2010; Gregg *et al*., 2012; Ittner *et al*., 2003a). This practice of concentrating on a single type of control is often motivated by the need for researchers to have focus (Alvesson & Karreman, 2004). However, despite the richness of the incentives literature, there is a shortage of literature that offers empirical evidence detailing how other forms of control influence the effects of reward and compensation controls. Notable exceptions include Christ *et al*. (2013), who studied the impact of complementary internal controls on incentive controls and found firms perform better when some task dimensions are controlled by internal controls, rather than linking compensation to all task dimensions, as this results in overall weaker performance across all dimensions. Additionally, due to the lack of publicly available incentive information for lower level employees, the majority of the compensation literature has been limited to CEO contracts without regard for how incentive measures might impact lower level employees' performance and/or risk-taking.

2.7.1 Management control packages

To address the issue of looking at one control in isolation from other controls, Otley (1980), discussed the notion of a management control 'package'. He later (Otley, 2016) defined a management control package as one composed of loosely coupled elements, potentially put together by different people, possibly at different times. The most extensive discussions on the topic of MCSs 'packages' since Otley's (1980) seminal paper were put forward by Malmi and Brown (2008) and Grabner and Moers (2013).

Malmi and Brown (2008), after reviewing a decade's worth of literature on the topic of MCS, developed the most inclusive MCS framework to date. They defined a 'package' as a set of controls loosely coupled with the aim of aligning an individual's activities with the organisation's goals. They distinguished an MCS from an MCS package by stating that an MCS comprises controls designed and coordinated intentionally, as opposed to a package, in which the controls are introduced at different times, potentially by different people, and so may or may not be coordinated. In this context, controls can be complementary or function as substitutes, and a new control might prove to be a positive addition to a package or might be less effective or even dysfunctional when applied in different circumstances (Otley, 2016). The benefit of looking at this thesis through the lens of an MCS package is that the new compensation controls are part of a wider PMS, which takes a holistic approach to the study avoiding looking at one element of the control package (incentive controls) in isolation from other controls that may be of importance to the study.

Grabner and Moers (2013) enhanced the work of Malmi and Brown (2008) by providing a framework for researchers investigating interdependencies in MCS. They advocated the use of regression analysis as a tool to examine the interrelationships between individual attributes in the MCS. The value of their framework lies in the fact that it guides researchers to understand whether or not they are examining a control system or a control package, and when it is important to look at multiple management control practices simultaneously. They argue that to understand an entire package, one must first understand the systems that operate within it. Despite the strengths of this framework, it was deemed unsuitable for this thesis because of its primarily analytical nature; therefore, it held no benefits as a standalone framework.

In terms of looking at the control aspects of this thesis, the Malmi and Brown (2008) typology was deemed the most suitable, as it put forward one of the most pertinent questions raised by this research: '[*W]hether the effectiveness of each control system is dependent on the existing configuration of the package*?' (p.297). They argued that when researchers study one element of a control package, rather than viewing it as a whole, they could conclude that the particular element under investigation is ineffective when in fact, the real problem is its '*misfit with other elements*' (p.297). As this issue was deemed highly relevant for this thesis, the section that follows discusses the framework in more detail.

The Malmi and Brown (2008) framework was developed as a tool to guide further research in the MCS domain. The framework identified five types of control approaches: planning; cybernetic; reward and compensation; administrative; and cultural. Reward and compensation controls were argued to increase the performance of individuals and groups by attaching rewards to goal fulfilment. They included four types of cybernetic controls in their typology: budgets; financial measures; non-financial measures; and hybrids, containing both financial and non-financial measures. Cybernetic controls they argued, allow for the use of performance targets, which are to be set, monitored, and modified as needed. While cultural controls are described as the '*values, beliefs and social norms*' that direct employees' behaviour through '*Value-based controls (Simons, 1995), symbols-based controls (Schein, 1997), and clan controls (Ouchi, 1979*)' (p.294), Simon's (1995) value based controls were described as the controls senior managers use to formally communicate an organisation's purpose and direction. This can be done in three ways: (i) through the selection of a person with the right 'fit', through the recruitment process; (ii) when '*individuals are socialised and have their values changed to fit the organisational values*' (p.294); and (iii) when it is made clear that certain values are expected, and individuals must comply even if they do not believe in them personally. Furthermore, they claimed that whilst management accounting research has focused on accounting type controls, there has generally been limited research on controls such as cultural controls. They defined cultural controls as: '*[B]road, yet subtle controls*', which are '*[S]low to change, thus, providing a contextual frame for other controls*' (p. 295). The advantage of obtaining a broader view of MCS, they argue, is to be in a position to propose better controls to increase organisational performance. As previously discussed, post-crisis, the attention given to the influence of culture in the financial services industry, specifically the

risk culture, as a means of directing behaviour has increased dramatically. One of the limitations of Malmi and Brown's (2008) typology is that it does little to explain whether the overall controls in a package are well integrated or coordinated, a term often referred to as 'tight coupling'. A further limitation of the Malmi and Brown (2008) typology in this post-crisis era, is that it viewed culture as exerting peripheral control, which researchers no longer believe to be the case.

Ferreira and Otley (2009), complementing the work of Malmi and Brown (2008), proposed a 12 question framework as the basis for a study of control systems. Although not explicitly discussed in the framework itself, contextual factors and organisational culture are said to permeate the control system. They argued that the literature has proven variables such as culture affect the design and use of control systems. Thus, they purport that these variables could be helpful as a means to explain why some aspects of a control system are '*more or less effective*'. As such, they believe that it is important to consider how culture impacts on the operation of control systems/packages.

Since the 2008 crisis, the importance of risk related cultural controls has gained prominence, not just in the financial services industry but also in other industries; for example, the BP Deep Water Horizon oil spill. In his most recent paper, Otley (2016) recognised the increased importance of organisational culture, stating that it has a '*[S]ignificant influence on attitudes and behaviour within an organisation*' (p.12), and can change employees' behaviour to a significant extent. He argued that unless attempts were made to take it into account on a case-by-case basis, '*[T]hen it is likely that any research results will contain significant amounts of noise*' (p.12). Otley (2016) believes the management of an organisation's culture has the potential to change employees' behaviour to a significant extent. In his 2016 paper, he offered the example of the regime used to train Korean airline pilots, arguing that their innate behaviour had to be changed, because they had such a high-level respect for authority that they failed to question more senior pilots' decisions, even when they thought those decisions were wrong. Therefore, this researcher believes that enhancing our understanding of MCSs 'as a package' with a particular emphasis on the role of risk culture as a significant, rather than a peripheral control is an issue that warrants further consideration. When used together, these frameworks can help researchers gain a better understanding of what they are investigating, thereby encouraging a holistic approach that avoids looking at one element of the control package in isolation, which may be of importance.

2.8 Positioning this thesis within the literature

As discussed above, the main literature streams included in this thesis are literature on incentives and risk-taking, and control systems literature. Further, as identified from the incentives and risk-taking literature, no previous empirical studies have employed a qualitative methodology to look at the implications of these new control mechanisms on risk-taking behaviour. In fact, there is no empirical research on the extent to which traders' risk-taking behaviour fits the academic models purported by the incentives and risk-taking literature, and none that complies with regulatory demands in this area.

In terms of the control systems literature, this is the first study using real world empirical data from the UK financial services sector to investigate incentive controls as part of a package of overall controls. Furthermore, this is the first study to highlight the increased importance of risk culture as informing the success of the package of controls imposed on the banking sector.

2.9 Chapter summary

Chapter 2 has explored the literature detailing the link between incentives and risk-taking, and has evaluated the types of methods used in those studies and their various limitations. It concluded that the conflicting evidence found in the studies could be due to the methods employed in them, and also due to how the studies measured 'risk', with each having their own unique measurement criteria. The chapter also illuminated the importance of looking at incentive controls as part of a wider package of controls, and not in isolation, as was the case with many previous studies on the topic.

The chapter highlighted gaps in the literature; specifically, the lack of studies exploring the impact of the new incentive controls on the risk-taking behaviour of traders in the real world, the absence of studies asking traders directly to share their views on whether their risk-taking behaviour was changing, and if so in response to what, and the limited search for unobservable factors driving risk reduction across the portfolios as mentioned by Kleymenova and Tuna (2016). An additional gap identified in the literature relates to the lack of studies highlighting the increased importance of risk culture as a significant, rather than a peripheral control, in the package of controls.

Having identified the gaps in the literature, the chapter that follows will discuss how these gaps will be addressed and the most appropriate methodology and methods for doing so.

3. METHODOLOGY AND METHOD

3.1 Introduction

Chapter 1 provided a detailed analysis of the research problem and the aims and objectives of the thesis. It identified the primary aim of the research as to investigate banks' responses to the new control mechanisms imposed on them by EU and UK regulators, and to assess from the actors' point of view, whether these new control mechanisms altered the risk-taking behaviour of traders.

Chapter 2 explored literature highlighting the link between incentives and risk-taking, detailing the type of methods used in those studies and their limitations. It concluded that the conflicting evidence to emerge between the studies could be due to the methods used, and the fact that 'risk' was measured differently in each. The chapter also stressed the importance of not looking at incentive controls in isolation from other controls in an MCS package, because doing so could render the results meaningless.

This chapter discusses the epistemological perspectives used in management accounting research and the rationale for the thesis design. It will demonstrate how and why the approach to this thesis differs from most of the studies discussed in Chapter 2. The first section will outline the design of the thesis, followed by discussions of epistemology and ontology within management accounting research. The second section describes the chosen method, and introduces what is intended by the phrase middle-range thinking (Laughlin, 1995; 2004) and how it is employed in this thesis. Section three describes the research process and the techniques used to analyse the collected data.

3.2 Research approach

The design of the thesis emerges from Lukka and Modell's (2010) methodology, which took Interpretative Research (IR) as a starting point. In its simplest form, an IR ontology views reality as subjective, demanding the world be studied in its natural state without manipulation or intervention from the researcher. However, as with all paradigms, there are extreme versions of IR. In its archetypical form, its primary aim is to produce rich descriptions and emic understandings of research subjects at the expense of external (etic) interpretations of actors' meanings (Lukka & Modell, 2010). The version of IR adopted for

this research, as advocated by Lukka and Modell (2010), combines both emic and etic perspectives. It adopts a pragmatist philosophy that integrates social constructivism with a moderate form of realism. Researchers that hold an interpretative worldview often use qualitative research methods (Chua 1986; Creswell, 2007); these allow for the discovery of rich and theoretically informed explanations of phenomena (Lukka & Modell, 2010), which are crucial to answer the *how* and *why* components of the main research question; questions often ignored in other studies in this area.

To achieve the aims of this research, the main interviews and data collection took place over a period of 17 months from April 2014 - August 2015, with the remaining interviews with regulators and the Head of Corporate Governance of an asset management firm taking place in April and May 2017. A pilot study of ten traders was conducted in April 2014, with the remainder of the interview data collected from bankers being over a three-month period from June – August 2015. Employees from ten large investment banks based in London participated in the study, using a field-based approach. This empirical data forms the main contribution of this thesis. IR is used to bring together both the empirical findings with theoretical interpretations to explain the phenomena under investigation (Lukka & Modell, 2010). A detailed discussion of the research methods used will be provided in section 3.8.

3.3 Methodology – epistemology and ontology within management accounting research

The epistemological and ontological position of the researcher is a key factor that informs the methodological positioning of a study (Ahrens & Chapman, 2007). It is this methodological position that governs whether a researcher is mainstream, interpretative or critical. The three main paradigms in management accounting research will now be outlined to illuminate why interpretive research was deemed the best choice for this thesis. Table 1, adapted[19] from Chua (1986) explains the main differences between the top three ontological perspectives in management accounting research.

[19] The layout is different from the original source but the text remains mostly the same.

Table 1 Top three ontological perspectives in management accounting research. (Source: Adapted from Chua, 1986)

	Mainstream	**Interpretative**	**Critical**
Beliefs about knowledge (Epistemological, Methodological)	Theory is separate from observations that may be used to verify or falsify a theory. Hypothetico-deductive account of scientific explanation accepted.	Scientific explanations of human intentions sought. Adequacy is assessed according to the criteria of logical consistency, subjective interpretation, and agreement with actors' common-sense interpretation.	Criteria for judging theories are temporal and context-bound.
Methods favoured	Quantitative methods of data analysis and collection to allow generalisation are favoured.	Ethnographic case studies, and participant observation encouraged. Actors studied in their everyday environments.	Historical, ethnographic research and case studies most commonly used.
Beliefs about physical and social reality (Ontological)	Empirical reality is objective and external to the subject. Human beings are characterised as passive objects; not seen as the makers of social reality. Single goal of utility-maximisation assumed for individuals and firms. Means-end rationality assumed. Societies and organisations are essentially stable; "dysfunctional" and conflict may be managed through the design of appropriate accounting control	Social reality is emergent, subjectively created, and objectified through human interactions. All actions have meaning and intentions that are retrospectively endowed and that are grounded in social and historical practices. Social order assumed. Conflict mediated through common schemes of social meanings.	Human beings have inner potentialities which are alienated through restrictive mechanisms. Objects can only be understood through a study of their historical development and change within the totality of relations. Empirical reality is characterised by objective, real relations which are transformed and reproduced through subjective interpretation. Human intention, rationality, and agency are accepted, but this is critically analysed given a belief in false consciousness and ideology. Fundamental conflict is endemic to society. Conflict arises because of injustice and ideology in the social, economic and political domains which obscure the creative dimension in people.
Relationship between theory and practice	Accounting specifies means, not ends. Acceptance of extant institutional structures.	Theory seeks only to explain action and to understand how social order is produced and reproduced.	Theory has a critical imperative: the identification and removal of domination and ideological practices.

In summary, it can be argued that the mainstream accounting paradigm seeks to generalise, the interpretative paradigm, deconstructing it into its simplest form, to achieve understanding; whereas, the critical paradigm seeks to liberate. Chapter 2 presented a review of the sparse theoretical literature concerning the implications of the new

compensation controls designed to reduce employees' risk-taking behaviour. It also highlighted the fact that the most prominent methodology applied to research in this area to date has been agency theory. These studies showed some of the potential consequences of using such incentive arrangements; however, they lacked an explanation of *why* and *how* such incentive arrangements produce the results that they do. Therefore, the knowledge that could be gleaned from these existing studies was consequently limited.

Using the interpretative approach advocated by Lukka and Modell (2010) will help answer the *why* and *how* questions posed in this research. Moreover, the findings reported in previous academic literature suggest the policies that regulators have advocated to the banks to reduce their propensity for excessive risk-taking behaviour are flawed (Hagendorff *et al.*, 2016; Yermack, 2013). As such, this research also aims to identify the gap between theory and practice. Ontologies and theories that avoid disputes centred on a subjective versus objective opposition will be rejected in favour of a multi-dimensional concept of reality espoused by Nørreklit *et al.* (2006). This will allow for the *reality* of the research context to be explored, rather than any radical categorisations of it.

3.3.1 Mainstream accounting research

Ontologically, the view most widely held in mainstream accounting research is that objective reality exists independently of the researcher (Chua, 1986; Scotland, 2012). Facts and logic predominate, and researchers aim to formulate research for the purposes of prediction and generalisation (Nørreklit *et al.*, 2006). According to Chua (1986), mainstream accounting researchers make two significant assumptions about the social world. First, that human behaviour is purposive, which translates into the belief that humans think rationally and are capable of setting rational goals. According to this assumption, managers will then act rationally, because rationality improves performance, which in turn leads to greater rewards. Second, that social order is controllable; this means, they believe that results gathered in the course of research are generalisable and can be used to predict and control events that take place in organisations.

A problematic aspect of mainstream management accounting research is the assumption that all members of an organisation share the same values (Nørreklit *et al.*, 2006). Consequently, this rigidity of mainstream accounting research has limited the type and scope of issues studied and the methods used, and possibly restricted the kinds of insights gleaned from studies (Chua, 1986). More pertinently, mainstream accounting research has

made no attempt to assess or modify institutional forms (Chua, 1986). However, despite these limitations, mainstream accounting research has been very beneficial to the field of management accounting, as it demanded validity, rigour, and objectivity from the research community.

A mainstream accounting paradigm was deemed inappropriate for this research for a number of reasons. First, as previously stated above, mainstream accounting research makes no attempt to assess institutional forms, as will be discussed in detail in Chapter 4 (because these forms play a pivotal role in all research). Second, while mainstream accounting research could be beneficial for assessing *what* is happening as a result of modern control mechanisms, it would fail to assess *why*, and *how* these new control mechanisms function. Answers to *how* and *why* questions can only be obtained by speaking with the actors (traders) themselves. Finally, the actors in this thesis are regarded as highly intelligent and knowledgeable. They do not act in a consistent manner, nor do they have the same values.

3.3.2 Critical research

The ontological stance of the critical paradigm is historical realism. Guba and Lincoln (1994) state that historical realism views reality as being shaped by social, political, cultural, economic, ethnic, and gender values. Reality is socially constructed, and '*under constant internal influence*' (Scotland, 2012, p.13). Critical philosophers would argue that '*there are no theory-independent facts that can conclusively prove or disprove a theory*' (Chua, 1986, p. 620). Rather, they believe that truth is something to be deduced and agreed, and furthermore, very much context dependent (Chua, 1986). Knowledge is derived from the cultural and historical context and is influenced by political beliefs (Scotland, 2012). They believe that individuals act within an environment of intersubjective meanings, and, similar to the interpretive researcher, that researchers should know the language of their object of study (Chua, 1986). The primary agenda of the critical paradigm is to spur social change, whilst also liberating and enhancing the lives of its participants (Scotland, 2012).

Where critical researchers differ from interpretive researchers is in their acceptance of the validation of a theory. Critical researchers take an interpretive stance relative to validation; i.e. suggesting that seeking agreements from actors to provide explanations is inadequate. Methods of research favoured by critical researchers focus on ethnographic studies, in

which detailed historical and cultural explanations can be given (Scotland, 2012). Validity in critical research is mostly determined according to its potential to succeed in spurring social change (Cohen *et al*., 2007).

The critical accounting paradigm was deemed inappropriate for this thesis for two main reasons. Firstly, because to search for widespread conflict in society is not the ontological position of this thesis. Second, because the primary agenda of this thesis is not to spur social change, but to gain a better understanding and explanation of the phenomena under investigation.

3.3.3 Interpretive research

The ontological stance of interpretivisim is relativism. Relativism is the view that reality is deemed to be subjective, and is individually constructed, and that there is no guarantee of a consensus between individual interpretations (Guba & Lincoln, 1994; Lukka & Modell, 2010). With interpretivisim, knowledge is accepted as '*being culturally derived and historically situated*' (Scotland, 2012, p.12). The real world is studied according to its natural state without manipulation or intervention from the researcher. Chua (1986) argued that '*People… cannot be treated as natural scientific objects because they are self-interpretive beings who create the structures around them*' (p. 604). Interpretivisim aims to understand phenomena from the individual's viewpoint, whilst acknowledging the historical and cultural context in which they reside (Creswell, 2007).

Cohen *et al*. (2007) encouraged the use of interpretivisim, arguing that individuals are unique and thus, largely non-generalisable: there can be, and usually are, multiple interpretations and views of single events and situations, as viewing events through the eyes of participants is preferable to viewing them through the eyes of the researcher.

In contrast to mainstream accounting research, interpretive research does not believe that social order is controllable. As previously stated in the introduction, the version of IR adopted for this research combines both emic and etic perspectives. The strength of combining these two perspectives is that IR can provide rich theoretically informed explanations. Lukka and Modell (2010) call these explanations *thick*, stating that their basic position is similar to that of Kakkuri-Knuuttila *et al*. (2008), as they '*argue for an integration of social constructionism with a moderate form of realism*' (p.463). Using this approach, the study of events is not reduced to simple interpretations: rather they are

thickly described. As will be discussed further in section 3.7, the use of an interpretative ontology fits with this thesis' chosen theoretical approach, of middle range thinking. Moreover, as will be discussed in Chapter 4, the use of an interpretative ontology aligns with Oliver's (1991) typology, as used in this thesis.

Lukka and Modell (2010) argue that there is no single truth. However, they do argue that there is a place where truth must be located in order to be seen as valid. They believe that an important part of IR resides in its etic element, which allows explanations to be generated using theory as a guide to help researchers rationalise and provide explanations according to the data generated in IR studies.

3.3.4 Knowledge – doing gap

In recent years, management accounting scholars have argued that there is an increasing gap between management accounting research and the reality of practice (Hall, 2010; Jonsson, 1998; Nørreklit *et al*., 2006). Nørreklit *et al*. (2006) claimed that a split between knowledge and doing has arisen from problems inherent to management accounting paradigms, specifically, their inadequate understanding of reality. In addressing this issue they proposed'*[A] concept of reality as an integrated set of conditions for actions*' (p.42), arguing that '*[M]anagement accounting and control only provide valid results in practice if they incorporate the four aspects of the world of human life – facts, logic, values, and communication*' (p.42). Furthermore, they argue that the issue of validity could not be addressed without such a concept, and that management accounting researchers who want to diminish the 'knowledge-doing gap', must incorporate all four aspects into their research. They proposed that to limit the gap between theory and practice, management accounting researchers must investigate the *reality* of actors, as opposed to simply focusing on those ontologies that suit them. Furthermore, they explained that the above mentioned four dimensions (facts, logic, values, and communication) must be applied to practice, and translated into practical knowledge. By integrating the four dimensions, researchers will avoid the tendency to narrowly focus on a single dimension, as can arise when employing mainstream paradigms. This is particularly important for this study, because as stated in Chapter 1, this thesis aims to address the gap between theory and practice.

3.3.5 Validity and reliability in interpretive research

It is necessary to consider *how* and *why* decisions were taken by investment banks to interpret the new compensation regulations according to data gathered from the stakeholders involved. Stakeholders include: the UK and European regulators, politicians, the public, the investment banks, shareholders, and individual investment bankers.

Interpretivists establish the validity of a theory by establishing the extent of actors' agreement with their explanations (Chua, 1986). Triangulation is a problem when conducting and assessing qualitative field studies because it is generally only useful if the world is viewed as possessing the potential for objective reality (Ahrens & Chapman, 2007). For interpretive researchers, the notion of validity is linked to reliability, and data is deemed reliable if the instruments used for measurement are fit for purpose (Nørreklit *et al*., 2007). This can be problematic because interpretive research does not typically use quantitative measures. However, Ahrens and Chapman (2007) argue that in the case of interpretive research, the question of data validity arises if valid and reliable things are said about a field. Similarly, Nørreklit *et al*. (2006) argue that reliability is demonstrated if different professionals examining the same dataset reach the same conclusions.

Lukka and Modell (2010) contributed to the debate regarding validity in IR by suggesting that validity can be assumed if research is deemed credible. For this to occur, findings must be both authentic and plausible. Similarly, Ahrens and Chapman (2007) argue that attaining validity from a qualitative field study is possible if findings are 'plausible' (p.834). Lukka and Modell (2010) discuss *plausibility* as '*[U]sed to denote whether an explanation "makes sense" and whether it can be inter-subjectively accepted as a likely one*' (p. 469). They contend that many alternative explanations can be offered to ensure studied phenomena are more authentic, which then increases the likelihood of readers accepting them as plausible. Finally, Lukka and Modell (2010) argue that authenticity is a central aspect for validating IR. They argue that authenticity is possible when researchers provide rich descriptions that convince readers their account of the field is genuine.

The researcher took steps to establish the validity of this thesis by discussing her findings with industry experts and regulators.

3.3.6 Abductive reasoning

Lukka and Modell (2010) argue that the thick descriptions that IR generates can also be used to produce explanations, which in turn can also be labelled 'thick' because they are rooted in the real worlds of actors. They believe a major consideration when adopting this position is the process of *abduction.* The concept of abduction was first introduced by Peirce in 1960, since then it has been widely used in moderate forms of realism (Lukka, 2014). The process of abduction typically starts from empirical findings and not from theory. However, the process of abduction does not limit the role that prior theoretical knowledge can play in providing a background when looking for the most likely explanation for empirical observations (Lukka & Modell, 2010). The process of abduction usually starts with reference to a surprising or anomalous event that could not be explained by previous theoretical knowledge (Kelle, 2005). When confronted with such an event, the researcher revisits observed facts and rearranges them, so they are no longer surprising '*[W]e turn over our recollection of observed facts; we endeavour so to rearrange them, to view them in such new perspective that the unexpected experience shall no longer appear surprising*' (Peirce, 1974 cited in Kelle, 2005). Lukka (2014) expands on this understanding by explaining that abductive reasoning usually '*[S]tarts from a striking empirical observation that begs an explanation, triggering the process of* '*making sense*' *to begin*' (p.563). Furthermore, he continues, defining abductive reasoning as '*[A]n approach through which interpretive researchers can apply the central resources of causal analysis and also integrate the emic with the etic, thereby linking an individual piece of interpretive research with the extant body of knowledge on the focal field*' (p.560). It differs from the inductive form of reasoning as it '*[R]elies on the skilful development of theoretical explanations with the help of everything that is known empirically and theoretically about the issue being examined*' (Hanson, 1958, 1961 cited in Lukka & Modell, 2010, p. 467). Whereas inductive reasoning '*[I]s characterised by a kind of semi-automatic generation of theoretical generalisations from data*' (Lukka & Modell, 2010, p. 467). Lukka (2014) likens abductive reasoning to the work of a detective who looks for clues, finds evidence, follows the most promising leads and then puts them into perspective based on other evidence at hand. Lukka (2014, p.563) cites Peirce (1960, p.117) when giving an explanation of the process of abductive reasoning:

> *Surprising phenomenon Y is observed.*

But if proposition X would be true, then Y would be a matter of course.

There is reason to assume X is true.

Therefore, from the above explanation, it can be understood that the result of an abductive research process usually involves a causal explanation, whereby X is used to explain Y. It is not a linear process: rather one that requires repeated back and forth between the empirical data and the theoretical concepts deemed most relevant to the observed phenomena (Lukka & Modell, 2010). When applying an abductive approach, researchers must continually examine alternative explanations to determine which is the most plausible. When addressing a research problem and its possible explanations, a field researcher must put any observations made in the context of other observations (Ahrens & Chapman, 2007). '*A good field study, therefore, requires a problem to be addressed and a theory that can frame the problem such that the fieldwork can contribute to the ongoing debate*' (Ahrens & Chapman, 2007, p. 836). The benefit of using an abductive mode of reasoning in interpretative research is that it can help to theoretically explain the primary empirical findings, whilst linking them to what is already known about the field (Lukka, 2014).

There have been recent debates regarding the similarities that arise when using a grounded theory approach versus an abductive approach (Kelle, 2005; Reichertz, 2007, 2010; Star, 2007). Lukka (2014) argues that the process of abduction shares many similarities with grounded theorisation. Reichertz (2010) argues that grounded theory (in the form advocated by Strauss & Corbin, 1990, 1994) contains an abductive research logic (as developed by Peirce (1960)). However, he argues that grounded theory is not purely abductive, as it can also contain the logic of qualitative induction characterised by *semi-automatic theoretical generalisations from the data* (Lukka & Modell, 2010), which make the two approaches distinct.

In a similar vein to Lukka (2014), Shepherd and Suddaby (2016) call for an approach to theorising known as 'pragmatic empirical theorising', which advocates the use of abductive reasoning as it '*[R]ealistically captures the authentic process by which theorising occurs*' (p.21). They argue that at the core of compelling theories lie compelling stories, and claim that theorising can be initiated by interesting facts. These interesting facts, they argue can make a substantial contribution if the researcher makes a first attempt at offering an explanation as to why these facts were found, rather than simply offering facts that other researchers then attempt to theorise.

3.3.7 Interpretative research in this thesis

The central point of this interpretative research is to understand the banks' responses to new compensation controls and to explore if these new controls have changed the risk-taking behaviour of traders in UK-based investment banks. As discussed in Chapter 2, an abundance of research has been conducted using mainstream accounting paradigms that show the apparent results arising from some of these control mechanisms on risk-taking behaviour. However, what is clearly lacking in these studies are answers to the *how* and *why* questions that establish the impact of regulations (if there is any at all). The interpretive methodology often yields insights to assist in the understanding of behaviour, and can also provide explanations for that behaviour from the viewpoint of actors, as an interpretative methodology was clearly the most appropriate design choice when answering the research questions. Developing theoretically informed explanations is an important component of this thesis; therefore, an abductive approach to theory was decided upon.

3.4 Suitable research methods for chosen methodology

The methodological assumption in this thesis is that the chosen research methods are the most appropriate for the study (Chua, 1986). Positivism poses the ontological assumption that reality is objective, and that as such, it can be studied and verified using empirical methods, such as surveys and experiments. As the ontological assumption made by this researcher is that reality is subjective, the chosen research methodology is a qualitative field study.

The traditionally held view of qualitative research is that it is, by its very nature, inductive; meaning that theory usually emerges after data has been gathered and analysed. Quantitative research, on the other hand, is traditionally seen as deductive, meaning that data is collected and analysed relative to a hypothesis and theory formulated prior to the data collection process. However, Bryman and Bell (2011) and Lukka and Modell (2010) argue that qualitative research does not have to be inductive, and can instead have a deductive element, whereby the researcher has a theory in mind to help shape the data collection and analysis process, what Lukka and Modell refer to as an abductive approach to theory. Similarly, the middle-range thinking approach used in this thesis also advocates

having a 'skeletal' theory in mind prior to entering the field. This is the approach the researcher chose when conducting the research described herein. This approach is frequently found in management accounting research, and researchers move back and forth between data and theory as findings emerge. As explained by Ahrens and Chapman (2007) '*Problem, theory, and data influence each other throughout the research process. The process is one of iteratively seeking to generate a plausible fit between problem, theory and data*' (p.836). A typical example of this in the management accounting field, is a study by Malina and Selto (2001). Their study was positivistic in nature and aimed to statistically test hypotheses in relation to effectiveness measured using a balanced scorecard; however, it relied entirely on the analysis of semi-structured interviews to do so.

3.4.1 Field-based methods

This researcher has captured accounts of the changes (or lack thereof) in risk-taking behaviour as the main actors (traders) perceived them. She then corroborated those accounts with senior personnel in the control functions who work alongside the key actors. As the research relies very much on the 'self-reports' of the main actors and their own perception of the situation, it was thought to be useful to ascertain whether their own perceptions could be validated by the individuals who work alongside them in the control functions. The control functions involved in the thesis were: risk, regulation, and product control functions. Finally, the results and recommendations from this thesis were presented to policy makers at the BoE, and the Head of Corporate Governance at a large asset management firm, whose company is a large shareholder in many of the investment banks discussed in this study, and as such, plays a key role in voting on the banks' remuneration policies and their election of board members. These discussions were undertaken to check that the results reported in the study did not convey any misinterpretations, and to validate the findings reported here.

Ahrens and Chapman (2007) define qualitative field studies as those that '*collect data in the domain* '*field*' *and employ* '*qualitative*' *methodology*' (p.821). They argue that with a qualitative methodology, the field is not just deemed a component of the empirical world, but that it is also influenced by the theoretical stance of the researcher. Furthermore, they argue that '*The practice of doing qualitative field studies involves an ongoing reflection on data and its positioning against different theories such that the data can contribute to and develop further the chosen research questions. Data are not untainted slices of objective*

reality but aspects of recorded activity that a study finds significant for theoretical reasons' (p.820). Similarly, Vaivio (2008) argues that for qualitative research to be seen as more than simply a mere collection of interesting field data there must be links to theory deriving from the interpretations of empirical evidence. Additionally, to make a strong theoretical case, he argues there must be frequent iterations between empirical data and theory.

Ahrens and Chapman (2007) claim that multiple theories can be used to explain events in the field, they argue that with qualitative methodology comes the understanding that through the interactions of actors, social order is created subjectively. Many different theories might then emerge to which a potential contribution can be made: '*[Q]ualitative field studies are characterised by a flexibility to respond to new insights from the field by developing, testing, and discarding or refining suitable theories*' (Ahrens & Chapman, 2007, p.831).

3.4.2 Middle-range thinking

As briefly discussed in Chapter 1, middle-range thinking argues that no one theory can provide a complete picture of accounting reality: due to the fact that accounting is a socially constructed phenomena. Thus, only 'skeletal' theories should ever be used when examining social phenomena (Laughlin, 1995). Middle-range thinking allows for a 'skeletal' framework of both methodology and theory (theories) during the research design of a project that can be 'fleshed' out and led after the collection of empirical data. Middle-range thinking assumes the social world is interpretively constructed, however embarking upon a research project with no prior theory is not accepted under a middle-range thinking approach (Broadbent & Laughlin, 2014), as in this case prior theory is vital, as researchers need to be explicit about all the theories used (Broadbent & Laughlin, 2014). Broadbent and Laughlin (2014) reason that it is these theories that provide a 'language' that allows researchers to discuss the empirical situation; this empirical situation is then 'fleshed' out. If the empirical data does not fit the theoretical 'skeleton', then it can be used to extend or reform the framework (Laughlin, 2004). Thus, middle-range thinking allows for the empirical situation to be explored but not defined (Broadbent & Laughlin, 2014).

Laughlin, informed by the work of a sociologist and philosopher Jürgen Habermas, and borrowing the term 'middle-range' from Robert Merton (1968), first introduced the notion

of middle-range thinking in 1995. The theory was further enhanced in 2004 by Laughlin, in response to criticisms from Lowe (2004) regarding its usefulness.

Laughlin's (1995) middle-range thinking approach was primarily based on the work of Burrell and Morgan (1979), and organised accounting research according to three ontological dimensions: theory, method, and change. Theory encompasses what is already known about the world, and ontological assumptions describe its nature and how it relates to the topic under investigation. Methodology refers to the 'set of spectacles' or the theory informing the methods employed by the researcher, and the role of the researcher with regard to collected data. That is, at one end of the spectrum the researcher is expected to have no bias or influence on the outcome of the project, whereas at the other end of the spectrum, the researcher is perceived as integral to the outcomes of the research project (Broadbent & Laughlin, 1997). Laughlin (1995) referred to change as: '*[A]ttitudes by the researcher concerning the worth or otherwise of maintaining the current situation that is being investigated as well as views about the necessity for actually doing something about this situation*' (p.67). Three choices (high, medium, and low) are available in relation to the three ontological dimensions. Figure 1 illustrates this.

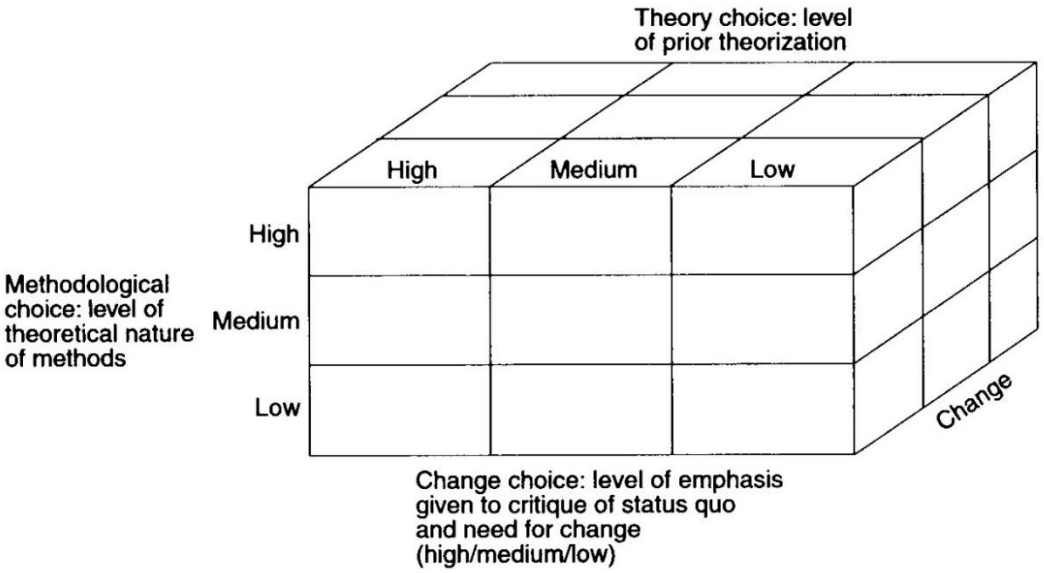

Figure 1
Dimensions on the choice process for empirical research. (Source: Laughlin, 1995, p.70)

Laughlin (1995) argued that those who believe that 'high' levels of change are necessary view everything as 'inadequate' and 'incomplete', and as such in need of change, even if

they cannot make those changes happen themselves. Whereas those who believe in 'low' change are happy to see the existing situation remain the same. Those in the 'middle', however, would view things more strategically: acknowledging that on occasion, some things need changing, whilst others should remain unchanged. The high, middle (medium), and low continuums also apply to theoretical and methodological dimensions. Laughlin (1995) claims that the three choices are interrelated, with theory and methodology being related linearly, i.e. those who believe in high levels of theorisation also believe in '*[H]igh levels of theoretically defining the methods of investigation*' (p.69), and vice versa for low levels. Change, he reasons is less predictable, and thus cuts across both theory and methodology. Middle-range thinking requires taking the mid-point on each of the three dimensions of theory, methodology, and change. Figure 2 represents this.

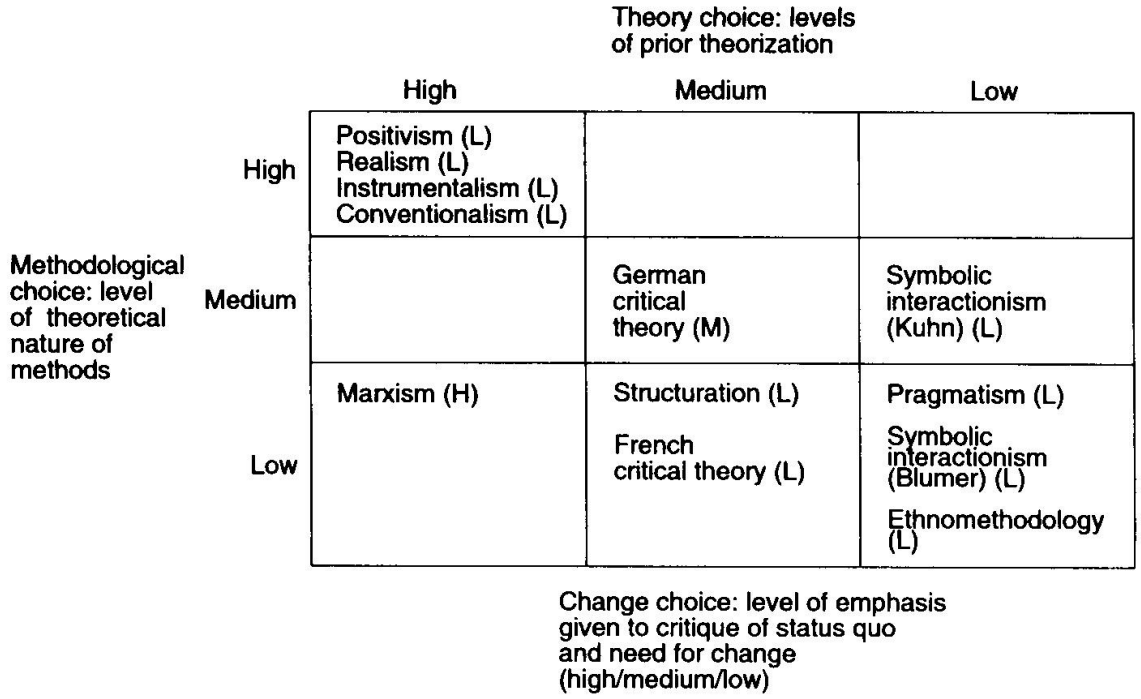

Figure 2
Characteristics of alternative schools of thought. (Source: Laughlin, 1995, p.68)

Laughlin's (2004) updated views on middle-range thinking were conducted in response to Lowe (2004), who stresses that response to change is only possible after much is understood from the theoretical and methodological dimensions. In Laughlin's (2004)

response to Lowe (2004), he updated fig 2 with fig 3, arguing that it provided a richer, more focused picture of the choices to be made in a research programme.

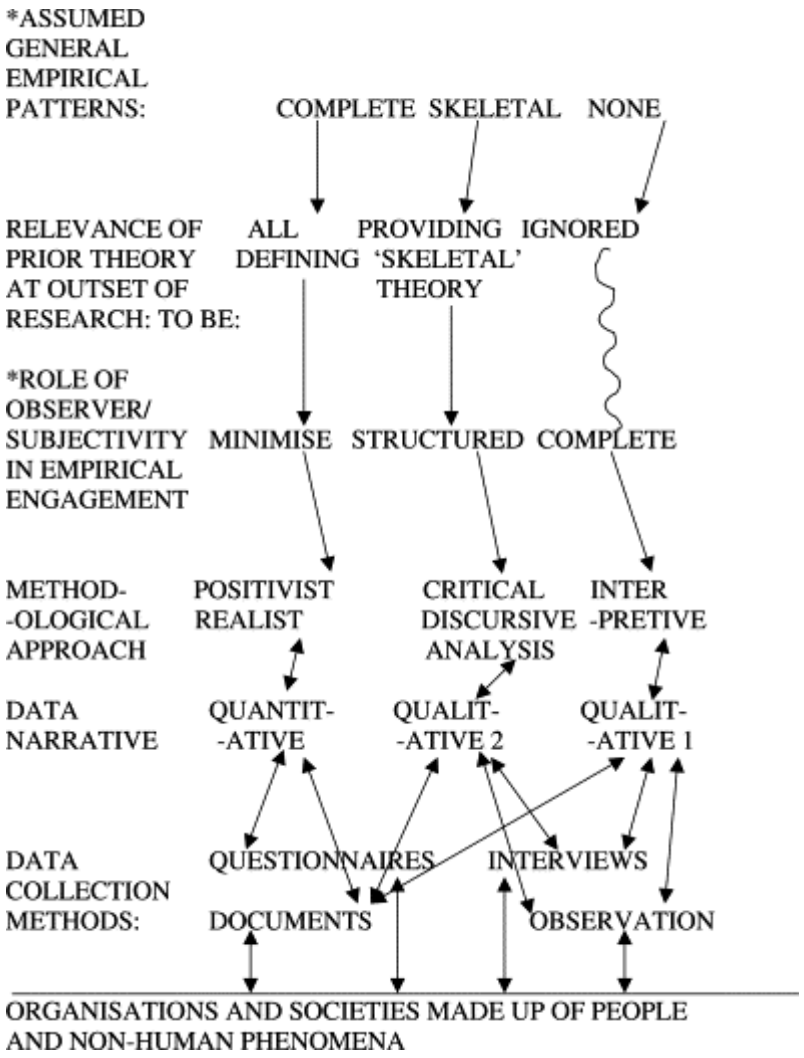

Figure 3

Alternative research approach assumptions. (Source: Laughlin, 2004, p. 272)

The first discussion about middle-range thinking as a methodological approach in an empirical setting appeared in a paper by Broadbent and Laughlin in 1997. The study was a longitudinal study of schools and general practitioners in the UK, and provided an example of 'middle-range' thinking, whereby a 'skeletal' framework is 'fleshed' out in the context of an empirical setting (p. 623). Broadbent and Laughlin (2014) state that they used this

middle-range thinking approach for over 25 years in many of their research projects. The majority of these projects were qualitative longitudinal studies. However, many other management accounting scholars have employed middle-range thinking not using longitudinal studies; for example, Modell (2001) who used an interpretative qualitative study to investigate managerial responses to institutional pressures in the Norwegian health care sector, and Otley and Franco-Santos (2017) who used it as a tool to develop a conceptual framework to explain the occurrence of unintended consequences in respect of PMSs.

As is the case with most approaches, middle-range thinking is not without critics, most notably Lowe (2004). Lowe (2004) argued that suggesting a mid-point on the three dimensions of theory, methodology, and change, only avoids the 'problems' found in alternative research approaches without offering any guarantee that we are not adopting the worst features of each approach when doing so. Furthermore, he reasoned that Laughlin's (1995) descriptions of methodology, theory, and choice were partially 'contrived'. What Lowe most took issue with in Laughlin's (1995) paper was the suggestion that the 'middle' position is the superior position when discussing a programme of research. Laughlin's response was that he did not intend to insinuate the middle position was the best for everyone, maintaining that it is the researcher's right to work at the extremes, if they so choose. However, what he did stress was that contrary to Lowe (2004), '*No one approach, including the* '*middle position*'*,… has total privilege to claim some* '*absolute*' *status–all will only ever provide partial insights into the world in which we inhabit*' (Laughlin, 2004, p.270).

Middle-range thinking was deemed a suitable approach for this research project, as its primary advantages (as cited by Broadbent & Laughlin, 1997) encapsulate the spirit of what is important here. Namely, the linking of theory to practice, the ability to constructively challenge the status quo, and being conscious of the importance of the societal and historical context of the organisational process in this thesis.

3.5 Research method

The first step in this research project was for the researcher to identify a research problem that would be both of interest and suit the parameters of a PhD. As a qualified Chartered Management Accountant with several years of recent experience in the financial services sector, her desire was to find a contemporary issue that had real life impact in an industry

with which she was very familiar. As she had recently left the industry in the aftermath of the 2008 financial crisis, the researcher was aware of some of the primary issues facing it at that time. Whilst contemplating what research topic to choose for her PhD, the researcher had several informal conversations with individuals who had also recently left the industry. The purpose of these conversations was to determine why they left and to gauge their opinions about the greatest problems currently facing the industry. She also had informal conversations with some individuals who were continuing to work in the industry. When she had decided the area she wanted to focus on, she used her academic contacts to sound out the project's feasibility from an academic point of view. When she eventually decided on her topic of study, she returned to her industry contacts to enquire about the potential value of the planned research to the industry and its feasibility, and to also set the groundwork for obtaining access to the individuals she needed to contact to collect empirical data.

With a research topic chosen and the main research question formulated, the next step was to gather an in-depth understanding of the topic, to be investigated from both a practitioner and academic perspective. Understanding the topic from a practitioner point of view was important to the researcher, given her previous industry experience. Vaivio (2008) supports the need to balance practical and theoretical aspects of a research study, to ensure that the research connects with the world within which it is practised. He argued that too much focus on theoretical aspects would make the research interesting to only a small niche community, whereas too much emphasis on its practical side would make it irrelevant to academic communities.

In qualitative studies, it is important that the researcher not only knows the topic well with regard to the field settings and participants, but also that they understand the findings reported in previous research, including the methodologies used in those studies and their limitations. As the researcher had several years' experience in the field, she was confident about her practical knowledge of it. What was lacking was the knowledge of academic literature relevant to the topic and the research designs available to facilitate the chosen research topic. Furthermore, as the remuneration regulations that provided the context in the thesis were new, there was also a need to more fully review their details.

Her starting point was to analyse all the policy and consultation papers available on Remuneration Code and the Capital Requirements Directive IV bonus cap regulations. She

also searched the archives of good quality newspapers to gauge industry responses and public opinion about the new regulations. Next, practitioner journals discussing the regulations were analysed and annual reports were gathered from the top ten UK-based investment companies to gauge their reaction to them, and their plans for implementation. Finally, academic journals were searched to assess whether anything had already been published about the new regulations to try to locate a gap in the literature, and to find a theoretical frame that might assist with answering the research question and help with shaping the interview questions. Keyword searches were made of the Emerald, Swetswise, Sciverse, Science Direct, and Business Source Premier databases, and then further searches were made in SSRN and Research Gate. The researcher also attended three highly regarded international academic management accounting conferences to determine if any other researchers were exploring ideas similar to hers, but no evidence of this was found. The final step in the research process was to discuss the research idea with a leading management accounting scholar to seek advice and validation of her chosen research topic and research design. The outcome of that meeting provided the researcher reassurance that she had chosen an understudied, but highly relevant topic, and that she was the right person to conduct such a study given her previous industry experience and contacts. As the scholar stated, the prior knowledge and contacts gave the researcher a 'competitive advantage' over other researchers wishing to investigate the same issues. At this stage of the project the researcher was focused solely on the following research question: Did the new control mechanisms change the risk-taking behaviour of traders. If so, *how* and *why*?

Based on the academic analysis described above, three gaps in the literature were found. First, and unsurprisingly, considering the regulations were relatively new, the researcher could not find any research that dealt directly with the impact of the new compensation controls on risk-taking behaviour[20]. Second, she identified that whilst there was empirical evidence linking certain elements of the new compensation controls (i.e. bonus deferrals) to risk-taking behaviour, no studies explored the *how* and *why* questions prompted by the control mechanisms and their connection with risk-taking. Finally, as the malus/clawback clause is a relatively new concept as applied to compensation packages for individuals working in the financial services sector, there was no evidence regarding its effectiveness as a mechanism to reduce the propensity for individuals to engage in excessive risk-taking.

[20] This changed in 2015 with the Hartmann & Slapničar study and in 2016 with the Kleymenova and Tuna study.

A pilot study was conducted in April 2014, after which the researcher realised the literature review did not provide sufficient answers to assess the data to satisfactorily answer the questions she wished to pose. This prompted her to look for a more suitable analytical framework for the thesis, as will be discussed further in the chapter. The literature review conducted prior to the pilot study was still useful, creating a background narrative that enabled the research project to move in the right direction.

3.5.1 Research design

Qualitative methods of primary data collection and analysis were chosen, and the nature of the research required in depth insights and understanding that would not have been achievable conducting a quantitative study (Patton 1990). In a qualitative study, the extent to which prior theory should inform the research question and data collection process becomes an important question (Eisenhardt, 1989).

At the time of the data collection, the changes in the compensation regulations were very new, and their impact unknown. Therefore, the researcher was not convinced that the existing management accounting theories could capture all the relevant factors revealed by the data collected for this thesis. This encouraged the researcher to use an abductive approach to gathering the data. By choosing a qualitative method, the researcher was able to gather rich data by speaking directly with the people involved, allowing them to recount their stories without bias derived from prior expectations based on previous literature (Creswell, 2007). A benefit of this approach was that it brought to light many additional and often surprising factors that could not be anticipated solely based on existing theories. Malina and Selto (2001) who studied the effectiveness of the balanced scorecard adopted a similar strategy, as similar to this author, they were not convinced that current management accounting theories captured all the relevant factors at play in their study:

> While the study's use of management control and organisational communication theories represents a deductive approach to research and does guide later analysis and model building, we were not confident that we had identified all relevant factors related to the effectiveness of the DBSC. At this stage, we preferred to gather data more freely and let the respondents' natural, undirected commentary support, deny, or extend the theories. An important benefit of this approach is that respondents may identify factors that affect the effectiveness of the DBSC other than those anticipated by the study's theory. (Malina & Selto, 2001, p.61)

To address the research questions data was collected from five qualitative data sources: (1) Regulatory policy and consultation reports, (2) investment banks annual reports, (3)

internal compensation contracts of employees, (4) media reports on the new regulations, and (5) interviews with senior employees from UK-based investment banks. The main source of interview data was interviews with investment bankers, but these were supplemented by conversations (often informal) with a variety of other very senior employees. In April 2017, the researcher presented findings and recommendations from the thesis to two policy makers from the BoE[21], and in May 2017 she discussed the findings of her research with the Head of Corporate Governance at a large asset management firm, whose firm is a majority shareholder in many investment banks, and who plays a key role in voting on investment banks' remuneration policies. She has been invited to present a further discussion of her findings and recommendations to a wider team comprised of policy makers from the BoE in October 2017.

The regulatory documents were used to glean an understanding of the technicalities, and the context and background of compensation regulations. The banks' annual reports and media reports were used to show their interpretations of, and reaction to the regulations. Finally, the interview data was used to assess how the regulations actually played out (i.e. did they succeed in their aim to reduce excessive risk-taking, and if so *why* and *how* did they achieve it?).

To the best of the researcher's knowledge, due to the difficulties accessing senior level risk-takers in the financial services industry (Power *et al*., 2013), this is the first study of its kind on investment banks in the UK, since the 2008 financial crisis.

3.5.2 Primary data collection

The primary data source was collected via thirty eight face-to-face semi-structured interviews[22], conducted with thirty-four MRTs, one partner at a large accountancy firm who provides tax advice on compensation packages for MRTs, two senior regulators, and one Head of Corporate Governance at a large asset management firm. Of the thirty-four MRTs interviewed, twenty six were senior traders who take proprietary risk[23], and all but one of the twenty six were desk heads. Twenty-four out of the twenty-six traders were male, which is representative of the 85% demographic of men on the trading floor

[21] The meeting with the policy makers was conducted under Chatham House rules, therefore their identity is not disclosed. However, they gave permission for their affiliation to be disclosed.
[22] Details of the interviews can be found in Appendix E
[23] Proprietary risk occurs when a trader takes a risk on the market using their bank's capital rather than trading on client commissions

(Efinancialcareers.com, 2013). In addition to the twenty six interviews with senior traders, a further eight interviews were conducted with heads of the control functions: four EMEA[24] Heads of Risk Management; one EMEA Head of Regulation; one Global Head of Regulation; and two heads of EMEA Product Control[25]. As all the interviewees held very senior positions, and come from a range of departments, and a range of large investment banks, it is assumed that possible data bias was mitigated in the interviews (Eisenhardt & Graebner, 2007). As the researcher had previously worked in the industry, she knew the '*language*' of the interviewees, and quickly developed a rapport with them apparently gaining their trust.

Semi-structured interviews were chosen in preference to structured or unstructured interviews because they allow for unexpected responses, whilst having some structure ensured the interviewees were also answering the research questions. For the pilot study, which was conducted in April 2014, purposeful sampling was used to identify a certain class of trader, i.e. one who took proprietary risk and was classified by the regulators as being a material risk taker. After the pilot study different classes[26] of banks started to emerge, and so '*stratified purposeful sampling*' (Gray, 2004, p. 325 (adapted from Patton (1990)) was used to select the investment banks and traders for interview.

The researcher also tried to achieve balance in terms of the number of interviews conducted in both bank types; the details of which are provided later in the chapter. Ten London-based investment banks participated in the thesis. The number of banks who participated was limited to ten, due to difficulties with access. Access to banks is notoriously difficult for researchers (Power *et al*., 2013); therefore, this researcher was very fortunate that her past experience in the industry afforded her the opportunity to gain access to senior individuals at ten banks. The banks included in the study have various geographical origins, e.g. European, Swiss, UK, and US. London was deemed to be an appropriate place to conduct this study, because the specific compensation regulations examined were specific to investment banks operating under the jurisdiction of UK and EU regulations. Additionally, as London is one of the world's two leading international financial centres, and as such was intensely affected by the global financial crisis,

[24] Europe, Middle East and Africa.
[25] Product control sits in the finance function of the bank, and its main responsibility is to produce the daily, monthly and yearly profit and loss accounts for individual traders and overall profit and loss at desk level.
[26] See section 6.3 for detailed information.

circumstances provide a unique opportunity to conduct research that would not be possible in times of 'normal' transformations (Van der Stede, 2011).

All the banks who participated in the thesis were classified as large banks with a global presence; each having over 120,000 employees. The reason for choosing only large banks was twofold. One, they were more likely than smaller banks to have traders that took proprietary risk; two, the bonus/incentive structures across large global banks are likely to be very similar, which was important to the thesis. Access to individuals in the banks was secured through the researcher's personal contacts; allowing access not usually afforded to other researchers, as mentioned above. Post-crisis, investment banks were reluctant to let outsiders in to conduct any form of research, especially relating to sensitive topics such as incentives. Therefore, the researcher was very fortunate to gain access to senior level employees who were willing to discuss their compensation arrangements with her. A survey of such senior level bankers would not have been granted, and more importantly, would not have shed light on the '*how*' and '*why*' questions of this thesis.

In addition to taking proprietary risk, those selected for interview had to be classified as MRTs, in accordance with the criteria set out in the Remuneration Code. Traders who take proprietary risk were deemed to be an excellent research group for this thesis, as they make risky trading decisions daily. In the case of individuals who make risky decisions daily, it should have been evident that their risk-taking behaviour had been modified in response to the new incentive controls.

In each bank a small number of MRTs met the interview criteria; however, access to these individuals was difficult to obtain, as it is not usually afforded to researchers. Accordingly, no set number of interviewees was planned in the design stage of the thesis. The approach taken was initially taken to gain access to banks, and from there, to increase the number of interviewees. The researcher was fortunate in that once access had been obtained, further interviewees became available.

The interviewees were approached via the researcher's professional contacts and were guaranteed anonymity. As all the interviewees were guaranteed anonymity and produced similar answers to the questions posed in the interviews, it is assumed that their responses were candid. They were interviewed once: the interviews lasted from under one hour to two and a half hours. The length of time spent on the interviews was dependent on the interviewee's availability and what they had to say. All the interviewees were advised in

advance that the interviews would take approximately one hour. Many of the interviewees were happy to work beyond this time slot if their schedule permitted. The researcher kept a research diary and immediately after each interview made notes on her observations and feelings about the interviews. Later that same day, these observation notes were written up more formally, allowing the researcher to reflect on her field notes and assess whether any patterns were emerging from the data. Moreover, this reflection time allowed the researcher to assess whether she could make any interpretations about behaviour from the field notes, and this often sparked her interest leading to further investigations of possible literature sources and theories that might explain what she was observing. Twenty-eight interviews were recorded electronically. Of the ten interviews not electronically recorded (because of reluctance on the part of the interviewee) notes were taken during the interviews; subsequently more detailed notes were written up immediately after the interviews.

Qualitative analysis of a range of archival data was conducted, including: relevant white papers; directives; internal reports on compensation arrangements; annual reports from banks, published between 2008 and 2016; public presentations, and media commentaries on the regulation changes. The first step in this process was to review all the papers and consultation reports on the Remuneration Code and the CRD IV Bonus Cap regulations. This gave the researcher a flavour of the banks' attempts to influence these regulations before they came into effect. Additionally, a search was made, and an alert setup on media sources (Bloomberg, BBC, FT, Times, Reuters and the Guardian) discussing bankers' bonuses, the Remuneration Code and/or the CRD IV bonus cap. As will be discussed in Chapter 6, the banks used scare tactics such as threatening to leave the UK in order to try to influence the regulators recommendations in their favour. Banks' annual reports were also analysed to assess if the banks were complying with these new regulations and their attitude towards them. Some banks' chief executive officers were very vocal about the damage that these regulations were causing to their business. Some interviewees provided the researcher with revised compensation contracts, detailing how these new regulations would be implemented. During the course of this study, there were many changes to the Remuneration Code and the researcher kept abreast of them by regularly checking the BoE website. Furthermore, the researcher had many informal conversations with those in industry and was kept in the loop about how the banks were going to respond to the various compensation regulations expected, often long before they became common

knowledge through the media. Finally, the first paper produced from this thesis, which explored if the new control mechanisms were effective in changing risk-taking behaviour, has since been reviewed by several industry experts, some of whom were also interviewed for this thesis.

3.5.3 Formulation of the interview questions

As previously discussed, the researcher was not convinced that existing management accounting theories captured all the factors at play in this thesis. Therefore, as described above she chose an abductive approach. Existing literature and theories were used to help shape the interview questions. Theories used in the literature were used to 'guide' the thesis and the development of research conjectures. For the pilot study, agency theory, prospect theory and management control systems theories helped formulate some of the semi-structured interview questions, as they presented strong arguments regarding the implications of the link between incentives and risk-taking behaviour. Many of the interview questions were open-ended, to allow the interviewees to speak freely, express their own opinions, and explore the unintended consequences arising from the new regulations that the researcher had not considered the initial design of the thesis. The pilot study highlighted areas known to be important to the thesis, but which had not been considered initially. Therefore, the results of the pilot study influenced the remaining interviews. Details of the initial and revised interview schedules are available in Appendices A and B.

3.5.4 Modified research design as a result of the pilot study

New and often surprising facts came to light when conducting the pilot study. In this case, the pilot study confirmed the preference for an interpretive research approach, rather than a positivist approach, for the thesis. The pilot study also led to the removal of several interview questions. It also unearthed several new potential questions; the most prominent relating to the role that risk culture plays in the risk-taking behaviour of traders. The pilot study also highlighted a clear split in the data. The interviews revealed stark differences in the attitudes of traders working in different banks towards the new incentive measures and compliance with the required risk metrics. However, a pattern started to emerge, and the interview data clearly split into two subsets. One subset included banks that had undergone a forced change in leadership after receiving government bailouts during the crisis or as a result of a large-scale scandals at the bank (referred to as type B banks for the remainder of

the thesis). The second subset had received no government bailouts, and had not undergone a forced changed in leadership (referred to as type A banks for the remainder of the thesis). The discovery of this division determined which remaining banks would be chosen for the study, so the researcher could achieve a 50/50 balance between the number of type A and type B banks. These bank types will be discussed in greater detail in Chapter 6.

3.5.5 Data analysis

Twenty-eight interviews were electronically recorded, transcribed and analysed using Nvivo software. Ten interviews were not electronically recorded, due to the interviewees' reluctance to do so, and these interviewees received detailed notes, written up after the interviews and analysed manually. The field work stage was brought to a close when theoretical saturation point was reached (as described by Glasser (1992)). Eleven interviews were transcribed by the researcher and the remainder were transcribed by professional transcription services. The process of transcribing the first round of interviews provided the researcher with familiarity and closeness to the data. Professional transcription services were used for the remaining interviews due to time pressures. The researcher's first paper from the thesis had been accepted for presentation at an international conference and the researcher wanted to include the latest interview findings to guarantee the best possible feedback from the conference.

3.5.6 Analysis of the interviews

The approach to the data analysis was phenomenological. Analysis of the interviews was conducted in two stages. The initial phase involved analysing each of the interviews independently and producing an analytical narrative describing the main themes (Ryan & Bernard, 2003). As coding patterns emerged, they were linked together into theoretical models (Ryan & Bernard, 2003). The Nvivo software (version 11) allowed for the data in the transcripts to be coded and then categorised into key themes that emerged from an initial analysis of the data. The categories were chosen from the initial theoretical work outlined in Chapter 2, and themes also emerged from the empirical data in the pilot study. The categories chosen in advance included categories that dealt with: bonus cap, control, clawback, deferrals, risk, risk seeking, risk aversion, incentives, and performance reviews. The categories that emerged from the interviews were compliance, culture, risk culture, risk limits, regulators, staff morale, and excessive risk-taking. The categories that emerged

determined the scope and content of the subsequent interviews conducted for the main study. The quotations from the interview transcripts provided in Chapter 6 were selected as representative examples of each category.

3.5.7 Analysis of other documents

The literature on content analysis informed the analysis of the other documents used in this research, more so with the intention of employing it from an interpretive and discursive viewpoint than for pure content analysis. A search for patterns and common themes in these documents was conducted manually and iteratively. The analysis of data took place throughout the research process, with the results of each analysis guiding future investigations. The data analysis concluded by linking theory with the results collected for the thesis.

3.6 Conclusion

This chapter provided a synopsis of the three most popular methodological choices found in management accounting research and provided the rationale for the selection of an interpretative approach utilising a middle-range thinking framework for the thesis. It also explained why a qualitative field study was deemed the most appropriate choice for the thesis. The chapter concluded with an explanation of the research process and explained how the data in the thesis was analysed, and the limitations of the chosen method.

Pre-existing theories, as discussed in Chapters 2 and 4, were used to bring theoretically informed explanations to the thesis findings. Whilst the selection of theories was subjective, the majority of the empirical investigations were rooted in management control systems theories, behavioural economics theories, and institutional theories. The next chapter will discuss the rationale for the use of the additional theories drawn upon to answer the research questions posed in this thesis.

4. ADDITIONS TO THE THEORETICAL FRAMEWORK

4.1 Introduction

As discussed in Chapter 3, a middle-range thinking approach provides the overarching theoretical framework for this thesis. Chapter 2 discussed the theories (prospect, agency and management control systems) and empirical findings of studies identified to address RQ3: Did the new control mechanisms change the risk-taking behaviour of traders? The aim of this chapter is to discuss the theory that assisted with providing theoretically informed explanations to RQ2 and RQ3. As evidenced by the varied and often conflicting results presented in existing literature on the topic, it is evident that no single theory could fully address all the questions posed in this thesis. This is unsurprising given the complex nature of remuneration in the financial services industry, with its multiplicity of purposes; i.e. to motivate performance, manage shareholder goal alignment, attract and retain talent, prevent excessive risk-taking, and change normative culture. As discussed in Chapter 3, this led the researcher to choose an abductive approach to the thesis, as she was not convinced that the existing management accounting theories analysed in Chapter 2 could capture all the relevant factors at play in the thesis. That said, existing literature and theories were useful for helping to shape the study and formulate the research questions.

The starting point of the thesis focused on two main themes:

1. The behavioural aspects motivating individual risk-taking; and
2. The link between incentives and risk-taking.

The behavioural economics literature, and specifically prospect theory, proved a good starting point from which to explore what behavioural aspects motivate individual risk-taking. The literature on incentives and risk-taking, and specifically agency theory, provided a good building block for understanding what was already known about the consequences of incentives on risk-taking behaviour.

However, following the pilot study, it was became apparent that prospect theory combined with agency theory did not provide an adequate theoretical frame for this thesis, as it could

not provide the depth of answers sought. Specifically, prospect and agency theory could not offer theoretically informed explanations to the '*how*' and '*why*' questions posed.

Another point of departure from prospect and agency theory as the main theoretical frame for this thesis was the discovery in the pilot study of a significant bifurcation of practices in the implementation of the new control mechanisms, and the resultant impact of these variations on individual's risk-taking behaviour. Management control systems theories proved to be more useful for providing the in depth explanations required from this thesis and hinted at in the pilot study.

After all the interviews were completed and the data had been analysed, practice variations emerged as a dominant theme in the research. Exploring the identified practice variations led the researcher to question why such differences occurred in practice, resulting in RQ1 and RQ2 being added to the thesis. Institutional theory, and specifically Oliver's (1991) typology of strategic responses to institutional processes provided an appropriate lens, through which theoretically informed explanations for the questions posed could be identified. The use of Oliver's (1991) typology also fits with the interpretative ontology of the thesis, and this was demonstrated in a prior study (Modell, 2001) that combined interpretative ontology with Oliver's (1991) typology. To reiterate, and as explained in Chapter 1, the addition of an institutional framework to the study was intended to explain the findings of this thesis *after* initial collection and analysis of the primary data.

4.2 Chapter overview

As previously discussed, this thesis details attempts by the European and UK regulators to change the risk-taking behaviour of MRTs working in investment banks after the 2008 crisis. This thesis links the actors' and investment banks' responses to those attempts to illustrate their consequences. It specifically concerns the UK regulations and the Remuneration Code, whilst also considering the European directive, CRD IV bonus cap and how the 'bonus cap' was translated at the local level in the UK.

It explains how the regulators used coercive isomorphism (discussed in section 4.3), introducing controls on MRTs incentive arrangements to attempt to change the risk culture at banks. It highlights the flaws that arose when trying to push a universally designed PMS into an organisation without due regard for the other pressures faced by that organisation, and shows the contingent nature of PMSs. The use of a universally designed PMS does not

guarantee that the behaviour predicted will materialise, or manifest in the same way for all individuals, or across all organisations. The reason why this might be the case lies in both contingency theory literature and the institutional literature. The institutional perspective can be used to help to explain why organisations behave in the way they do; why some organisations that operate in the same institutional environment respond differently to institutional pressures; and what factors motivate organisations to change. In the context of this thesis, Oliver's (1991) typology of strategic responses to institutional processes provides a good framework for explaining the diversity of banks operating in the same institutional environment with respect to their responses to institutional pressures. Moreover, the model can be used to explain '*[H]ow elite and powerful institutions will attempt to actively shape and defeat legislation and regulation that adversely affects their interest*' (Shapiro & Matson, 2008, p.2001), as evidenced in this thesis with regard to a legal challenge of the bonus cap rule[27].

Oliver's (1991) typology of strategic responses to institutional processes will be used to theorise the strategies and resources deployed by organisational actors when interpreting and applying the imposed remuneration regulations. The institutional explanation is useful for highlighting that not all organisational behaviours are derived from the self-interest of organisational actors. Cognition and obligation are also motivating forces. An institutional view will help to explain how the nonchoice behaviour within organisations occurs repeatedly in the absence of evidence that choices further organisations' goals.

Since their inception, many variants of institutional theories have emerged, offering various insights into behaviour in organisations. The section that follows describes the most prominent institutional theories to have emerged, and discusses the rationale for selecting the theory used in this thesis.

4.3 Institutional theory

Institutional theory is considered the leading approach when seeking to understand how organisations behave in their institutional environments (DiMaggio & Powell, 1983; Meyer & Rowan, 1977; Oliver, 1991; Selznick, 1957). Although there is no universally accepted definition of an institution, Scott (2014) states that they: '*[C]omprise regulative, normative, and cultural-cognitive elements that, together with associated activities and resources, provide stability and meaning to social life*' (p.56). Institutional theory studies

[27] This will be discussed in detail in Chapter 6.

the processes by which rules, norms and routines form the guidelines for what is deemed socially acceptable behaviour. Organisations that follow these norms are believed to have an increased chance of survival (Covaleski & Dirsmith, 1988).

This is a theory that not only considers organisational change, but also the similarities (*isomorphism*, the term used by DiMaggio and Powell (1983)) shared by organisational processes in a population or field of organisations. Moreover, institutional theory posits that behavioural responses from organisations are not driven solely by market competition, but by institutional pressures designed to ensure the legitimacy and survival of the organisation. Theorists argue that it is these pressures that persuade some organisations to follow the same organisational format, even when their forms are not efficient (Meyer & Rowan, 1977). Evidence of this type of behaviour will be discussed in Chapter 6 of this thesis.

Institutional theories have been used in recent years to extend the study of management accounting and examine management accounting change beyond the neo-classical economic theories concerned with rationality and equilibrium (Ribeiro & Scapens, 2006). There are numerous strands to institutional theories (Scott, 1987; Zucker, 1987), but the most prominently used in the accounting literature to date are Old Institutional Economics (OIE) and New Institutional Sociology (NIS), also known as new institutionalism (Burns & Scapens, 2000). These theories have different origins, but they share a capacity to shed light on the process of management accounting and management accounting change (Burns & Scapens, 2000). Simply put, with regard to the study of management accounting and management accounting change, OIE is useful as a mechanism for studying the intra-organisational processes of change, resistance to that change, and/or the rationale for decoupling formal schemes from actual work practices within individual organisations (Burns & Scapens, 2000; Ribeiro & Scapens, 2006). By contrast, NIS is useful for studying the impact of extra-organisational institutions; for example, the regulations imposed on organisations at a more macro level, and why certain formal structures and practises are adopted in organisations operating in the same environment (Burns & Scapens, 2000; Ribeiro & Scapens, 2006). As the focus of this thesis concentrates on the impact of new compensation regulations at the more macro level of the organisational field, new institutionalism was deemed to be a more appropriate theoretical lens.

4.3.1 New institutionalism

Selznick's 1957 paper on '*Leadership in Administration*' is often cited as the source of *old* institutionalism. The fundamental tenets of old institutionalism combine issues of influence, coalitions, and competing values, with power and informal structures also playing a role (Selznick, 1949, 1957). Here, the dominant theme is the rational-actor model, and the driving force for organisational change is efficiency. *Old* institutionalism explains how organisations react to the legal and regulatory environment in which they operate, and to government demands. Moreover, it stresses the role that organisations play in trying to influence their environments to make them more accommodating of their goals.

The notion of *new* institutionalism was conceived in 1977 in two prominent academic papers: Meyer and Rowan (1977), and Zucker (1977). Subsequent research in the 1980s by Meyer and Rowan (1983), DiMaggio and Powell (1983), Tolbert and Zucker (1983), and Meyer and Scott (1983), established the foundations of what became known as modern organisational institutionalism (Greenwood *et al*., 2008).

New institutionalism brought about the notion that organisations are influenced by their institutional context. However, there have been divergent views over what this institutional context consists of: Meyer and Rowan (1983:84) have argued that it was '*the rules, norms, and ideologies of the wider society*', whilst Zucker (1983:105) claims it was '*common understandings of what is appropriate and, fundamentally, meaningful behaviour*'. The fundamental tenet of this perspective is the emphasis placed on the importance of culture and shared meanings. Theorists (Meyer & Rowan, 1977; Meyer & Scott, 1983; Zucker, 1977) have argued that it is these cultures and shared meanings that shape organisational behaviour. As will be discussed in the findings section of this thesis, culture plays a prominent role in shaping not only organisational behaviour, but also individual behaviour.

In the case of *new* institutionalism, the rational-actor model of *old* institutionalism is rejected and replaced with the need for legitimacy and survival as the main motivating force for organisational actors (DiMaggio & Powell, 1983; Meyer & Rowan, 1977). Hence, organisations' need for legitimacy and survival triumphs over their need for efficiency. Legitimacy is a key concept under *new* institutionalism, and is seen as the dominant force for both change and/or inertia. Theorists (Meyer & Rowan, 1977; Meyer & Scott, 1983) believe that it is this quest for legitimacy that encourages organisations to

adopt normalising behaviour, rather than resistant strategies. Evidence from this thesis will provide conflicting evidence regarding the strength of legitimacy as a driver of organisational change in the UK financial services sector.

Meyer and Rowan (1977) argue that phenomena in the organisational environment determine how they are structured and that they become *isomorphic*. They believe that it is *isomorphism* that helps organisations build success and create opportunities for survival, because:

> a) They incorporate elements which are legitimated externally, rather than in terms of efficiency.
>
> b) They employ external or ceremonial assessment criteria to define the value of structural elements.
>
> c) Dependence on externally fixed institutions reduces turbulence and maintains stability.
>
> (Meyer and Rowan, 1977, pp.348-349)

Moreover, they argue that not only are organisations influenced by their environments, but they also influence them. This belief was recently validated in studies by Bozanic *et al*. (2012), and Canning and O'Dwyer (2013). Thus, institutional theory continues to play an important role in regulations such as the Remuneration Code and the CRD IV bonus cap rule, because of organisations' ability to influence their institutional environments, and thus the regulations proceeding from those environments.

Conforming to institutional rules often results in conflict with the goal of efficiency (Meyer & Rowan, 1977). Under *old* institutionalism, it was believed that organisations behave rationally; hence, Meyer and Rowan (1977) believed that complying with *institutional myths*[28] that pursued legitimacy instead of efficiency, was irrational. However, they recognised the value that these *institutionalised myths* have as means to ensure the survival of organisations, and thus believed that following these myths might not ultimately prove to be irrational. To deal with these conflicting goals, they propose that formal structures are *loosely coupled* with actual work practices, allowing organisations to have *ceremonial* conformity only when arranged based on formal structures. This decoupling of formal work structures from actual work practices was a key contribution in

[28] Myths are widely held ideas or beliefs that are often false.

Meyer and Rowan's 1977 paper. Evidence of decoupling formal work procedures from actual work practices is evident in this thesis with regard to the banks' use of monthly allowances. This practice will be discussed in detail in Chapter 6.

Meyer and Rowan (1977) argue that not all organisations are influenced by institutional pressures to the same degree. They believe that organisations whose output is difficult to measure (such as governmental agencies and not-for-profit organisations) have a greater need to appear rational, and thus conform more readily to institutional pressures. This might then explain why the majority of the previous studies in this area have preferred to examine for-profit firms rather than not-for-profit firms. This thesis will provide evidence corroborating the fact that organisations operating in the same institutional environment are influenced to different degrees by the same institutional pressures. Additionally, empirical evidence from this thesis will describe the experience of non-governmental for profit banks that feel the pressure to conform.

4.3.2 Conformity to institutional pressures

It has been argued that organisations conform to the demands of appropriate organisational forms in order to gain legitimacy, and thus increase their chance of survival (DiMaggio & Powell, 1991; Meyer & Rowan, 1977). DiMaggio and Powell (1983) argue that bureaucratisation is no longer a motivating force for structural change in organisations. Yet, organisations are still becoming more similar, not out of a desire for greater efficiency or market competition, but due to processes in the *organisational field* that render them similar. They define the organisational field as '*those organisations that, in the aggregate, constitute a recognised area of institutional life: key suppliers, resource and product consumers, regulatory agencies, and other organisations that produce similar services or products*' (DiMaggio & Powell, 1983, p.148). They further argue, that it is this similarity/*isomorphism* that inhibits an organisation's ability to change at a later stage.

They recognise two types of isomorphism: (1) a competitive form, which considers market competition; and (2) an institutional form, which considers political power, legitimacy, and social and economic fitness. Banks' remuneration policies can be viewed through the lens of competitive isomorphism as the majority adopt similar remuneration policies. The key contribution of DiMaggio and Powell's (1983) paper is that it provides an argument to explain how institutionalisation occurs; i.e. what factors motivate organisations to change. They identified three mechanisms through which institutional isomorphic change can

occur: *coercive; mimetic*, and *normative*, and argued that such changes can occur, even when there is no evidence to suggest that the result may be an improvement in the organisation's performance or efficiency.

In order to examine how UK based banks responded to the institutional pressures imposed after the financial crisis, the following three instruments will be used: coercive isomorphic, mimetic isomorphic, and normative isomorphic. These three instruments have previously been identified in the literature as mechanisms through which institutional isomorphic change occurs. By reviewing these pressures, it will be possible to establish if and how UK based banks changed after the financial crisis.

Coercive isomorphism can result from both formal and informal pressures, and centres on political influence and issues surrounding legitimacy. The pressures encountered are typically exerted through the cultural expectations that society imposes on organisations operating in a specific environment. Thus, they emerge in organisations that operate under similar legal and regulatory environments, but also in management control systems and financial reporting requirements. If organisations fail to conform to environmental expectations, not only can they be penalised, but they can also lose their perceived legitimacy. This can result in situations where organisations become more homogenous and conform to wider institutions (DiMaggio & Powell, 1983).

In this thesis, the following sources are acknowledged to be in a position to exert *coercive* pressure on the UK financial services industry through new regulations on remuneration: the UK PRA, and the European Banking Authority[29] (EBA). If UK Banks fail to comply with these pressures, then they can lose their banking licenses and cease to exist. Coercive pressure is also evident in this thesis when evaluating the relationship between traders and control functions. As previously discussed in Chapter 2, traders are given star status due to the nature of their role as revenue generators, which limits the capacity of control functions to exert sufficient power over them to change their behaviour. Regulators deemed this imbalance in power to be a contributory factor to the financial crisis (BoE, 2015a). As will be discussed in Chapter 6, evidence from this thesis points to a shift in the focus of this power in some banks.

[29] The EBA are an EU regulatory agency, responsible for the prudential regulation and supervision of the EU banking sector.

Mimetic processes can occur where there is environmental uncertainty, and such uncertainty pressurises organisations to imitate one another. Organisations tend to imitate other organisations that they perceive as more successful, or as possessing greater legitimacy. Typically, the strategies and business models of the most successful organisations would be copied. This mimetic pressure can cause organisations to adopt processes that are not in their best interests, but can also cause them to reject processes that might bring them enhanced efficiency when they are not adopted by other organisations (Abrahamson, 1991). Mimicking other organisations' processes is deemed a rational response in this context, as imitation minimises the cost associated with looking for viable solutions. The similarity of the investment banks in the lead-up to the financial crisis is a good example of the *mimetic* processes at work in the financial services sector. When the crisis hit, the fact that the banks held similar securities and assets led to the rapid spread of financial turmoil across the globe.

Normative isomorphism occurs as a result of social obligations that organisations are expected to fulfil. These *normative* pressures are deemed to come from professionalisation and the general public. Professionalism is defined as '*[T]he collective struggle of members of an occupation to define the conditions and methods of their work, to control "the production of producers" (Larson, 1977:49-52), and to establish a cognitive base and legitimation for their occupational autonomy*' (DiMaggio & Powell, 1983, p.152). Compliance with professional norms and standards increases an organisation's social legitimacy (Deephouse, 1996; DiMaggio & Powell, 1983).

In the financial services sector, the majority of employees have undergone a similar formal education and professional training, meaning they share a set of attributes and skills. Additionally, as it is common for employees in the financial services sector to move regularly between organisations, they bring the skills learnt when working in one organisation to another. In the financial services sector, the higher up the career ladder one is, the more likely there will be similarities[30] (in terms of gender, formal education and professional training) among individuals working at that level across organisations. Furthermore, pre-crisis it was a professional norm for investment banks to create highly complex and risky financial products, and to pay large bonuses to adopters of these highly

[30] This was confirmed by reviewing the former experience and formal education of CEO's at the world's largest (by market capitalisation) 15 investment banks as at April 2017. It was found that in the majority of cases, CEO's at these banks were: male, educated in Ivy League or equivalent universities and had similar professional experience in previous roles.

complex products. Post-crisis, this norm appears to have changed at some investment banks, but to what extent is still an unknown. The general public has also exerted normative pressures on the UK financial services sector by publicly condemning banks' behaviour and remuneration policies, and demanding more socially responsible financial products and policies. As such, the banks should (in theory) have changed their policies to enhance their social and economic legitimacy.

Not only are firms under pressure to comply with regulations in their institutional environment, but they are also pressured to mimic the behaviour of other firms. DiMaggio and Powell (1983) argue that *mimicry* is mostly likely to occur in an uncertain environment. It can be viewed as irrational, as it can occur, even when there is no evidence of improved performance or efficiency. However, if mimicry is done to improve performance or efficiency then it is not deemed an institutional effect; rather it is a rational one (Scott, 2014). This thesis will provide evidence of mimicry in UK investment banks: as will be discussed in detail in Chapter 6.

During the mid-1990s, Scott (2008, 2014) started to develop a framework to assist researchers in their studies of institutions. His framework was based on three pillars of institutionalism:

- The *regulative pillar*, which stresses rule-setting, monitoring and sanctioning activities, both formal and informal;
- The *normative pillar,* which introduces a prescriptive, evaluative, and obligatory dimension into social life; and
- The *cultural-cognitive pillar,* which emphasises the centrality of symbolic systems: the use of common schemas, frames, and other shared symbolic representations that guide behaviour.

(Scott, 2008, p.222)

These pillars are presented in table 2.

Table 2 Three Pillars of Institutions. (Source: Scott, 2014, p.60)

	Regulative	Normative	Cultural-Cognitive
Basis of compliance	Expedience	Social obligation	Taken-for-grantedness Shared understanding
Basis or order	Regulative rules	Binding expectations	Constitutive schema
Mechanisms	Coercive	Normative	Mimetic
Logic	Instrumentality	Appropriateness	Orthodoxy
Indicators	Rules Laws Sanctions	Certification Accreditation	Common beliefs Shared logics of action Isomorphism
Affect	Fear Guilt/Innocence	Shame/Honour	Certainty/Confusion
Basis of legitimacy	Legally sanctioned	Morally governed	Comprehensible Recognisable Culturally supported

Scott (2014) argued that institutions are made up of diverse elements, and that in a given situation, depending on circumstances, any one of these pillars could operate independently or dominate. He claimed that it is when these pillars are aligned that '*the strength of their combined forces can be formidable*' (Scott, 2014, p.71). He also noted that there is the possibility for the misalignment of the pillars, supporting and motivating diverse choices and behaviour. For the purpose of this thesis (given its regulatory focus), the regulatory pillar provides a suitable basis for viewing the research issues identified through an institutional lens.

Broadbent *et al*. (2001) argue that when the normative pillar is threatened by regulation, then resistance is the most likely outcome. In contrast, if the normative pillar is not threatened, then conformity is the most likely outcome. They argue that key issues arise when all three pillars are in conflict. When this is the case, and the normative pillar is most under threat, the most likely resultant scenario is resistance to institutional pressure. In their study of changes to funding for GP practices, they found that when uncertainty was created by the regulatory environment, then the most likely response from GP practices was mimetic behaviour; whereas when the impetus for change was seen as a threat, the most likely response was resistant behaviour.

For UK-based investment banks subject to CRD IV it is a legal requirement that they comply with the rules of the Remuneration Code. Non-compliance with the code can result in fines and sanctions and also potential damage to the bank's reputation, and as a result, its legitimacy. This could prove very damaging to the bank's economic viability and survival, underlining why it is important for the banks try to influence these regulations in their favour.

Prior to 2008, remuneration[31] had not been a regulated activity in the UK financial services industry. Yet, remuneration in the corporate world is a highly institutionalised activity. As early as 1994, Westphal and Zajac's study showed just how institutionalised an activity remuneration is. Their research revealed the manipulative ways in which many organisations purported to adopt incentive arrangements that tied executive compensation to company performance; these plans were not followed through but were seen as a ploy to satisfy key stakeholders. However, since the late 1990s, tying executive compensation to company performance has become the norm, especially in the financial services industry, making remuneration a highly institutionalised activity.

4.4 Strategic responses to institutional processes

In contrast with earlier studies into organisations, understanding based on new institutionalism reveals how pressures from the external environments can impose on organisational operations, and how organisations might negotiate these impositions to ensure their survival. However, a primary factor of concern in relation to *old* and *new* institutionalism is that it portrays organisations as actors responding in a similar manner to environmental pressures. Moreover, *old* and *new* institutional theory fails to address how, given the same institutional pressures, some organisations adapt to organisational change whilst others do not.

Following on from DiMaggio (1988), Oliver (1991) developed a framework for strategic responses to institutional processes. This framework utilised institutional and resource dependent theories to predict the strategies organisations will adopt in response to institutional processes. Oliver (1991) suggested that organisational responses to the institutional environment are dependent upon various factors in their environment and within the organisation itself. The proposed framework acknowledged that firms do not always readily comply with institutional norms, and listed the factors that contribute to the

[31] With the exception of minimum wage legislation.

likelihood of noncompliance. The basic premise of the typology is that organisations will resist those institutional pressures that threaten their survival or autonomy (Shapiro & Matson, 2008).

The typology details factors that predict what strategies will be employed in a given context. Five strategic responses are highlighted, ranging from passive conformity to active resistance; with ten hypotheses included to predict the level of resistance. Moreover, the tactics that organisations might employ when implementing any one of these strategies are also listed, as are ten institutional factors that suggest what type of response is likely in each case. The framework focuses on how organisations behave in institutional contexts, and the conditions under which organisations will actively resist institutionalism. Moreover, it highlights the diversity between organisations operating in the same environment, with respect to their response to strategic pressures.

As with the studies conducted by Abernethy and Chua (1996), Canning and O'Dwyer (2013), and Modell (2001), this thesis will not test the ideas suggested in Oliver's framework, rather it will be use them as a theoretical 'skeletal' frame that can be 'fleshed' out with empirical data to attest to the study's validity (Laughlin, 1995). The strategic responses suggested in Oliver's (1991) framework will be used to explain the behaviour of the investment banks in response to the Remuneration Code and the EU directed CRD IV bonus cap regulations imposed on them.

The suggestion that organisations in the same environment respond differently to institutional pressures contrasts with the view put forward by DiMaggio and Powell, and Meyer and Rowan. They argue that lesser diversity and greater similarity characterises organisational responses to institutional pressures. As is the case in this thesis, it is not uncommon for organisations to choose more than one strategy when responding to institutional pressures. In contrast to *new* institutionalism, Oliver's typology highlights the fact that organisations do not passively acquiesce to institutional pressures, but instead act rationally in the best interests of the organisation, trying to influence the institutional environment for their best interests.

In this thesis, Oliver's (1991) typology of strategic responses to institutional processes will be used to theorise the strategies and resources deployed by organisational actors throughout the process of interpreting the imposed remuneration regulations. Table 3

adapted from Oliver (1991), details these strategies and tactics in ascending order of resistance.

Strategies	Tactics	Examples
Acquiesce	Habit	Following invisible, taken-for-granted norms
	Imitate	Mimicking institutional models
	Comply	Obeying rules and accepting norms
Compromise	Balance	Balancing the expectations of multiple constituents
	Pacify	Placating and accommodating institutional elements
	Bargain	Negotiating with institutional stakeholders
Avoid	Conceal	Disguising nonconformity
	Buffer	Loosening institutional attachments
	Escape	Changing goals, activities, or domains
Defy	Dismiss	Ignoring explicit norms and values
	Challenge	Contesting rules and requirements
	Attack	Assaulting the sources of institutional pressures
Manipulate	Co-opt	Importing influential constituents
	Influence	Shaping values and criteria
	Control	Dominating institutional constituents and processes

Table 3 Strategic Responses to Institutional Processes. (Source: Oliver, 1991, p.152)

Many accounting studies focused on the public sector (Abernethy & Chua, 1996; Carpenter & Feroz, 2001; Etherington & Richardson, 1994; Grafton *et al.*, 2011; Hyvönen *et al*., 2009; Modell, 2001) have used Oliver's (1991) typology. The contribution of this thesis is that it will analyse the strategic responses of the private sector, and specifically UK-based investment banks. Moreover, the sample of empirical data is split into both state-owned and privately owned investment banks, allowing for a comparison between responses to assess whether there are any similarities or differences between responses to institutional pressures (Remuneration Code and CRD IV bonus cap rule) and between the two investment bank types. A further contribution from this thesis is that there is no other empirical evidence in the accounting literature that specifically deals with tactics of concealment, which is the focus of the responses from organisational actors in this thesis.

Using Oliver's framework, it is anticipated that the local regulator (UK regulator) will passively accept the new EU regulations (CRD IV bonus cap). Moreover, the framework anticipates that as the investment banks are large and have high visibility, they are less likely to adopt active resistant strategies. On the other hand, the framework anticipates

that, as multiple regulatory bodies with conflicting ideas exist (for example the CRD IV bonus cap), banks are more likely to engage in strategies of active resistance. Similarly, where investment banks' freedom in pursuit of their own goals is threatened, active resistance strategies are also anticipated.

The focus of this thesis is on the non-conforming responses of avoid and defy. The avoidance tactic most prominent in this thesis describes the desire to escape from institutional pressures by way of concealment. This is evidenced through the tactics used to avoid the CRD IV bonus cap. To a lesser extent in this thesis is the defiance tactic of challenge, used by the UK government with the European Central Bank (ECB) in relation to litigation to prevent forced compliance with the CRD IV bonus cap. To the best of the researcher's knowledge, the tactics of conceal and challenge have not been the focus of any previous studies in the management accounting literature; thus, providing an opportunity to make an empirical contribution to Oliver's framework. Moreover, this thesis provides empirical evidence explaining why when some organisations encounter the same institutional pressures they might respond differently to them, providing further empirical contributions to Oliver's framework. As the focus of the empirical evidence deals with the tactics of conceal and challenge, and there are three predictive response factors (legitimacy, organisational goals, and legal coercion) the section that follows will discuss these in more detail.

4.4.1 Avoid: Conceal and Escape

In Oliver's (1991) typology, the tactic of concealment is part of the avoid strategy. Avoidance, as defined by Oliver (1991:154) is '*the organisational attempt to preclude the necessity of conformity*' by way of concealing nonconformity, providing protection from institutional pressures, and evading institutional rules. Shapiro and Matson (2008) argue that a more actively resistant strategy of avoidance will be used when regulatory or other institutional pressures threaten agents' autonomy.

Organisations that use concealment tactics, often do so under the guise of acquiescence (Oliver, 1991). The difference between the *conceal* tactic and *acquiesce* strategy is the degree to which conformity is real. Oliver (1991) argues that from an institutional perspective, the difference between appearance and reality is important, because appearance often informs the quest for legitimacy.

A more resistant tactic, which is also part of the avoid strategy, is *escape:* this tactic is evidenced where an organisation will either exit the market when they are being forced to comply, or alternatively move to a location where pressures to conform are more lenient or non-existent (Oliver, 1991). This thesis offers evidence of investment banks using both conceal and escape tactics. These will be discussed in Chapter 6.

4.4.2 Defy: Challenge

Defiance is the most resistant strategy in Oliver's framework. The three tactics within this strategy are: *dismiss*, *challenge*, and *attack* (Oliver, 1991). The challenge tactic is defined by Oliver (1991, p.156) as: '*a more active departure from rules, norms, or expectations than dismissal*' and one where '*Organisations that challenge institutional pressures go on the offensive in defiance of these pressures and may indeed make a virtue of their insurrection*'. Oliver argues that a challenge is most likely to arise when organisations can prove their rationality for issuing one. Evidence of the challenge tactic is found in this thesis and will also be discussed in Chapter 6.

4.5 Predictions of level of resistance

In addition to the five strategic responses to institutional processes suggested by Oliver, her model also theorised ten antecedents that predict the level of resistance to institutional pressures. Table 4 presents these factors. As stated previously in section 4.4, it is not the aim of this thesis to test these ideas, rather to be guided by them when assessing the qualitative data collected in this thesis. Three of the ten antecedents that predict level of resistance to institutional pressures are considered the most relevant to this thesis, and thus are discussed in the section that follows.

Table 4 Antecedents of Strategic Responses. (Source: Oliver, 1991, p.160)

Institutional factor	**Research question**	**Predictive dimensions**
Cause	Why is the organisation being pressured to conform to institutional rules or expectations?	Legitimacy or social fitness
		Efficiency or economic fitness
Constituents	Who is exerting institutional pressures on the organisation?	Multiplicity of constituent demands
		Dependence on institutional constituents
Content	What norms or requirements is the organisation being pressured to conform to?	Consistency with organisational goals
		Discretionary constraints imposed on the organisation
Control	How or by what means are institutional pressures being exerted?	Legal coercion or enforcement
		Voluntary diffusion of norms
Context	What is the environmental context within which institutional pressures are being exerted?	Environmental uncertainty
		Environmental interconnectedness

4.5.1 Cause- legitimacy or social fitness

The first prediction in Oliver's (1991) typology argues that large, visible organisations will be less resistant to institutional demands when working to maintain their social legitimacy:

> The lower the degree of social legitimacy perceived to be attainable from conformity to institutional pressures, the greater the likelihood of organisational resistance to institutional pressures. (p.160)

A study by Clemens and Douglas (2005), into the radioactive contamination of scrap steel in the steel industry refuted this prediction. They found firms in the steel industry adopted more actively resistant strategies when faced with institutional pressures. They argued that this finding might be caused by the fact that certain industries are more proactive in their responses when compared to other industries, a fact supported by Milliken *et al.* (1998,

cited in Clemens & Douglas, 2005, p.1211)). Similarly, Canning and O'Dwyer (2013), in their interpretative study into the regulatory changes made by Irish Professional Accounting Bodies (PAB's), found the PAB's adopted active resistance strategies to counter attempts to regulate them. The UK financial services industry is a large, highly visible industry. Oliver's typology suggests that, as such, it will be less resistance to institutional demands. Therefore, this thesis can make an empirical contribution to Oliver's typology here, as there is no empirical data showing how the UK financial services industry might respond to institutional pressures.

Complying with the Remuneration Code and the CRD IV bonus cap rule would bring an element of social legitimacy to investment banks. Bankers' bonuses are highly unpopular with those outside the industry and were deemed a key contributor to the 2008 financial crisis. Disobeying the Remuneration Code or the CRD IV bonus cap rule could damage a bank's reputation, weaken their economic position, and cause them to lose their banking license. It could also hurt them financially in the form of fines from regulators or by preventing them from doing business in certain jurisdictions. Investment banks can show stakeholders they are acting responsibly and are sorry for the misdeeds of the 2008 crisis by demonstrating a willingness to accept new remuneration regulations. However, as previously mentioned in Chapter 2, not all elements of the new remuneration regulations have been warmly received by the investment banks; i.e. the CRD IV bonus cap. Thus far, it has been left to the UK government to fight the banks' corner on this matter.

Oliver (1991) stresses that for-profit firms are most likely to resist state intervention if they anticipate efficiency losses. Therefore, her typology can be used to illustrate that organisations will adopt strategies to secure their own future when faced with institutional pressures they disagree with. As will be discussed in Chapter 6, this thesis provides evidence of some banks' resistance to state intervention.

4.5.2 Content - consistency with organisational goals

Prediction 5 of Oliver's typology discusses the extent to which institutional pressures are compatible with organisational goals. When institutional norms conflict with organisational goals or freedom, the typology predicts a high level of resistance:

> The lower the degree of consistency of institutional norms or requirements with organisational goals, the greater the likelihood of organisational resistance to institutional pressures. (p.164)

This prediction explains self-interested behaviour by organisations in an institutional environment. It also explains why some organisations, when faced with a loss of freedom, engage in avoidance strategies and ceremonial conformity (Oliver, 1991). This goes some way towards thwarting the critics of earlier institutional studies, who have argued that self-interested behaviour is not accounted for in institutional theory (Covaleski & Dirsmith, 1988).

When new regulations such as the Remuneration Code and the CRD IV bonus cap rule are introduced and are consistent with an organisation's goals, then Oliver's (1991) typology suggests they are more likely to acquiesce to these regulations. In contrast, when new regulations are introduced that are incompatible with an organisation's goals, then the model predicts that more aggressive resistance strategies will be employed. Moreover, Oliver's (1991) typology predicts that organisations are more likely to acquiesce to institutional pressures that do not impede decision making, such as '*hiring, compensation and promotion*' (p.166).

This thesis provides an opportunity to make an empirical contribution to Oliver's theory about organisational goals by reporting how investment banks with different organisational goals (in terms of risk appetite) respond to the same institutional pressures, i.e. the Remuneration Code and the CRD IV bonus cap.

In the context of this thesis, the institutional pressure aims to change the risk culture in investment banks. Specifically, the regulators want to dissuade banks from taking 'excessive' risk. The mechanism targeted to achieve this goal is remuneration, as the regulators believe (without any empirical evidence to justify their beliefs) that it is remuneration policies that drive the desire for excessive risk-taking.

4.5.3 Control - Legal coercion or enforcement

Prediction 7 argues that when regulators have recourse to legal action, low levels of resistance to institutional demands would be expected:

> The lower the degree of legal coercion behind institutional norms and requirements, the greater the likelihood of organisational resistance to institutional pressures. pp 167-168

Oliver's typology predicts that organisations will acquiesce more readily when faced with punitive measures for non-compliance, and when enforcement is strict. There are many studies that support this idea, for example Clemens and Douglas (2006) and Clemens and

Papadakis (2008). However, Shapiro and Matson (2008) argue that regulatees might not acquiesce so readily if they can access assistance from other parties to change or abolish the regulations. Moreover, they argue that the wealthier regulatees are, the more likely they will engage in defiant or manipulative strategies in order to corrupt the regulations. This can be done either directly or indirectly, through funding research and lobbying, or by getting legal advice (Shapiro and Matson, 2008).

In this thesis, the Remuneration Code and the CRD IV bonus cap rule are compulsory for investments banks; therefore under Oliver's typology it is predicted that they will acquiesce to these regulations. However, Shapiro and Matson (2008) would predict that as the investment banks are wealthy and can lobby other parties to change the regulations, then they are more likely to resist. As will be discussed in Chapter 6, this thesis provides evidence supporting the views of Shapiro and Matson.

A primary issue with Oliver's typology is that on the one hand, it states that organisations seeking legitimacy will typically acquiesce to new regulations, yet on the other it asserts that if such a new regulation threatens their economic efficiency or core values, then they are more likely to adopt active resistant strategies. This may render the typology useful only to describe new regulations post implementation, and less beneficial for predicting the behaviour of organisations facing new regulations. A further issue with Oliver's (1991) typology is that it tends to treat organisational responses to institutional pressures in a 'black-box' manner, assuming that all organisations operating under the same conditions and in the same environment will respond alike, which has been shown by some of the above-mentioned studies to be untrue. Additionally, Oliver's typology implicitly looks at one class of actor (the regulated) and does not take into account the responses that regulators might employ in relation to challenges to the regulations they impose.

4.6 Enhancements to Oliver's model

In 1994, Etherington and Richardson used Oliver's typology to study university accounting education; by applying all five of Oliver's strategies in the study they found they could be viewed from two dimensions: the level of activity (active to passive) and the level of resistance (negative to positive). Moreover, they rearranged the five strategies into three factors: passive, active-positive, and active-negative. The main contribution of their study in terms of enhancements to Oliver's typology was that they shifted the focus of it

from purely an institutional perspective to one that encompassed both institutions and organisations.

Following Clemens and Douglas (2005) and Etherington and Richardson (1994), Canning and O'Dwyer (2013) further enhanced this view. They advanced Oliver's implicit view about the strategic responses of one class of actor; i.e. that it is the actor that is the target of change (in this research the investment banks) during the process of institutional change. They extended Oliver's typology by focusing on two categories of actors (the regulated and the regulator) and highlighted the different responses that each class of actor might adopt when confronted with, and in anticipation of, the other actors' responses. Within the context of this thesis, they argue that Oliver's typology (1991) implicitly assumes the regulators strategic positioning will remain unchanged, irrespective of the pressures the regulatees exert. However, they refuted this view and found in their research of the regulatory schemes of the Irish accounting profession, that over time, there is a *staged interaction* between the regulator and regulatees that can shift the strategic positioning of the regulators. They argue that drawing attention to the motivation of these interactions and changes can help enhance understanding of the success or failure of the process of regulatory change. Evidence supporting Canning and O'Dwyer's findings has been presented in this thesis, as agents of the regulatees (the treasury department of the UK government) tried to restrict the powers of the regulator (ECB) by legally challenging the CRD IV bonus cap. Shapiro and Matson (2008) argued that this would lead the regulators to either a compromise based or an acquiescent strategy.

In contrast to previous research that found that regulators faced with aggressive resistance from regulatees (Shapiro & Matson, 2008), using the strategies of *acquiesce* and *compromise* (Oliver 1991), Canning and O'Dwyer (2013) found that regulators also successfully used strategies of defiance to kerb resistance from aggressive regulatees. They concluded that the '*[P]assivity of national regulators in the process of developing and interpreting (local or global) regulation should not be automatically assumed*' (p.169). In support of this finding, evidence from this thesis (discussed in Chapter 6) shows the tone of the regulators' (ECB) response to the legal challenge from the UK treasury meant compromise was not an option. Hence they remained steadfast in their conviction and adopted a strategy of defiance against the aggressive legal challenge from the regulatees' agents.

4.7 Chapter summary

Chapter 4 provided a critical review of the institutional literature from its inception in the 1950s, through to its present day use. Moreover, it has justified the use of institutional arguments as a suitable theoretical framework for a study that examines the responses of investments banks to the Remuneration Code and the CRD IV bonus cap regulations. First, this thesis used Oliver's (1991) typology of strategic responses to institutional processes to theorise the strategies and resources deployed by organisational actors throughout the process of interpreting the imposed remuneration regulations.

Second, it showed potential to make an empirical contribution to the institutional literature by providing evidence regarding the nature of these institutional pressures in the UK financial services industry. In particular, this thesis has the potential to contribute to institutional theory by providing empirical evidence to uphold Oliver's (1991) typology, and it shows how organisations who operate in the same environment under the same institutional pressures, respond differently to those pressures according to a number of factors, including consistency with other organisational goals, constituent demands, and legal coercion.

Third, this chapter established that Canning and O'Dwyer's (2013) extended typology of Oliver's framework is used to explain the behaviour of the regulators in this thesis. Empirical evidence supporting the conclusions from Canning and O'Dwyer (2013), who state that it cannot be assumed that local regulators will passively accept global regulations, is also provided.

The chapter that follows introduces the background to the field explored in this study, which is imperative given the interpretative nature of this thesis.

5. FIELD BACKGROUND

5.1 Introduction

Chapter 1 set out the motivation for this thesis, and provided a brief explanation of the historical background against which the remuneration regulations were formulated. This chapter explores the characteristics of the field in which the thesis is set in greater depth. As this is an interpretive study, it is vital to understand phenomena from an individual's viewpoint, whilst also acknowledging the historical and cultural context in which they reside (Creswell, 2007).

Gaining a thorough understanding of the field is important for several reasons. First, it was problems in the field that inspired an investigation into it, and the results of this investigation informed the primary research questions. Second, because an interpretative approach to the study is being used, placing the actors' interpretations of new control mechanisms in the context of the environment in which they are operating is important. Third, these new compensation controls were imposed upon a highly institutionalised[32] industry and a highly institutionalised activity (remuneration); therefore, understanding the background to these new compensation controls will help to explain how they were received by the various banks in the study.

Chapter 1 demonstrated the systemic importance of the financial services industry to the global economy. It also explained how repeated scandals since 2008 have proven that despite the efforts of regulators and banks to bring about change within the industry, it is still subject to multiple failings. Despite this, the regulators primary focus on incentive arrangements remains as a means to curb excessive risk-taking:

> The fundamental objectives of the remuneration policy are to sustain market confidence and promote financial stability through reducing the incentives for inappropriate risk taking by firms, and thereby to protect consumers. (PRA, 2015)

5.2 UK Regulator remuneration policies

The Financial Services Authority (FSA) was the regulator at the helm of the UK financial services industry during the crisis of 2008. It was abolished in April 2013 due to the

[32] Firms in this industry have similar organisational structures, processes, operations and remuneration policies. Additionally, they offer similar products and services, and operate under the same legal and regulatory frameworks.

apparent regulatory failure of the banks at that time. The FSA was replaced by two bodies: the PRA and the FCA. The FCA are responsible for regulating the financial services industry in the UK: their job is to protect consumers, ensure stability in the market, and promote healthy competition among financial services firms. The PRA forms part of the BoE and regulates and supervises banks, building societies, credit unions, insurers, and investment firms, at the firm level. The regulatory approach to remuneration adopted by the UK originates from the conditions of the Principles and Standards on compensation set out by the Financial Stability Board (FSB) and also the European legislation (Capital Requirements Directive), on which a significant amount of the Remuneration Code is based. Today, the FCA today state:

> Our remit on remuneration is to make sure that pay practices in the firms we regulate do not encourage inappropriate risk-taking and that firms do not pay out more than they can afford. We are not looking to limit individual levels of pay, as that is not our mandate, but we believe that firms must have remuneration policies that are consistent with sound risk management. (FCA website, 2015)

The first briefings on remuneration policies occurred in October 2008 when Hector Sants, the then chief executive of the FSA, wrote an informal letter to bank chief executives explaining that remuneration policies (particularly in investment banking and trading) were one of the driving forces behind the then ongoing crisis. He stated that:

> It is possible that they frequently gave incentives to staff to pursue risky policies, undermining the impact of systems designed to control risk, to the detriment of shareholders and other stakeholders, including depositors, creditors and ultimately taxpayers. (FSA, 2008)

In the letter, the FSA made it clear that they had no intention of becoming involved in the setting of remuneration levels for firms, however it wanted:

> [T]o ensure that firms follow remuneration policies which are aligned with sound risk management systems and controls, and with the firm's stated risk appetite. (FSA, 2008)

It set out high-level criteria specifying how banks could measure performance for the calculation of bonuses, composition of bonuses, deferred bonuses, and governance.

5.2.1 Remuneration Code and CRD IV Bonus Cap

The first formal rules on remuneration arrived in the form of the Remuneration Code, introduced in August 2009 by the FSA, and coming into effect on 1st January 2010. It

initially applied to only 27 of the largest UK banks, building societies and broker-dealers, and required that firms establish remuneration policies that promoted effective risk management. It was revised in January 2011 to meet the needs of the Capital Requirements Directive III (CRD III), and again in January 2014 for the Capital Requirements Directive IV (CRD IV). It now applies to 2,700 UK-domiciled banks, building societies and investment firms and the subsidiaries of these firms operating outside the European Economic Area. As previously discussed, the key aim of the Remuneration Code was to mitigate the propensity of MRTs to engage in excessive risk-taking.

The general requirements of the Remuneration Code apply to the employees of all firms under its scope. However, additional specific criteria apply only to individual employees. Up until 2015, these employees were known as 'code staff'. However, since 2016, the regulators no longer use the term code staff, having replaced it with the term 'material risk takers' while also extending its scope.

Despite popular misconceptions, the bonus cap was not a requirement of the Remuneration Code but was a requirement of the Capital Requirements Directive (CRD) IV. The CRD IV is an EU regulation that implements part of the Basel III agreement in the European Union (FCA, 2015). It came into effect in January 2015 but was related to performance awards for the year January 2014. The Remuneration Code requires that the proportion of fixed to variable pay should be sufficiently balanced to allow the fixed proportion to be sufficiently high, so that no variable element needs to be paid (for the employee to have a reasonable standard of living). However, in contrast, the requirement of CRD IV is that variable pay must be restricted to 100 per cent of fixed pay or 200 per cent of fixed pay with shareholders' approval.

5.2.2 Material risk takers

MRTs, previously known as code staff[33], were deemed to be those individuals whose work could have a material impact on a firm's risk profile. The PRA's guidance suggests MRTs should include: senior management; a person who performs a significant influence function (audit, risk and compliance); employees who have an impact on the risk profile of the firm (sales, trading, foreign exchange, commodities and structured finance); and all

[33] For ease of reading, going forward, code staff will be referred to as 'material risk takers', even when discussing regulation that pre-dated the term 'material risk taker'.

staff whose remuneration takes them into the same bracket as senior management and risk takers, and whose professional activities could have a material impact on the firm's risk profile.

The requirements of the Remuneration Code for MRTs were:

- At least 40 per cent of variable pay must be deferred over a period of at least three years. At least 60 per cent must be deferred for the most senior management, or when an individual's bonus is more than £500,000.
- At least 50 per cent of any bonus must be made in shares or equivalent non-cash instruments.
- Guaranteed bonuses can only be awarded in exceptional circumstances for new hires in the first year of service.
- Remuneration policies must promote sound and effective risk management.
- Remuneration policies must be disclosed at least annually.
- Malus: firms and the regulators can reduce unvested variable remuneration where there has been employee misbehaviour, or material error, a material downturn in the firm's performance, or a material failure of risk management.
- Clawback: firms and the regulators can clawback the value of vested variable awards for 7 years after payment applies where there has been employee misbehaviour, or material error, or a material risk management failure (taking into account when the material failure arose and the closeness of the employee at that time).
- Bonus pools must be risk-adjusted.[34]

Source (PRA, 2015)

5.2.3 Changes in key performance indicators in the performance appraisal process

One of the requirements of the Remuneration Code was that there had to be a change in the appraisal process for MRTs. MRTs were no longer to be appraised solely on how they perform financially, but on how they manage/comply with risk metrics. When appraising an individual employee, these risk metrics that are largely qualitative in nature and hard to

[34] Meaning bonuses must be adjusted for malus or clawback criteria. For detailed requirements visit: https://www.fca.org.uk/publication/finalised-guidance/guidance-on-ex-post-risk-adjustment-variable-remuneration.pdf

measure are considered. An example of one such qualitative metric is the appraisal process, which allows risk managers and other back office control staff input regarding the bonus and promotion opportunities of traders (theoretically at least). If a trader breached any risk limits during the year, or was seen to be obstinate about risk and control functions, then this would be highlighted in his year-end appraisal process, resulting in negative implications for his bonus and potential for promotion. Other qualitative risk metrics include: compliance breaches; and failure to respond to control issues in a timely manner; for example, on audit issues. Quantitative risk adjustments to financial data were also recommended but generally to the bonus pool at a group level, not at the individual level.

5.2.4 Clawback clause

In July 2014, the PRA announced a revision to the Remuneration Code that had introduced the clawback clause. This came into effect on 1st January 2015, and states that all elements of variable remuneration (both deferred and vested) should be subject to clawback provisions for a period of seven years after payment. The main difference between the malus and clawback clauses is that clawback is limited to cases of serious individual misconduct and risk failure, whereas malus, in addition to individual misconduct and risk failure, can be triggered when the firm or business unit suffers a material downturn in its financial performance, without any need for individual culpability. Under clawback provisions, firms have the ability to adjust individual level or group level bonuses as they wish. It is up to the firms themselves to decide what level of misbehaviour would trigger clawback. In the case of clawback, firms have to make reasonable efforts to recover appropriate amounts on an individual case by case basis. In practice, this means that if a firm believes that bringing a law suit against an individual to clawback a bonus would prove unsuccessful (maybe because the person was in a different jurisdiction), then they do not have to enforce it.

5.3 Proprietary trading – Volcker rule

The actors interviewed in this research study were traders who have taken an element of proprietary risk in their trading books. As previously discussed, proprietary risk arises when a trader takes a risk on the market to achieve a gain on the bank's own accounts, rather than trading on client commissions. Traders use the bank's own capital for this purpose. Most forms of proprietary trading are now outlawed by US banks due to the

Volcker rule. The Volcker rule is a US regulatory requirement that prohibits banks from proprietary trading and restricts commercial banks' investments in hedge funds and private equity firms whose business models utilise proprietary trading strategies. The Volcker rule bans proprietary trading of: securities, futures, derivatives, and options on these instruments for the banks' own accounts. Banks can no longer use their own funds to make these types of investments for their own benefit: they only trade securities if they are part of a client order, or intended for hedging purposes. The Volcker rule also limits the ownership stake banks can have in risky funds to a maximum of three per cent. The Volcker rule applies to all US banks and their subsidiaries abroad and to branches of foreign banks operating in the US. The exemption to this rule is that proprietary trading will continue to be allowed for US government bonds, and in more limited circumstances, foreign banks proprietary trading of the sovereign bonds of their home countries. For example, a UK bank based in the US can be involved in proprietary trading of US government bonds and UK government bonds. A similar regulation does not yet apply yet in Europe, as the European and UK regulators believe that the ability to trade in and out of positions is an essential tool to keep liquidity in the stock market.

Even though proprietary trading is not banned in the UK, since the financial crisis, many UK banks have closed down those trading desks that focused solely on proprietary trading. At the time of the interviews conducted for this thesis (2014), traders were able to do a limited amount of proprietary trading. However, based on informal conversations with actors in the industry in the years since 2014, it has emerged that proprietary trading is becoming increasingly unpopular with the larger investment banks.

5.4 Bench mark for risk-taking in investment firms

The board establishes a firm's risk appetite and this risk appetite is communicated down the command chain to individual targets, where risk limits are set. Most firms' risk appetite is already controlled by the FSA under principle 4[35], which requires them to maintain adequate financial resources, including adequate capital and adequate liquidity. A key challenge for boards is to set an appropriate risk appetite. If risk appetite is wrong, this can have catastrophic consequences for a bank, as evidenced by Citigroup's near collapse in 2008. Less than a year prior, the then CEO, Chuck Prince, was quoted as saying:

[35] In April 2006, the FSA moved from prescriptive based regulation to principles based regulation as they believed prescriptive standards did not prevent misconduct and were instead becoming a burden to the industry and themselves.

> When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing. (FT, 2007)

In terms of this research and in particular in reference to the trading floor, risk taking is deemed acceptable when undertaken within set trading limits. Any breaches outside trading limits are deemed 'excessive' risk-taking by firms.

5.5 Bankers' remuneration

At the time of this study, in the majority of banks post-crisis overall levels of remuneration in banking had been widely maintained, despite a shift between fixed and variable pay. Pre-crisis, banking bonuses of several times base salary had been the norm. However, post-crisis, the shift between the variable and fixed component had shifted, with bankers receiving a higher fixed component (Deloitte, 2010). This invariably led to consequences for the fixed costs of the banks and their ability to incentivise employees.

Bonuses are part of the reward system in investment banks, and generally comprise cash, stock, and stock options. Reward systems are a subsystem of the overall PMS, and can include both financial and nonfinancial rewards with a penalty factor, being linked to the measurement subsystem (Ferreira & Otley, 2009). In theory at least, achievement of performance metrics leads to bonus awards. However, reward systems in investment banks have a multitude of purposes that extend beyond the achievement of set performance metrics; for example, in addition to being used to reward past performance, they are also used to motivate future performance, attract staff, retain staff, and control staff behaviour.

Bonuses are considered a regular part of the compensation package underpinning satisfactory performance at investment banks, not for exceptional performance. A common misconception about bonuses is that they are performance contingent, which is true to an extent, except that bonuses are entirely discretionary and traders do not receive a set percentage of the profits they make. Investment bankers' total compensation is made up of a base salary, plus a year-end discretionary bonus based on individual, group, and company performance. Usually, a committee decides the levels of executive director bonuses and bonuses for other senior employees. Executive director bonuses are determined by reference to group and individual appraisals during the year. Achievement of executive directors' objectives is supposedly assessed against both quantitative and qualitative measures, including both financial and non-financial metrics. However, it is

widely accepted in the industry that this process is highly subjective. Similar to the process for executive directors, the process of determining bonuses for employees is also supposedly linked to performance at the group, business, and individual level. Line managers assess performance against individual performance objectives and group goals. As bonuses are discretionary, an employee can meet or exceed all of his/her performance targets but still receive no bonus.

To those outside the investment banking world, the word 'bonus' is thought of as something awarded for superior financial performance. It is this disconnect with regard to the meaning of the word bonus that can cause misguided regulation and public furore. Murphy and Jensen (2011) argued that compensation structures can encourage excessive risk-taking if substantial rewards are given for superior performance, in a climate where there are no penalties for failure. However, they argue that existing compensation arrangements do penalise failure, by keeping fixed salaries well below market rate, meaning that if an employee receives a zero bonus, then that is in fact is a major penalty. They state that: '*Contrary to popular (and uninformed) opinion these plans reduce, rather than increase, incentives for risk taking*' (p.48). This explains why, what the academic community argue to be the best policies on remuneration, might result in ineffective regulatory policies in terms of risk-taking.

Now that the scene has been set, the next chapter will discuss the findings of this thesis in relation to the research questions posed in Chapter 1.

6. FINDINGS

6.1 Chapter overview

This chapter presents the data collected for this thesis to answer the overarching research questions: What were the banks' responses to the new control mechanisms, and have the new control mechanisms changed the risk-taking behaviour of traders in the UK financial services sector? If so, *how* and *why*?

Chapter 6 will provide theoretically informed explanations of various factors, helping to explain the banks' responses to key control mechanisms, and *if*, *how* and *why* the new controls mechanisms have changed the risk-taking behaviour of traders working in UK based investment banks. Chapter 6 will show how these findings might be used to gain a preliminary insight into the complex world of risk-taking, risk culture and incentives in the financial services sector in the UK. Furthermore, the chapter will shed light on the many institutional pressures faced by the financial services industry in the UK, the effect of these pressures on the remuneration policies of the banks, and the resulting impact on the effectiveness of the newly introduced control measures.

The semi-structured interviews with the investment bankers produced several unexpected findings. This reinforced the choice of a qualitative approach for the thesis, as these findings would not have come to light using a survey or archival based study. Some of the initial findings were so surprising that the researcher initially doubted the authenticity of the answers received. It was only as the interviews progressed and a pattern started to emerge that the researcher gained confidence in the validity of the comments.

In summary, the findings indicate that institutional pressures have played a significant role in determining how different bank types have responded to and implemented the new control mechanisms. How these new controls were implemented at bank level played a key role in determining how they were perceived and accepted by individual traders, and thus their effectiveness as a mechanism to change risk-taking behaviour.

The remainder of this chapter is structured as follows: research questions one, two and three will be discussed individually and the findings of each question will be presented immediately after. The chapter will conclude with a summary of the primary research findings from all three questions. The section that follows starts by discussing RQ1 and presents the findings to this research question. As previously mentioned, the order of the

research questions as presented below does not reflect the chronological sequence of events. They are presented in this way to clearly and concisely present the outcomes of the abductive process used in this thesis.

6.2 RQ1: What were the banks' responses to the new control mechanisms?

6.2.1 Overall banks' responses

UK based banks fiercely resisted the initial proposals of the Remuneration Code and the CRD IV bonus cap rule: both proposals received unprecedented adverse commentary from the industry. The main argument put forward by the banks was that both these policies would weaken the competitiveness of UK banks and the UK financial services industry as a whole. As the Remuneration Code only applied to UK banks, their subsidiaries abroad, and the subsidiaries of non-UK banks who operated in the UK, they argued that it would make the UK and UK banks unattractive places to work. Several UK headquartered banks operate globally and compete directly against banks in other countries for the talent they consider to be a key asset of their business. The banks were concerned that the restrictions being imposed on remuneration would cause their top talent to simply move to locations or other firms where no restrictions were in operation. A comment from Barclay's CEO, Antony Jenkins, when discussing the Remuneration Code stated:

> This [Remuneration Code] caused demonstrable damage to our business. (Barclays Annual Report, 2013)

The chairman of Barclays, Sir David Walker, told the Parliamentary Commission on Banking Standards (PCBS) that:

> [M]any of the most senior people we [Barclays] have are marketable internationally—that includes the chief executive—and have opportunities elsewhere. (PCBS, 2013, p.408)

Walker argued that regulations on remuneration should be '*[S]et by reference to standards internationally*' (PCBS, 2013, p.408) to level the playing field. As international jurisdictions did not have such stringent regulations on remuneration, he claimed that the UK banks would be severely disadvantaged. A recent study by Kleymenova and Tuna (2016), showed the concern about retaining top talent was not unfounded. In their investigation into the impact of the Remuneration Code, they found that compared with their US counterparts and other UK firms there was higher CEO turnover in banks affected

by the Remuneration Code. They tracked the leavers' destinations and found they either: retired, started their own firms, or took positions in unregulated firms in the financial services industry. This they claimed, was an unintended consequence of regulating remuneration in UK banks.

Another concern voiced by the banks was that the stringent regulatory environment in the UK could hamper their ability to compete effectively in the global marketplace. In response, some banks threatened to move their headquarters from the UK to locations with more favourable regulatory environments[36]. One of the largest UK banks, HSBC, considered moving their headquarters from the UK due to the harsh regulatory environment. HSBC's chairman stated:

> As I said at our informal meeting in Hong Kong on Monday, we are beginning to see the final shape of regulation and of structural reform, including the requirement to ring fence in the UK…The board has therefore now asked management to commence work to look at where the best place is for HSBC to be headquartered in this new environment. The question is a complex one, and it is too soon to say how long this will take or what the conclusion will be, but the work is under way. (FT, 2015c)

The bank's shareholders supported the idea of moving, and the stock market reacted favourably to the announcement with the bank's share price rising 3.4% after the announcement (FT, 2015c). Other UK banks, such as Standard Chartered, also considered moving their headquarters from the UK (Reuters, 2015).

From an institutional perspective the banks' reactions to the regulatory pressures were understandable and predictable as they threatened their core normative values. In this scenario, their core normative values being their ability to use variable incentives to: maintain their fixed cost base, award superior performance, and to attract and retain top talent. Not only did these policies threaten their core normative values, but for some banks in this study they also conflicted with their strategic objective to have a high performance culture, as demanded of them by their shareholders. If the banks acquiesced to the new policies they would run the risk of losing their top talent, which would then have a knock on effect on their financial returns. As will be discussed in greater detail when assessing

[36] These responses were made specifically in relation to the new regulations. Further threats to leave the UK were made by the banks after these events in relation to the election that decided the future of the UK's membership in the EU.

RQ2, Oliver's (1991) typology of strategic responses to institutional processes can be used to explain many of the reactions observed among the banks.

6.2.1.1 CRD IV bonus cap challenge

The more contentious of the two remuneration policies was the CRD IV bonus cap. Not only was this strongly opposed by the banks themselves, but UK policy makers and government officials also fiercely opposed it. The banks, policy makers and government officials opposed the CRD IV bonus cap believing it would have the opposite effect to that intended[37], making the financial services industry riskier. The UK and the European regulators disagreed about the best solution to curb banks' excessive risk-taking. The UK regulators opposed the CRD IV bonus cap, instead preferring more awards of a variable nature, stating: '*[A]s this is critical to the positive incentive effects of the deferral, (1) malus, (2) risk adjustment and other provisions of the Code, as well as ensuring a degree of flexibility over costs which can contribute to firms*' *resilience in times of business stress.*' (FCA, 2015)

The Mayor of London, Boris Johnson's, infamous quote on the bonus cap at the time it was announced was:

> This is possibly the most deluded measure to come from Europe since Diocletian tried to fix the price of groceries across the Roman Empire. (Independent, 2013)

Such was the strength of opposition to the CRD IV bonus cap, that in September 2014, George Osborne (the then Chancellor of the UK Exchequer) challenged it in the European Court of Justice. The grounds for challenge were: that the bonus cap would *add* risk to the financial services industry, lead to increased salaries and fixed costs, and limit the effectiveness of clawback and deferral mechanisms (BBC, 2014). Osborne argued that because fixed salaries could not be clawed back later for malfeasance, the higher levels of basic pay would render firms more exposed in the event of another crisis. This challenge was met by a strong defence from the ECB, and in November 2014 Osborne withdrew the legal challenge stating:

> I'm not going to spend taxpayers' money on a legal challenge now unlikely to succeed… The fact remains these are badly designed rules that are pushing up bankers' pay not reducing it. These rules may be legal but they are entirely self-defeating, so we need to find another way to end rewards for failure in our banks (BBC, 2014).

[37] The aim of the CRD IV bonus cap was to curb banks' excessive risk-taking.

Thus, the CRD IV bonus cap came into force in January 2015. However, as will be discussed in the section that follows, the banks quickly found ways to circumvent it.

6.2.1.2 Monthly allowances

A short time after the CRD IV bonus cap was implemented, the EBA reported 39 banks in six EU states had started paying monthly allowances to their staff, in addition to their fixed salaries and bonuses (Guardian, 2014). The EBA claimed that these monthly allowances were introduced with the sole intention of circumventing the CRD IV bonus cap. Monthly allowances were frequently used by UK banks; indeed, all the banks involved in this study reported using monthly allowances to circumvent the CRD IV bonus cap rule. The monthly allowances were paid primarily in cash (some awards were made in shares for the most senior staff members), and could be adjusted upwards or downwards. Moreover, they were not pensionable. The UK PRA accepted the use of monthly allowances, with Andrew Bailey (Head of the PRA) calling them the '*least worst alternative*' to bonuses (Reuters, 2014). He stated:

> The bonus cap is the wrong policy, the debate around it misguided, and the best I can say about allowances is that they are a response to a bad policy (Sunday Times, 2016).

The banks argued that, because monthly allowances were not linked to performance (or so they claimed) they could be adjusted upwards or downwards and stopped at any time; thus, they should not be classified as bonuses, and as such, they were breaking no rules by paying them. However, the EBA disagreed, demanding the allowances be classed as variable pay, like a bonus, and that the banks that used them were in breach of the CRD IV bonus cap. Thus, from early 2016, monthly allowances, in the form they were initially used, were no longer permitted as part of MRTs' remuneration packages. However, regular fixed allowances were permissible (FT, 2015d).

The commentary above illuminates UK-based banks' and regulators' general response to the remuneration regulations. Information gleaned from these responses was taken from sources in the public domain. The section that follows discusses how the individual banks involved in this thesis responded to the remuneration regulations, as told by the actors and evidenced from the interviews. This information is not in the public domain.

6.2.2 Individual banks' responses

What became apparent from the semi-structured interviews with individual bankers from the ten banks involved in the study, was that they did not all embrace the new control mechanisms in the same way. During the course of the interviews, a pattern started to emerge that saw the responses from traders converging along the lines of a split based on bank type. Two bank types were identified, categorised as type A and type B, as will be clarified in the section that follows.

6.2.2.1 Type A banks

The distinguishing characteristic of the type A bank is that it received no government bailouts during or after the financial crisis, unlike all but one of the type B banks, which were recipients of government bail outs. The primary shareholders of type A banks were institutional investors, and it has been claimed that when institutional investors are the majority shareholders of a bank there is increased pressure to boost financial returns. The Royal Bank of Scotland told the Parliamentary Commission on Banking Standards that:

> [I]n some instances investors pressed for what were arguably unsustainable levels of return, creating pressure to increase leverage and take on additional risk. (PCBS, 2013, p. 326)

Similarly, Lloyds Bank informed the commission that:

> Shareholder behaviour "pre-crunch" focused on a drive for growth with emphasis placed on delivering potentially unsustainable returns, without recognition of the downside risks. This was a factor in creating a culture that arguably led to failure in the sector. (PCBS, 2013, p.326)

Consequently, it appears that the type A banks involved in this study have a higher risk appetite compared with the type B banks; this seems to be a consequence of the need for them to generate the higher returns demanded by their institutional investors. The compensation arrangements at these type A banks did change in line with the requirements of the Remuneration Code and the CRD IV bonus cap. However, traders at this type of bank still received approximately the same amount of total compensation at the time of the interviews[38] as they did pre-crisis, albeit in a different arrangement; i.e. higher fixed pay, lower variable pay, and monthly allowances. Compared with traders working at type B banks, type A bank traders received a larger proportion of their overall remuneration via a

[38] Total compensation is defined as all the resources available to an employee, including base salary, bonuses, perks, allowances and benefits.

variable discretionary bonus. Like all banks operating in Europe at the time of this study, they were subject to the CRD IV bonus cap, but the interviews revealed they were routinely using monthly allowances to circumvent the CRD IV bonus cap.

6.2.2.2 Type B banks

The distinguishing characteristic of all the type B banks in the study was that they had undergone a forced change in leadership post-crisis as a result of government bailouts received during or immediately after the 2008 financial crisis, or as a result of large scandals as the bank. Four out of the five type B banks received government bailouts. Therefore, instead of having institutional investors as their majority shareholders, they had the government. This change in the ownership structure of the banks resulted in a lower risk appetite than that observed in the type A banks (PCBS, 2013). The one outlier in this bank classification is a bank who did not receive a government bailout during or after the financial crisis, but did have a change in leadership as a result of a major scandal at the bank. The new leaders publicly declared they would dramatically change the culture of the bank, and as such, their response to the remuneration regulations mimicked the responses observed at the other type B banks in the study. As such, at the time of the study it still had institutional investors as its majority shareholder, and a similar risk appetite to the type A banks. It must be stressed at this point that the classification of the banks into type A and B type did not occur at the design stage of the project, nor was it linked to ownership structure; rather, the classification occurred as a result of observations in the interviews regarding how the actors involved in the study responded to the remuneration regulations.

The compensation arrangements at type B banks were altered to comply with the Remuneration Code and the CRD IV bonus cap. Compared with the type A banks, traders at type B banks received lower variable pay as a percentage of their total remuneration. They were also subject to the CRD IV bonus cap and consequently used monthly allowances to circumvent the cap, albeit to a lesser extent than at those at type A banks. The level of overall compensation in these banks reduced post-crisis, with bonus pools down up to two-thirds on average, and overall compensation down thirty percent on average[39].

[39] Data as at year end 2014, taken from the banks' annual reports.

6.2.2.3 Risk culture

The most striking observation to emerge from the interviews with actors from the different bank types concerned their attitude to the new control mechanisms, and their respect for the risk and other control functions at their respective banks. Further investigation revealed stark cultural differences in attitudes to risk[40] between the type A and type B banks, and the researcher believes these cultural differences are a significant indicator of behaviour in the banks; in fact, more so than compensation controls. As previously discussed in Chapter 2, there is no firm consensus on what constitutes a 'strong' or a 'weak' risk culture; Power *et al*. (2013) argued that risk culture is socially constructed and subjective. Whilst our findings support Power *et al*. (2013) on the socially constructed nature of risk culture, the stark cultural differences between the bank types' attitudes to risk in this thesis were too strong to ignore. Therefore, whilst acknowledging that the concept of a risk culture is rather fuzzy and socially constructed, for the purpose of this thesis, features of what the researcher believes demonstrate the difference between a strong and weak risk culture on the trading floors of investment banks are presented in table 5.

Table 5 **Features of a Strong Risk Culture**
The risk management department acts as a partner in the business.
Strict *compliance* with, and *respect* for the risk and other control departments.
Clarification of the firm's risk appetite.
Clarity and *enforcement* of trading limits by senior management.
Transparent sanctions for control failures.
Timely responses to control issues.
Performance management and reward systems that are linked with risk management.
Effective whistle blowing policy.
A senior management team whose goals are aligned to, and who are truly committed to a strong risk culture.
Where risk management pervades the entire organisation and is everyone's business.

[40] A definition of risk culture was provided in Chapter 2, p.15.

On the other hand, table 6 suggests features that exhibit a weak risk culture affecting operations on the trading floor of a bank.

Table 6 **Features of a Weak Risk Culture**
Where the risk management departments focus is *compliance* with rules and guidelines.
Weak/mediocre *compliance* with, and *respect* for the risk and other control departments.
Bank's risk appetite is unclear.
Few or no consequences for breaching trading limits.
No visible sanctions for control failures.
Slow responses to control issues.
Performance management and reward systems that have a weak or no link with risk management.
No or ineffective whistle blowing policy.
A senior management team whose goals are not aligned to, and who are not truly committed to fostering a strong risk culture.

From the observations made in the interviews, and the features described above, the type A banks in this thesis would be classed as exhibiting behaviour linked to a weak risk culture, with type B banks exhibiting behaviour aligned to a strong risk culture. It must be stressed here that this classification only applies to the risk culture on the trading floor, there is no evidence to suggest the risk culture observed from the interviews permeates other departments in the banks studied. It is also important to stress at this point that the researcher does not believe a strong risk culture equates to an overall reduction in bank risk. It is perfectly feasible for a bank to have a strong risk culture whilst also having a high-risk appetite, as evidenced by the outlier type B bank in this study. For the other type B banks in the study, the strong risk culture is accompanied by an overall bank risk reduction, which while not essential is unfortunately the case.

The institutional pressures, whether from regulations or new corporate governance guidelines, placed on the investment banks post-crisis imply a 'strong risk culture' in some form. As mentioned above, with the exception of an outlier type B bank in this study, all the other type B banks 'conversion' to a strong risk culture were connected with a new

ownership structure that called for risk reduction across banks and less pressure to demand unsustainable returns. Therefore, at the time of this study, this way of thinking and investing was the new 'norm' at these banks, meaning the pressure to adopt a 'strong risk culture' did not threaten the normative value systems, and thus there was low resistance. At the type A banks, however, there was no change in ownership and business continued as usual. Their 'norms' remained the same and new guidelines to introduce a 'strong risk culture' threatened normative values, so their natural reaction was to resist them. Traders at the type A banks continued to be under pressure to produce substantial returns, and were fearful of relinquishing some power to the risk function, which one trader in the study nicknamed 'The BPU', translated as 'The Business Prevention Unit'. These findings correlate with those reported by Broadbent *et al*. (2001), who claimed that when the normative pillar is threatened resistance becomes the most likely outcome.

As the normative values between the two bank types had changed, it can potentially be argued that they no longer operate in the same institutional environment. However, although outside the scope of this study, an alternative answer could be that the observed differences between the two banks types could be attributable to conducting the study at a time of dramatic change to the institutional environment, the results of this study simply showing a snap shot of one moment in that change process.

However, as the focus of this thesis centres on institutional pressures in the regulatory domain, Scott's (2014) regulatory pillar and Oliver's (1991) framework were deemed to provide the most appropriate basis for viewing the research issues, as identified through an institutional lens. Therefore, for the purpose of this thesis, it was decided to view the different bank types as existing in the same institutional environment.

6.2.2.4 Exploring the differences in risk culture between the bank types as observed from the interviews

Chapter 2 discussed the concept of risk culture and acknowledged it is a socially constructed phenomenon. However, for the purpose of this thesis, risk culture is understood to refer to: leadership and the dissemination of messages from the board to lower level employees, in conjunction with the main themes associated with cultural change initiatives in the banks; e.g. compliance with risk and control functions; adherence to risk limits, clarification of the firms' risk appetites, and ensuring performance

management and reward systems are linked to risk management. As will be discussed in detail in section 6.4, minimal changes to risk-taking behaviour were apparent from the interviews with traders at both bank types, however the stark differences in risk culture between bank types were very clear. The section that follows explores the differences in risk culture between bank types as emerged from the interview data.

6.2.2.5 Leadership and dissemination of messages from the board to lower level employees

Whilst type A banks purport in their annual reports and media outlets to be highly committed to risking cultural change, their actions (on the trading floor at least) send a different message. They have not been as rigorous as type B banks at enforcing clawback clauses, and a common reason given for this has been that they fear enforcement of the clause could bring them negative publicity, and harm the bank's reputation. This is illustrated by a quotation from trader 20 (type A bank):

> [I]f you start to pursue clawbacks, you run the risk of major legal action between yourself and that party, which keeps whatever issue it is that you're clawing back on alive and potentially press worthy for a lot longer than otherwise. And I don't think anyone wants these issues to be dinner table conversation. So they've dealt with it, and they prefer it to be dealt with and done with quickly.

This was confirmed by trader 23 (type A bank):

> A lot of what we come from - the position we come from, we just don't want the company's name in the press.

This absence of enforcement sends a signal to the rest of the banks' employees that they need not worry about clawback, which may explain why all traders interviewed in the type A banks reported they do not think about the implications of clawback whilst trading. If there are no visible sanctions for wrong-doing in these banks, then the cultural norms, in the minds of the employees at least, is that these behaviour are acceptable. Post-crisis, it appears to be business as usual for these traders. Trader 1 (type A bank) stated:

> I don't believe that the firm would take back my bonus, not for a risk that's gone bad or an error. If they did, I could argue it by saying that my job is to take risk, not every risk will go in my favour, that is the definition of risk, so they can't penalise me, so long as they were aware of what risks I was taking and I wasn't concealing anything or wasn't doing anything fraudulent then I think it would be very wrong of them, and I think they would accept that it would be wrong of them as well to take it away. In a sense then you are being paid to do a risky job, but you're only ever paid when those risks come good, and that is not fair.

On this point, trader 3 (type A bank) said:

> If I truly thought it would be applied to me, it might well change my behaviour, but as I said I don't believe it would be enforced unless I deliberately defrauded the bank.

These quotations suggest the traders feel 'shielded' from the reality of the code. This "shielding" can possibly be explained by the findings of a study by Power *et al*. (2013), which examined cultures in financial institutions. They found that it is commonly the business that is left to cope with regulatory demands and that senior managers '*[T]ry to leave traders/risk-takers free to do their job.*' (p.66)

In contrast to type A banks, type B banks have enforced the clawback clauses on numerous occasions. Moreover, traders are regularly reminded via internal meetings that their bonus is at risk of clawback if a trade does not go in their favour, if there is a material error in their accounts, or if any wrongdoing is uncovered. A quotation from trader 9 (type B bank) illustrates this:

> [M]y team are constantly reminded that if they mess up that their bonus will be clawed back.

And trader 19 (type B bank):

> Do it once, do it well, do it properly, move on. That's, don't f*ck around trying to do this in a dodgy way or you're out.

As can be seen from the selection of quotes above, there are glaring differences in the attitudes of the type A bank traders towards the new remuneration regulations and those of type B bank traders. The researcher attributes these differences to how senior management conveys the importance of the new remuneration regulations in the different bank types. In type A banks, whatever the senior management publicly proclaim about their bank's changing attitude to risk, their actions prove otherwise, as evidenced by their reluctance to enforce clawback measures. Conversely, in type B banks, senior managers' proclamations regarding their bank's changing attitude to risk was effective is reinforced by their actions, including their use of clawbacks.

6.2.2.6 Compliance with risk and other control functions

In terms of compliance with risk and other control functions; whilst compliance is now taken more seriously in both bank types post-crisis, it still appears to have gained less traction on the trading floors of the type A banks. Another striking difference between the

bank types relates to their management of more qualitative risk-metrics, an example of such is their attitudes to risk limit breaches.

This can be illustrated by quotations from two type A bank traders:

> I suppose the way I'd phrase it is I reckon there is still an element of leniency, no matter that any town hall would always start with a call to perfect compliance and all that. I think it's fair to say that there's a level of leniency around who your top producers are and that even now people would still find a way to – if there was anything that was interpreted as being an issue, would be – covered up probably isn't the right word but there'd be some bulls*it explanation. (Trader 24, type A bank)

And,

> The only thing I'd say is, I know people in other areas where you heard that they'd done this, that and the other, but that would certainly never come up in the performance review. If that was somebody they liked, well you wouldn't want to put it in a performance review that actually they had a warning, off the record, or perhaps even they'd had a warning on the record…. I don't think, from a regulatory point– every bank will, of course, say, "Oh yes, it's a critical part," but I'm just saying it's not. It's a box ticked, isn't it? (Trader 13, type A bank)

And confirmed by the Head of Risk Management at a type A bank:

> For star traders, the attitude is, "Those guys, they have got to be looked after and everyone else is actually a second class citizen", although they would never say that. But, in terms of IT, Operations, Risk, which is viewed with a great deal of suspicion, Audit, which is viewed with a bit of horror, Product Control, all of those support areas, HR, are all there to service this fantastic group of people. So, the sales people are also pretty well looked after. There's a real sort of front and back office mentality, and they can have all sorts of cultural efforts and away days and edicts coming down, but that is actually the truth of the matter.

And the Head of Corporate Governance stated:

> [T]he bailed out banks are definitely on the more conservative side of the things we see, whether it's on recruitment packages, risk-taking, accounting, all sorts of things, and some of that is not for the benefit of all shareholders. And certainly conservatism is not always a bad thing in a bank, but it's very restrictive.

The findings here are supported by a report from the Parliamentary Commission on Banking Standards (PCBS, 2013, p.364) who stated:

> As long as the incentives to break codes of conduct exceed those to comply, codes are likely to be broken. Where that gap is widest, such as on trading floors, codes of conduct have gained least traction.

Conversely, the type B banks appear to more actively manage their qualitative risk-metrics; for example, they operate a zero tolerance approach to risk limit breaches, with permission to trade outside risk limits being a rare occurrence:

> [I] think our limits are tight... it's quite hard to take really excessive risk. (Trader 10, type B bank)

> We're reminded every flipping week that if you breach, you'll get the chop. They have a "three strikes and you're out" rule. There is a very fine line as in "this is your limit". I think if you went over for a technical reason, they'd be okay; if you did it on purpose, you would be straight out. And that's being going for quite a while now, so there is, I would say, zero tolerance on that. I think the thing is, though, there is not a thing that you can't take risk. The thing is that it's within your risk range limits. If you're a star trader you just get bigger risk limits. And it's stupidity, if you're warned you can't do that, and you're a star trader. You can't be a star trader if you're that stupid to break the bloody thing, and you'd ask for an increase before you do it. In that sense, that is stupidity. And so that's why 99% of risk breaches are generally technical system errors. The problem is, of course, it all has to be reported to the regulators. (Trader 19, type B bank)

The EMEA Head of Regulation (type B bank) echoed this sentiment:

> I think we have had to improve things, as every firm has, but it's not only the improvement; it's the demonstration, it's the audit trail, etc. etc. Now, again, this might only be sort of peripheral, but it paints an overall picture about the culture of the place, and we have to be cleaner than clean here.

Similar sentiments regarding the shift in relationship were expressed by the Head of Product Control at one of the type B banks:

> I think they see us more as an asset as opposed to a hindrance now because we're the guys that can tell them what their balance sheet is. We're the ones that can tell them on a day to day basis, "This is how much P&L you've made". They tend to work off what they coin as EV, expected value. Well, what we see from the books and records is the day-one P&L, which may or may not reflect what they think they will make from a trade. They rely on us to give them more MI[41]. I've seen the relationship between the traders and us and credit control, or one of the controller's functions has moved from one to which they're very reactive to us, to one where they're very proactive to try and glean or get as much information as they can from us that will improve I guess their returns. Constant things would be, "If I do this kind of trade, how much balance sheet will I take?" Traders don't get the accounting aspect. They just want someone to tell them, "If I do this trade, will my balance sheet be X or will it be Y? If it's Y, then my balance sheet return is cut in half". I see us being more as partners to them, as opposed to more of a reactive, "Can you sort this problem out for that?"

[41] Management information.

And the Head of Risk Management at a type B bank:

> I don't wander around, with a big stick, hitting people on the head saying, "Stop what you're doing." We have a very collegiate team-based approach to stuff and I will be part of the governance of projects… If I weighed in to a situation or I'm involved in… someone wants to do something and I get involved and I tell people to stop doing what they're doing or I say, "No," to something, which I don't generally do in that way anyway, because generally I would hope that we would come to that conclusion ourselves, and that would be achieved through influence rather than command.

A further striking distinction between the bank types that was apparent from the interviews related to their attitudes towards the control functions. The traders at the type B banks appeared to be very compliance orientated, whereas a flippant attitude towards control functions was observed at the type A banks. This can best be illustrated by the quotations from both bank type staff:

> There wasn't like a moment when it changed; it just gradually seems to have gone that way. You could argue now that actually some of the support functions have more power than even the trading functions do. (Trader 19, type B bank)

> Actually not to raise your hand makes you a fool; it's actually the wrong thing to do to stay quiet. You can get into more trouble, if you see something going on, for not raising it. Nobody is trying to encourage a culture of telling tales here, but it's so accountable, so transparent that sometimes you're actually obliged to do something. (Trader 10, type B bank)

> [S]et the tone, and make sure that people know, don't worry about upsetting the businesses if you're worried about something. Raise the question now, and we'll look at it. You encourage people to be forthcoming if they've got genuine concerns, to speak up. (European Head of Risk Management, type B bank)

> I remember when I worked as a junior, I'd go down to a desk and I would get shouted at, actually shouted at by a trader. That just doesn't happen anymore, it doesn't happen. (Head of Product Control, type B bank)

> The point is, you have too many, dare I say it, monkeys in market risk[42] who don't know what they're doing. (Trader 20, type A bank)

> [H]ow ridiculously incompetent our market risk and credit risk departments are. (Trader 16, type A bank)

Lim *et al*. (2017) argue that today there is a '*critical imbalance of power*' between the front office trading staff and the back office control functions. The Head of Corporate Governance reported that such an imbalance remains, but commented that he has seen an improvement over time:

[42] Market risk refers to a team who work in the financial regulation department. They are responsible for reporting traders' positions to the regulators on a monthly basis.

> [T]he imbalance is reduced, I can absolutely see that…but I still think; and I think it's very difficult to change the fact that the people who generate revenue have more power than the people who don't and are a cost centre, and I think that is a natural tension that you have in any organisation…The problem with it is though, is that the functions you talk about: compliance, risk etc., are naturally a 'no' function, and 'no' isn't always the right answer, it should be 'yes, but', and I think especially in the investment banking industry we haven't got that balance right.

Lim *et al*. (2017) argue that this imbalance of power remains for all investment banks; however, evidence from this thesis refutes that claim arguing that this is only the case in some banks, not all; for example, in this study the type A banks, but not the type B banks. This finding was supported by a discussion with the Head of Corporate Governance who stated that from his experience, he believes the '*bailed out banks are much more balanced than the non-bailed out banks*'.

It would appear that the type A banks operate within the letter of the law, but not within the spirit of the law, whereas the spirit is adhered to in the type B banks.

> If you go back, even a couple of years, the senior trader was just a guy that had made a lot of money over a few years, and so he's elevated to a position of authority. Now that's not so much the case, now your head trader is a guy who understands compliance, understands legal, understands risk, understands all these other functions and so that filters down a little bit. (Trader 8, type B bank)

This finding corroborates the findings by Lim *et al*. (2017), who as previously discussed, found that front office staff often game the regulations and '*engage in grey market practices*' (p.88). However, in contrast to Lim *et al*. (2017), who found this to be true for all the financial institutions in their study, the findings from this thesis argue this is only true in type A banks, not type B banks.

Pre-crisis, and today in some banks, the front office revenue generating staff are given star status. Lim *et al.* (2017) attribute this to institutional hierarchies that place the value of traders' work for the organisation above that of the risk and control functions. Due to this higher status afforded to traders, they argue, the balance power has swung in their favour over and above that of control departments. A 2015 report by the BoE recognised that the power yielded by the trading staff at banks contributed to banks failings, as witnessed during the crisis, stating:

> [T]here was an increasing shift in power within firms and their management teams towards trading staff… (BoE, 2015a, p.63)

The recognition by regulators of the negative effects of an imbalance of power on trading desks is a positive step towards helping regulators take a more balanced view of the causes

of bank failure during the crisis, as their focus was previously on remuneration alone. The changing nature of the power shift observed in this thesis between the front office trading staff and back office support staff shows enormous improvements in the risk culture at the type B banks; as no such power shift was apparent in the type A banks, with support staff being bullied if front office staff need to get a deal through. This is best illustrated by a response from the Head of Risk Management at a type A bank regarding the power balance between the first office and control functions:

> Some desk heads[43] are, let's call it 'persuasive' at getting their own way with the control functions.

When asked if there was ever a scenario that he felt slightly uncomfortable about approving, he responded:

> Yes, well you're damned if you do and damned if you don't aren't you? Because if you raise it then you're basically a Judas.

However, the power shift observed in the type B banks, whilst a step in the right direction, is still not without issues. The argument from the front office staff in relation to this were that back office functions can over complicate their jobs, making it difficult to generate revenues. The Head of Corporate Governance reported, that in his opinion the bailed out banks have gone too far. He stated that:

> [T]he bailed out banks are more balanced, but it's not always nuanced the right way. It's very easy if I were to go into compliance now to say 'no' and I could be promoted ten times for saying 'no' but does that make that bank better…. [A]nd that's where I think the bailed out banks have gone too far.

6.2.2.7 Adherence to risk limits

Enforcement of trading limits is seen as a key feature of the strong risk culture at financial institutions. In the type A banks it was observed that compliance with risk limits is sometimes treated as a box ticking exercise with limited genuine impact on day to day trading activity. A trader with a proven track record can secure permission to trade outside his/her risk limits, meaning that breaches were uncommon, however, if breaches are made they are rarely reprimanded:

> When it comes to star traders, a blind eye is often turned when it comes to risk breaches. (EMEA, Head of Risk Management, type A bank)

[43] Trading desk heads.

In response to the question: Are there any factors that contribute to you feeling pressurised into pursuing something against your better judgment, for example like putting on a deal? Trader 3 at a type A Bank answered:

> There are always occasions where you might have to put on a deal that you wouldn't otherwise do, because of things like client relationships, or to be seen to be competitive with other banks. It's sometimes necessary to put on a deal which doesn't make much economic sense to me personally, but you just have to do it because it's part of the game. There's also, I guess, the emotional side of trading as well. Things like if you're running a loss making position, if you're able to step out of that position and look on it, your better judgement would say you should cut that position. Your emotions take over, and they say, oh, no, let's just run it a little bit longer. Maybe it will come good. There is that.

When asked to clarify further, the trader responded with:

> Emotions get involved sometimes with proprietary trading, unless you're very very disciplined, which not everyone is. You can run positions, whether they're loss-making or profit making, for longer or shorter or than actually makes good sense.

In stark contrast, it was observed that in type B banks it was very difficult to get permission to trade outside risk limits and that there was a zero tolerance approach to risk limit breaches. This is illustrated by a quotation from trader 10 (type B bank) when discussing the implications for traders of breaching limits:

> If a guy breaks his limits, then he is out.

This was confirmed by trader 14 (type B bank),

> [My bank] are very compliant, each trader is set a limit that is monitored daily, if they break it then they are hauled up and made to explain themselves.

And by the Head of Risk Management (type B bank),

> In the past if there was a large spike in risk it was looked at and it was like, "Okay, that's fine. This shouldn't happen again," etc. Whereas now, there's a lot more of a regimented process around what happens if you do exceed a risk on there or if you do, do anything that's a little bit out of the realms of the ordinary. There's a lot more focus, a lot more groups looking at it. If something were to go wrong there's corrective action plans, audit for instance, there's all that.

6.2.2.8 Clarity of a firm's risk appetite and attitude to risk

Clarity of a firm's risk appetite was found by Power *et al*. (2013) to be a key feature of many risk cultural reform initiatives, and is heavily relied upon in practice to display commitment to a strong risk culture. At type A banks, such clarity was seen as fuzzy, with senior management publicly saying one thing but not sending the same message to the

trading floors. During the course of the interviews, traders explained they often felt under increased pressure to boost returns in ways that were not always discernible. This is illustrated by the following quotation from trader 24 (type A bank):

> Going back to the big risks, so I could now become a manager of trading, not a trader as such. I direct a bigger book in a very similar way to how I approached a number of inputs. I have the market place, I have management, the people around me and how they react, and I have the firm's risk appetite… Those have visible and invisible signs. The visible ones are the ones that they actually tell you in the meeting. The invisible ones are things like when they ask you for returns on balance sheets, if they are not risk adjusted then they are asking you to take more risk… You watch it happen because senior management are telling shareholders one thing, regulators another thing and their employees another.

And trader 20 (type A bank):

> They are pretty keen for us to take risk where it's appropriate and it's encouraged within the right parameters and the right boundaries, but they are keen for us to use what we know and what we understand to try and add value I guess to what we do on a day to day basis. It is definitely encouraged.

The impression formed of type A bank traders was that they are risk loving; all agreed that they like taking risks and believe it is their job to do so. The following quote from trader 4 (type A bank) illustrates this point:

> If you're a trader whose remit it is to take risk, it's going to be in your DNA to take risk.

And trader 23 (type A bank):

> I think the reason you're on a trading floor is because you like that environment and actually you want to take risk.

And trader 3 (type A bank):

> There are those of us who just enjoy risk, we don't get up in the morning to make lots of money for ourselves, we make it for the bank because that's our job.

Conversely, some of the traders at the type B banks appeared to be risk averse as a result of changes in their bank post-crisis, whereas previously and similar to the type A bank traders they enjoyed taking risk. They explained that they were not encouraged to take risk, and were in fact fearful, as doing so could jeopardise their jobs. This can be illustrated by the quotations from type B staff:

> It's the opposite of the incentive. It's the stick, not the carrot. You will get fired; this will happen. (Trader 19, type B bank)

And,

> You've had traders that have either had to adapt to that or leave. We've seen a culture where if the traders are looking for those big day-one gains and those big pay-outs, you can't really get them now [in my bank]. (Trader 12, type B bank)

Some of the traders interviewed accepted this new risk culture, whilst others found it very frustrating:

> The objective is that people do the job with tighter risk controls to make sure that the bad apples are exposed and weeded out. But actually, it weeded out the good apples in my view, and made life irritating and not fun anymore. You're there to be commercial, and now you're being told to do a risk management job. (Trader 18, type B bank)

And,

> People are less inclined to take risk but more worryingly, people are less inclined to do new business also, and that for me is not the way a bank should work, you need to incentivise people to do new business. (Trader 6, type B bank)

Therefore whilst the concept of a 'strong' or 'weak' risk culture maybe rather fuzzy and subjective, all the points mentioned above point to stark cultural differences between the bank types, which for the purpose of this thesis as least, are defined as a weak risk culture on the trading floor of type A banks, and a strong risk culture at type B banks.

6.2.2.9 Rewards systems and their link with risk management

A requirement of the Remuneration Code was that MRTs have risk and control objectives integrated into their performance metrics. One such example of these objectives was that traders are required to adhere to daily trading limits; another example being that they are required to fully cooperate with control functions, such as audit, regulation, risk and product control. Evaluations relative to cooperation with the above mentioned control functions are also meant to be included in a trader's performance review, and if they are deemed to be non-cooperative, then their bonuses and promotion prospects could be adversely affected.

The consensus amongst those interviewed at type A banks was that they believed they were still assessed solely based on their financial performance, with non-financial measures having no perceptible impact on their prospect of either receiving a bonus or a promotion. This point is illustrated by a quotation from trader 16, from a type A bank:

> At the end of the day, the only thing that really matters is the bottom line.

And trader 4, also at a type A bank:

> Performance reviews are a way to get rid of the bottom 10%. Even if it was a great year and those staff performed very well, they are just a tool, performance reviews are a bit of a joke, managers don't take this seriously. Are they compliant would never come up from a review. It's a box ticked, nothing else. Your get your bonus pot and you think, ooh, I've got to pay him, don't have enough cash so I'll give him a lower score.

All of the traders interviewed at the type A banks were responsible for the allocation of bonuses to their teams. When asked how they appraised their team members, the common answer was that it was based on financial performance and relationships with clients, not compliance with stated risk or control metrics. As previously mentioned, many of the risk metrics introduced into MRTs' appraisal processes were qualitative in nature and hard to measure. Moreover, when the researcher questioned the traders about whether they knew what the impact on their bonus would be for non-compliance with the risk metrics, the unanimous answer was '*no*'. The traders reported that as their bonuses were discretionary and somewhat arbitrary, there were many factors that determined how much they would be awarded; the weightings of these factors were not transparent. This researcher believes that this lack of transparency around the reward system is a fundamental issue impacting the effectiveness of the PMS. As trader 1, at a type A bank stated:

> I've given up worrying about how they (his senior management) decide on promotions, ratings and my bonus, none of it makes any sense to me. You are brought into a room and told your number (bonus) and given some b*llshit explanation about how the pot is down this year and that's it, end of discussion.

And trader 20 type A bank

> I think what is frustrating at times is that I could do and act the same way, but I could do the same work and one year I'd be paid $1m bonus and the next year I'd be paid $75,000. I'd be like, "I didn't do anything differently. How do we have this volatility in compensation?"

Conversely, the consensus amongst traders at the type B banks was that compliance with risk metrics did indeed affect their bonus and promotion prospects. How much weight was attributed to these metrics was unclear; however the metrics were at least discussed in the appraisal process. This is illustrated by a quote from trader 14, at a type B bank:

> A significant amount of weight is placed on financials still, but softer criteria like being compliant with the risk teams and building the business are also important.

And trader 8 type B bank:

> In the last bonus I got there was a reasonable component that was reflective of my status as a very highly rated Risk Manager[44]… maybe 10% of my 'comp'[45] was really about the robustness of my risk approach, as judged by third parties. Ninety percent of it was the fact that I made a ton of money for the firm. I was the highest paid person in Equities for three years. I was paid more than the Global Head of Equities, partly because I made a tonne of money for the firm, but I think without using much balance sheet, capital or anything else.

And trader 22, type B bank, commented,

> So, by saying that these little things matter, they're trying to change the culture of the firm. I actually think it does work, because if you had it drummed into you that all that matters is P&L[46] and no one ever picks you up on the other things. If the first question, from your boss is, "How much money did you make? What's the value of that trade?" you're just going to focus on money.

As with the traders interviewed at the type A banks, the type B banks' traders involved in this study allocated bonuses to their teams, and they all categorically stated that non-financial measures were important to bonus and promotion decisions.

If senior management are truly committed to a strong risk culture, then in order to strengthen the effectiveness of the risk metrics in the PMS, applying transparent predetermined weightings of these measures is key. However, as the process of rewarding traders is highly discretionary, adding weightings to compliance with risk-metrics might not be as effective as it ought to be if senior management decide to find ways to circumvent its application. Practical advice on how this could be implemented will be discussed in Chapter 7.

As previously discussed, part of the risk metrics built into the PMS of MRTs require regular training on compliance and regulation topics. It was observed from the interviews that the type B banks expend a significant amount of time and resources on online training in compliance and regulation. If a trader fails to attend his training, or is late in completing his training, then this is immediately flagged and an explanation sought. Any lack of compliance in this area is also recorded and forms part of the year-end review process.

[44] This person is a trader, even though they call themselves a 'risk manager'.
[45] Compensation
[46] Profit and loss

This can be illustrated by a quotation from trader 19, at a type B bank:

> We spend a ridiculous amount of time on repeated online training. They've realised that people do forget and you're constantly reminding people of the importance of the culture, so that's a huge effort. At the end, they put deadlines on these core training, if you miss the deadlines they feel that to emphasise adherence, that if you break a deadline, it might be a flag of misbehaviour, it gets escalated and reviewed and one late is mentioned at your annual review.

And trader 18, at a type B bank, stated:

> It's like a brain-washing exercise, to be honest. There are a lot of seminars and classes and things like that.

And trader 14, at a type B bank, agreed:

> You know what's going on and you're constantly instilling a culture around how things should and could be done. And, actually, when I said to them this is being watched, no one in my team has missed a deadline; it's interesting, right?

And trader 6, at a type B bank:

> But, [my bank] has what we're saying is a gold standard. So, we're attempting to go beyond and above the new alignment. It's what the firm wants; they want to be seen to be completely clean and transparent. They think there's a competitive advantage in that, but the costs are just gigantic. We're literally having online training on different aspects of everything, repeat training. It feels like we must have at least 20 a year, probably more like 30 a year, I'm trying to guess. You can imagine the hours, I have to spend at least 30 hours a year online, just learning things, which I probably should know…. Here we are in the front office and all we're worrying about is, "Is our online training up to date?" I have cancelled client events, meetings, just to do my online training. Now, that's nonsense, but at the same time, the firm wants to see if that has an impact on the culture. So, I'm going with it… To the extent that if we see ourselves as purely administrators of government money, the clerks to the government, then this sort of mind-set is the correct one, but if we actually thought for a second that we might be business people… It's making important decisions alongside CEOs, CFOs of industry, to assist them in moving their businesses and growing the world economy. If we thought that for a second, then that mind-set that we have is the wrong one. The truth is, it's halfway between, or maybe three quarters are the administers of the public purse, but there's definitely a requirement for someone in these institutions to think as the entrepreneur might think and that is where the dilemma comes in and who is going to do that job if we completely change the culture.

And trader 22, type B bank:

> We have to do the same thing every three months instead of every 12 months, which is absolutely ridiculous. They give examples of how banks got done for and fined hundreds of millions of dollars or pounds for various offences. Those various offences were money laundering etc. So here are the signs, and this is what happens if you don't spot the signs. You might get done, the bank definitely gets

> done, and you'll lose your job…. But [my bank] has got something to lose: its reputation, believe it or not. They drill it into us constantly.

According to the type A banks' annual reports, they have also invested a significant amount of resources in training for compliance and regulation, but on the trading floor at least, they do not seem to stress this training as heavily as at the type B banks. When the type A bank traders were questioned about the training they responded flippantly, with one trader even hinting that it was easy for him to get someone else to take the online training for him. Some of the responses given are illustrated below:

> We have compliance training that comes through on most subjects once a year and you have to take an online course and then answer questions at the end to make sure that you've actually understood what you're trying to do. (Trader 16, type A bank)

And trader 23, at a type A bank, also described a flexible attitude,

> Yes, we occasionally get online training to do, but whether or not we have completed it is not something that is discussed in our reviews.

As can be seen from the quotes above, there is a stark difference in how traders at the different bank types view the importance of complying with the regulations, and the compliance training aspects of the required risk metrics. A fundamental issue affecting the design of the current PMS used by financial institutions is that the system is intended to elicit desired behaviour; however, individuals are not fully aware of which behaviours will be rewarded or punished under the system in terms of deciding their awards. Therefore, in order to strengthen the existing PMS, traders must be fully informed about what behaviour will be rewarded and what behaviour is deemed unacceptable and therefore will be punished.

6.2.2.10 Attitude towards the regulators and regulations

MRTs at both bank types believe that the Remuneration Code and CRD IV bonus cap rule were misguided and based on flawed assumptions; this is largely attributable to the fact that the regulators did not fully understand their business. As trader 1, at a type A bank put it:

> The code is based on a 99% misunderstanding of the business; it makes the assumption that the city is full of casino bankers, all still swinging their bat, trying to make enormous amounts of money, while in fact that may only have been 5%, which is still a lot and definitely did need pruning, so that is just another measure on top of all the measures that banks are under constant duress about.

And trader 3, at a type A bank stated:

> I think they're misjudging people at the other end of the deal because they're making assumptions that the thing that gets us all up in the morning is to make a massive bonus. That may have been a driver for a lot of people at one point in time but I don't actually think it is anymore.

And trader 11, at a type A bank, further commented:

> I would say 99% of people are sensible, they're being looked after, they're being properly managed; stretched, of course they are; given targets, of course they are, but know the right way and not. Of course, it's the 1% and, of course, that's what gets printed and stuff like that and, in a way, you have to have sympathy with the regulators for doing it. It's a case of bashing people into shape, and it's signifying that this is completely unacceptable and making people aware of that.

And trader 18, at a type B bank:

> I would start by first saying that if you look at the two banks that collapsed, they were organisations that were the highest employee-owned firms on the street with the biggest deferral. So I was at Lehman Brothers for 10 years. My last five years of bonuses were paid in stock I never saw a dime of it. I treated the company like it was my company. So now that you have the regulators trying to say, "Well, you need more skin in the game," I kind of laugh and think they missed the boat. Because Bear Stearns and Lehman had the most skin in the game of employees, and therefore we had the most pain and suffering.

Furthermore, employees at the type A banks spoke at length about their ability to work around the new regulations, whilst traders at type B banks conceded there was more pressure on them to be seen as compliant. This 'gaming' by the banks was also evident in a recent study by Lim *et al*. (2017). This is illustrated by the following quotations:

> Regulation by its very nature, the moment you publish it, someone there is trying to arbitrage it. Let's be honest, banks can throw so many resources at arbitraging a regulation that you will never be able to catch up with them. (Trader 3, type A bank)

> My view is it's hard to actually regulate capitalism on this stuff. Capitalism is like water, it will find its way through cracks and regulation is generally made with a precedent in mind. It's always backward looking and capitalism is always forward looking. The unfortunate, unintended consequences and what we're going to live with over the next five to ten years is that we've saddled banks in particular, with really high fixed costs and probably incentivised some not great behaviour… I think that probably one of the biggest challenges coming out of the financial crisis, is that the objectives set by regulators are wholly inconsistent with the objectives set by investors who own the companies. At the end of the day, a board of directors is not responsible to a regulator; they're actually beholden to investors. (Head of Regulation, type A bank)

And:

> It's more like a head teacher/ naughty school child relationship. (Trader 6, type B bank)

> That is just the culture at [my bank]. We don't have a choice because we have been bailed out. We absolutely have to be whiter than white here, and we are. (Trader 10, type B bank).

With regard to discussions surrounding the effectiveness of the regulations, interviewees reported:

> The industry is one that is very political. Do I think that they are effective in getting a clean industry that is very efficient? No, that is not their aim. "I would like you to lend money to SMEs", you would not be lending money to SMEs, these are political aims of fully employing lots of little businesses, blah, blah, blah. That is not compatible with having an efficient banking industry. Let's be quite clear about that. There is already political weighting and once you meddle and decrease efficiency then you can't blame the industry when it says, "Well, we are not here to behave efficiently." (EMEA Head of Regulation, type B bank)

And:

> Normally when there's a regulatory change, it's normally the finance functions or the back-office functions that need an extra box to tick. It's probably the first time in my career where I've seen regulatory change affect the whole organisation. For example, for our particular bank, they're required to formally sign off on the P&L at the end of each day, and also attest to the controls that derive the P&L. They have to formally say, "Yes, I agree" or, "No, I don't". I think that's the biggest culture change I've seen over the last couple of years. (Head of Product Control, type B bank)

And,

> Regulation is a blunt tool, some of the regulations on capital are a blunt tool but very useful in keeping the systemic risk in check… and that's probably the one that's had the most materiality and the reason I say that is, all of the other tools, and you see the way some of the banks have tried to circumvent them, shows that these are creative people, you don't get to be at the top of any large organisation, and certainly not investment banks without being able to come up with creative ideas that any rule that a regulator takes 4 years to get through parliament, has normally being circumvented the day it is put into rule, so I don't think rules and regulations always make a difference. (Head of Corporate Governance)

6.2.2.11 Traders' morale

Another striking observation made about the differences between MRTs in the different bank types related to their overall disposition. In general, the MRTs interviewed at the type A banks appeared neither demoralised nor demotivated. However, in contrast, a large number of the MRTs interviewed at the type B banks appeared demoralised with their jobs and the fate of the industry in general. This is illustrated by the following quotations from type B bank traders:

> [I]t's soul destroying to see the whole industry destroyed like this because now everyone is so scared about whatever they do, that they now don't want to do anything, which is wrong because people should be trading now; I think everyone just feels so demoralised that we're made to look like leeches on society. (Trader 22, type B bank)

And,

> In the past there was a lot more to stay for; whereas now, as a young trader you really are galloped to the hedge fund industry. (Trader 6, type B bank)

And, trader 14, when discussing the introduction of a new product:

> [A]ll of a sudden it will go to every f*cking control function you can imagine. Even if I came up with something today and I wanted to get through the organisation. At a minimum it would take, at a minimum, it would take three months and that's assuming that I work some magic, if I did all kinds of stuff. The other thing that comes up is, even if people don't quite know, the default response, if a response came back, they'd said, "The regulators won't like this." That's it, it's all off. It's done, there's nothing you can do. (Trader 14, type B bank)

An observed unintended consequence of these new regulations was that a large number of individuals left the industry; this was particularly problematic for type B banks, whose traders reported that they had lost a large number of their top performers to other banks or hedge funds. Furthermore, a large number of the traders interviewed at type B banks spoke of their desire to leave the bank and the industry entirely; however, market conditions made making such a choice difficult. This finding was supported by the Kleymenova and Tuna (2016). Some comments made by type B bank staff explain the large exodus of staff:

> Our global head didn't enjoy the changes at all, he was responsible for managing the whole of the Commodities Business, but his job involved running around doing administrative tasks and implementing regulations, rather than working with his team to make money. He hated it, so he resigned, went to Switzerland, went to one of the trading firms, where everyone goes to these days because there's less regulation there. So, we've got this big drain of talent and money-making ability going to Switzerland – it's just completely stupid – because they're not regulated like everybody else. (Trader 12, type B bank)

> They've all gone off to trading firms, funnily enough. Not because they're bad people, but because they're there to make money out of the market. They're not there to do all this other stuff. That's why Barclays ended up having to close down its business in some ways, because they lost all the people that actually made the money and got left with the pen pushers, essentially anyone who was happy to do that. So if the upshot of the legislation is to push risk taking people out of the business altogether because they're not going to like all the administrative stuff, you're going to be left with a bunch of civil servants, for argument's sake, then, yes, it has been a success. Then you get into a whole other debate about whether that's a good or a bad thing for the economy, because if you don't have people

> providing liquidity to markets, you don't have efficient markets. If you don't have efficient markets, you don't have efficient risk management. If you don't have efficient risk management, you introduce risk into companies that were accustomed to not having risk. (Head of Product Control, type B bank).

In terms of changing risk-taking behaviour, it is important to note that the consensus amongst the traders interviewed at both bank types was that they believed they had behaved and traded with integrity pre-crisis, and so continue to behave and trade with integrity post-crisis. Trader 4 (type A bank) summarises this sentiment:

> In terms of trading, my behaviour won't change at all, because I always thought I was doing the right thing in the first place.

Confirmed by trader 12, at a type B bank:

> I think what would happen if you had the right culture, the people that don't do the right thing will probably go somewhere else until they find an environment that they could thrive in, because from my experience of where I worked anyone around me was likeminded. We all did things the same way, and we all did things the right way.

And trader 11, type A bank:

> They won't change my behaviour because my behaviour was always quite risk conservative anyway. I'm a chartered accountant[47], so you learn 'prudence' and 'going concern'. You get told on your first day that you never defraud anyone and if you lie on an insurance claim or if you don't pay your fare on the Tube, you will be drummed out of the Institute. My "Don't ever lie. Don't ever do anything" is because I'm a chartered accountant. I don't need a bunch of regulations to tell me that is the right way to run a business. That was how I have been operating since 1987 when I started in accountancy. I may be a little bit different from other people…

It is the stark differences between the attitudes of MRTs working in the different bank types towards the new regulations that proved a distinguishing feature in responses to RQ1. The researcher concludes therefore, that it is predominantly the change in leadership, and to a lesser extent, state intervention in type B banks that has caused the observed improvements to their risk culture. The section that follows summarises the key findings from RQ1.

6.2.3 Summary of the main findings of RQ1

In relation to the banks' overall responses to the remuneration regulations, it was found that the banks fiercely contested the regulations, as they conflicted with their core

[47] This individual started out their career as a chartered accountant before moving into a trading position.

normative values. The most contentious point of the remuneration regulations related to the CRD IV bonus cap. When the banks' objections were dismissed they threatened to relocate their head offices to jurisdictions offering more favourable regulatory treatment. Additionally, they had government officials lobby the ECB on their behalf to bring a legal challenge to CRD IV bonus cap to the European Court of Justice. This legal challenge failed, and in January 2015 the CRD IV bonus cap was imposed. Soon after, and with implicit approval from the UK PRA, the banks circumvented the bonus cap by paying their staff monthly allowances[48].

In relation to the individual banks' responses to the remuneration regulations, a number of key findings emerged. Firstly, that the different bank types responded differently to the remuneration regulations, with the bank level response being a determinant of how individuals in those banks responded to the regulations. Secondly, two bank types emerged: banks exhibiting signs of a strong risk culture, classed as type B banks, and banks exhibiting signs of a weak risk culture, classed as type A banks. At the type B banks a power shift between the front office trading staff and back office support staff was observed, showing enormous improvements in the risk culture at type B banks. It was concluded that the change in leadership in the type B banks was a predominant driver of observed improvements in their risk culture, with state intervention providing a small contribution. However, the improvements in risk culture observed at type B banks was not consequence free: they had a large exodus of top performers, and the remaining traders appeared demoralised. In the type A banks it appeared to be business as usual; a weak risk culture was observed on the trading floor, with front office trading staff wielding the majority of the power rather than the back office responsible for control functions.

6.3 RQ2: What can be theoretically observed about the banks' responses to the new control mechanisms?

Institutional theory posits that organisational behaviours are not solely driven by market competition, but by banks' need for legitimacy and survival. Thus, organisations often adopt new organisational forms even when they are not efficient (Meyer & Rowan, 1977). It is the quest for legitimacy that forces organisations to normalise, rejecting resistant

[48] As previously discussed, as of early 2016, monthly allowances in the form they were initially used, were no longer allowed as part of MRTs' remuneration packages.

strategies (Meyer & Rowan, 1977; Meyer & Scott, 1983). As evidenced by the findings linked to RQ1 above, the responses of type A and B banks to the same institutional pressures were very different. This prompts the question of what caused type B banks to conform to, and type A banks to resist, the same institutional pressures? With regard to type B banks' responses specifically, it was observed that they complied with the new controls, even though doing so was damaging their businesses in terms of financial performance and ability to retain talent. Arguably this represented a coercive isomorphic change, as the need to retain their legitimacy, and thus their survival compelled them to change. Additionally, as all but one of the type B bank in this study received funds from tax payers during or after the crisis, the social pressures upon them led them to behave with the highest levels of integrity, as doing so was paramount to their survival. A partner at an accountancy firm working in close collaboration with both bank types offers some insight into this mindset:

> [I]t feels like they're conscious that every move is being watched closely, but not just watched closely as a monitor, rather watched closely like a parent watching a child and directing things in quite an active and day to day fashion... where there's been a forecasted change in legislation, and their heads of reward at these places of the bailed-out banks have received a call, before they've even sort of had time to consider the impact of this change, they've received a call to say, "Don't even think about doing any planning around this change." And some of the power of their position and some of the freedom for them to sort of work within that company to achieve the best result feels like it's been taken away… And I think that's where the heavily regulated bailed-out banks have got to be quite frustrating for premium trading talent because they are feeling that they're squashed into playing conservative bets on the outside of the roulette table, rather than going for a number. (Partner at an accountancy firm)

With type A banks however, this coercive isomorphic pressure appeared not to be dominant, as competitive isomorphism prevailed. Global banks' remuneration policies could be viewed through the lens of competitive isomorphism, as the majority adopt similar remuneration policies. As the Remuneration Code and the CRD IV bonus cap regulations were only applicable to UK based banks, and the branches of UK banks operating abroad, if type A banks succumbed to the coercive pressure applied to them, they would be expected to lose their ability to attract and retain top talent when competing with other global banks. Therefore, it is argued that competitive isomorphism was the driving force for type A banks.

6.3.1 Mimetic processes

One of the driving forces of institutional change is mimetic processes, wherein organisations tend to mimic their more successful counterparts; they do so in order to increase their legitimacy and/or to save time locating solutions to issues. An example of the mimetic processes at play in this thesis is that when one bank initially introduced monthly allowances as a way to circumvent the CRD IV bonus cap, they were quickly imitated by other banks without any evidence regarding the effectiveness of such an approach, or of the potential repercussions from the regulators when doing so.

6.3.2 Ceremonial conformity

As previously discussed, conforming to institutional rules can often result in conflict with the goal to guarantee efficiency (Meyer & Rowan, 1977). However, it has been recognised that firms often comply with *institutionalised myths* when seeking to ensure the survival of their organisations (Meyer & Rowan, 1977). Often this conformity is only *ceremonial* and confined to formal structures, with actual work being much more loosely coupled with formal arrangements. The consensus amongst those interviewed for this thesis, and also those the researcher held informal conversations with about the 2008 financial crisis, refuted the argument that incentives were the root cause of the crisis (stating they were at least not wholly culpable). Despite this view, the banks altered their incentive structures, even though they did not believe that this was the correct method to addressing the issue of their past failings. Therefore, arguably, these new incentive structures could be seen as *institutionalised myths* from the perspective of the financial services industry.

Failure to comply with the Remuneration Code and CRD IV bonus cap rule was not an option for the investment banks studied in this thesis. Non-compliance would result in: sanctions and fines; removal of banking licenses; and ultimately a failure to survive. This could help explain why neither bank type fully complied with the demand to change their remuneration structures, rather they complied in a *ceremonial* sense only. The investment banks in this study *loosely coupled* their formal procedures from their actual work, *ceremonially* accepting the rules of the Remuneration Code and the CRD IV bonus cap rule (as confirmed in their annual reports). This *ceremonial* conformity and *decoupling* of formal procedures with actual work is evidenced in two ways in this thesis. First, by banks accepting (*ceremonially*) the CRD IV bonus cap rule and restricting MRTs' bonus awards, and second by simultaneously undermining the CRD IV bonus cap rule by paying staff

monthly allowances instead. Second, as previously discussed, the banks were obliged to introduce risk and control metrics into performance assessments for MRTs, and evidence from interviews conducted with type A bank staff show little to no regard was given to these risk and control metrics in terms of deciding the performance award or promotion potential of MRTs. Therefore, this thesis adds empirical evidence from the UK financial services sector to Meyer and Rowans (1977) to validate the suggestion that organisations will generally comply with *institutionalised myths*, often *ceremonially*, in order to ensure their survival.

6.3.3 Institutional environment

Meyer and Rowan (1977) argued that not all organisations are influenced by institutional pressures to the same degree, with not-for-profit organisations expressing a greater need to appear rational and thus conforming more readily to institutional pressures. However, as evidenced by the for-profit banks discussed in this thesis, there are huge pressures for them to conform to institutional demands, if only ceremonially. Interestingly, however, the type B banks (whilst for-profit banks, but with less pressure than the type A banks for high returns) exhibited a greater need to conform than type A banks, supporting Meyer and Rowans' (1977) thesis.

As previously discussed in Chapter 4, the idea that organisations operating in the same institutional environment respond differently to institutional pressures is in contrast with the ideas of DiMaggio and Powell, and Meyer and Rowan. They argued that for organisations who operate in the same institutional environment, there would be less diversity and more similarity in their responses to institutional pressures. However, this thesis does not support this view: the splitting of the data into type A and type B banks revealed how banks operating in the same institutional environment might in fact respond differently to institutional pressures; this is congruent with findings from the contingency theory literature and Oliver's (1991) typology of strategic responses to institutional processes.

6.3.4 Strategic responses to institutional processes

The focus of RQ2, in relation to Oliver's (1991) typology, is on the non-confirming responses of avoid and defy. The avoidance tactic most prominent in this thesis relates to escaping from institutional pressures through concealment. This is evidenced by the tactics

used to avoid the CRD IV bonus cap. To a lesser extent, we identified the defiance tactic of challenge used by the UK government to question the ECB in terms of litigation to prevent forced compliance with the CRD IV bonus cap as significant. As discussed in Chapter 4, the tactics of conceal and challenge have not been the focus of any previous academic studies in the management accounting domain. Hence, this is where an empirical contribution to Oliver's typology can be made by this thesis. Moreover, this thesis provides empirical evidence exploring why some organisations, given the same institutional pressures, might respond differently to those pressures, again providing an empirical contribution to Oliver's typology.

As was evidenced by this thesis, and as discussed in detail earlier in the chapter, it proved relatively common that investment banks choose more than one strategy to respond to the institutional pressures they were facing. For example, this thesis provides evidence that some of the banks (mostly type A banks) in this thesis appeared to *acquiesce* to the CRD IV bonus cap rule and the Remuneration Codes requirement to link performance related pay to risk metrics. However, in reality, they concealed their non-compliance by paying monthly allowances to staff in place of bonuses, and ignored compliance with risk metrics when awarding pay to MRTs. Oliver's (1991) typology of strategic responses to institutional processes can be used to explain this behaviour by type A banks, as it highlights the fact that organisations do not passively acquiesce to institutional pressures, but instead can act rationally in the best interests of the organisation.

A more resistant tactic in the avoid strategy is one of *escape.* Oliver (1991) argues that organisations attempt to influence their institutional environment for their own self-interest. This tactic of escape can be evidenced when an organisation will either exit the market where they are being forced to comply, or alternatively move to a location where pressures to conform are more lenient or non-existent (Oliver, 1991). The investment banks' attempts to influence their institutional environment is evidenced in this thesis in two ways. First, were the unprecedented comments from the industry in response to the first proposal of the Remuneration Code under CRD III. Second, by their vocal outrage towards the CRD IV bonus cap proposal, some investment banks threatened to leave the UK if the CRD IV bonus cap was enforced. The banks' threat to leave the UK could be seen as an attempt to use the tactic of *escape* as per Oliver's (1991) typology. Michael Geoghegan, HSBC's CEO at the time of the announcement about the CRD IV bonus cap proposal, declared that the bank would review the location of their London based

headquarters due to concerns about the measures the EU and UK regulators were taking to restrict the bank's ability to reward their employees.[49] His concerns centred on the belief that the CRD IV bonus cap would place HSBC at a distinct disadvantage relative to their US counterparts (Guardian, 2010). Barclays and Standard Chartered also threatened to leave the UK if the proposals made by the regulators were too radical (Guardian, 2011). The UK Treasury department took these 'threats' of leaving seriously, and as previously discussed, legally challenged (albeit unsuccessfully) the CRD IV bonus cap rule in the European Court of Justice (FT, 2014a).

6.3.4.1 Defy and Challenge

As discussed in Chapter 4, defiance is the most resistant strategy in Oliver's (1991) typology. Within this strategy is the tactic of *challenge*, which Oliver argues is most likely to occur when organisations can prove their rationality for acting in a certain way. In terms of this thesis, it was not the banks themselves who challenged the CRD IV bonus cap, but the UK government acting on their behalf. The UK government, UK regulators and senior management at the banks believed that the CRD IV bonus cap rule was misconceived and that there was no rationale for its introduction. The UK Chancellor, George Osborne, argued that:

> The fact remains these are badly designed rules that are pushing up bankers' pay not reducing it. These rules may be legal but they are entirely self-defeating, so we need to find another way to end rewards for failure in our banks. (FT, 2014b)

His views arose from the belief that the CRD IV bonus cap would increase the fixed cost base of banks and push up bankers' pay, not reduce it: because there was no cap on the fixed salaries bonuses were pegged against. Murphy and Jensen (2011) supported this view, arguing that the model of low fixed pay and uncapped variable bonuses has been part of the success of investment banks; i.e. allowing for fixed costs to be controlled and paying uncapped bonuses tied to profits. Osborne also argued that the bonus cap limited the effectiveness of the Remuneration Code clawback clause and deferral mechanism, as under this rule, only bonuses (paid and deferred) could be clawed back, not fixed salaries. Additionally, he maintained that the CRD IV bonus cap made the UK less competitive than other global financial centres without similar strict rules on remuneration. The British Bankers Association also lent their support to the legal challenge put forward by the UK Chancellor, arguing that:

[49] At the time of writing this thesis, HSBC remain head quartered in London.

> We believe that shareholders should be given powers to determine staff pay – not politicians… We believe this law runs counter to recent reforms and will make the system less robust by incentivising firms to increase fixed pay. It also puts European banks at a disadvantage when competing with firms in other parts of the world. (FT, 2014b)

The actors interviewed as part of this thesis also believed that the CRD IV bonus cap rule was misconceived, stating:

> Yes, that's (the bonus cap) not really going to solve anything, because base salaries are already going up. It was in the press in the last couple of days. I can't remember which one of the banks it was, but they're consulting now about just increasing everyone's base salary. The regulation, in a weird, perverse way, is actually going to cause more problems, because banks are going to have much higher fixed costs, and less flexibility in down years to pay people less, because you can't just suddenly stop paying people their fixed salary, whereas, you can stop paying people their bonuses. It's actually going to, probably, make the bank's position, and the bank's profitability, much more volatile. (Trader 3, type A bank)

And

> Because of these restrictions in pay and caps, everyone is getting paid these ridiculous salaries; sometimes 3 times what they would have been paid prior to these regulations, so where is the motivation to do any work? Rather than it being 20/80 (20% salary, 80% bonus) now it's more like 80/20. (Trader 10, type B bank)

As can be seen from the above discussion and comments, from the actors' viewpoint at least, there are good reasons to challenge the introduction of the CRD IV bonus cap rule, congruent with Oliver's (1991) typology.

6.3.4.2 Predictions concerning level of resistance

As discussed in Chapter 4, in addition to the five strategic responses to institutional processes, as advocated by Oliver (1991), her typology also predicted ten antecedents that foretell level of resistance to institutional pressures. As stated previously in section 4.4, it was not the aim of this thesis to test these predictions, rather the aim was to use it as a 'skeletal' frame, which could be fleshed out with empirical data from the thesis, from the perspective of actors in the UK financial services industry.

6.3.4.3 Cause- Legitimacy or social fitness

The first prediction presented in Oliver's (1991) typology argues that large, visible organisations will be less resistant to institutional demands in order to maintain their social legitimacy. This idea was refuted by Clemens and Douglas (2005), who found that firms in the steel industry adopted more active resistance strategies when confronted by

institutional pressures. The UK financial services industry is a large, highly visible industry, and similar to Clemens and Douglas (2005), this idea can be refuted on the basis of the empirical data from this thesis, showing how the banks actively resisted the CRD IV bonus cap; thereby providing a contribution to Oliver's (1991) typology. As previously discussed in Chapter 4, obeying the Remuneration Code and the CRD IV bonus cap rule would indeed bring an element of social legitimacy to the investment banks. After the 2008 financial crisis, bankers' bonuses were highly unpopular to those outside the industry, as they were seen to be a key contributor to the crisis. Non-compliance with the Remuneration Code or the CRD IV bonus cap could damage a bank's reputation, and as a result, weaken their economic position, as investors may not feel comfortable investing with them and additionally due to the sanctions and fines imposed on them by the regulators. This could help explain the attempts made by the banks to *conceal* their resistance by decoupling their formal procedures from their actual work practices, and *ceremonially* accepting the new rules while circumventing them by paying monthly allowances to MRTs.

Oliver (1991) stresses that for-profit firms are most likely to resist state intervention if they anticipate efficiency losses. Therefore, her model can be used to show that organisations will adopt strategies to secure their own future when faced with institutional pressures that they disagree with. In the case of this thesis, this was found to be valid, as the banks firmly believed that the Remuneration Code and the CRD IV bonus cap were undermining their businesses, as evidenced in section 6.2.1 of this thesis.

6.3.4.4 Content - Consistency with organisation goals

Prediction five of Oliver's (1991) typology discusses the extent to which institutional pressures are compatible with organisational goals. When institutional norms conflict with organisational goals or freedoms, the typology predicts a high level of resistance. Interestingly, Oliver's (1991) typology predicts that organisations are more likely to acquiesce to institutional pressures that do not impede on substantive organisational decisions, such as '*hiring*, *compensation* and *promotion*' (p.166). As the primary focus of this thesis deals with compensation decisions, this thesis provides an empirical contribution to Oliver's organisational goals by showing how the banks' resisted pressures to conform to institutional pressures on compensation. Moreover, the results of the empirical data, as discussed in section 6.3 of this thesis, show how the different bank types responded to the same institutional pressures. *type A* and B banks had different

organisational goals (in terms of risk appetite). At type A banks, the need for increased growth and profits led them to escape the institutional pressures to conform to elements of the Remuneration Code, whilst type B banks more readily complied with such institutional pressures as they perceived them as more aligned with their overall organisational goals of real risk reduction.

6.3.4.5 Control - Legal coercion or enforcement

Prediction seven of Oliver's (1991) typology argues that when regulators have recourse to legal action, low levels of resistance to institutional demands result. Moreover, the typology predicts that organisations will acquiesce more readily when faced with punitive measures for non-compliance, and when enforcement is strict. However, Shapiro and Matson (2008) argued that regulatees might not acquiesce so readily if they can obtain assistance from other parties to change or abolish the regulation. Furthermore, they argued that the wealthier the regulatees are, the more likely that they will engage in defiance or manipulation strategies to corrupt the regulations. The empirical evidence from this thesis corroborates the findings from Shapiro and Matson's (2008) study, which showed how the wealthy regulatees (the investment banks) lobbied the UK Government to legally challenge the CRD IV bonus cap rule on their behalf. For the banks themselves, non-compliance with the rules was not an option, as they would have then faced punitive measures.

6.3.5 Summary of the main findings regarding RQ2

The findings discussed above highlight the role institutional processes played in determining the banks' responses to the remuneration regulations. Oliver's (1991) typology helps to explain the differences found in the reactions of the different bank types, particularly in relation to how they responded to and implemented the new remuneration regulations. It was found that both type A and type B banks employed the non-confirming responses of *avoid* and *defy* to escape from the institutional pressures they were facing. The use of monthly allowances in both bank types is evidence of their use of the tactic of *concealment* to disguise their non-conformity to the CRD IV bonus cap, with the banks, *loosely coupling* their formal procedures from their actual work, and *ceremonially* conforming to the rules of the CRD IV bonus cap. *Ceremonial* conformity was also evident in type A banks' response to the Remuneration Code, in relation to their compliance with risk metrics in the PMS. *Mimetic* processes were evident in both banks types when reviewing their introduction of monthly allowances. All banks quickly introduced monthly allowances without any regard for potential repercussions from the regulators for doing so.

When viewing the banks' responses to the remuneration regulations from a contingency theory perspective, there is no surprise. What the regulators had attempted with the introduction of these remuneration regulations, is force a universally designed performance system for MRTs upon the banks, without any regard for individual circumstances. Had the banks not adapted the system to their individual circumstances, then they could potentially have harmed them, as was evidenced by the type B banks that underwent an exodus of top performers.

6.4 RQ3: Did the new control mechanisms change the risk-taking behaviour of traders?

As discussed in Chapter 2, many factors are known to influence the risk-taking behaviour of individuals, incentives being just one. The weight of importance associated with the influence of incentives on risk-taking behaviour is an unknown entity. As such, this research question will be assessed from the perspectives of the actors involved in this study.

6.4.1 The elusive 'excessive' risk-taking

As the primary objective of the new incentive measures was to reduce 'excessive' or 'inappropriate' risk-taking, these terms need to be explained in the context of this thesis. The terms 'inappropriate' and 'excessive' risk-taking were emphasised in numerous policy documents, the media, and academic literature, as among the most significant contributors to the 2008 crisis. Subsequent global legislation was introduced with the aim of averting another crisis and focused on 'excessive' risk-taking as a key factor. However, nowhere in all these numerous documents was the term 'excessive' quantified in reference to risk-taking. As discussed in Chapter 2, the concept of risk itself is conceptually fuzzy and subjective. Adding the word 'excessive' to it exaggerates this subjectivity. When the term 'excessive' is not quantified, it truly is in the eyes of the beholder to gauge what they believe to be 'excessive' risk-taking. Attempting to regulate away such a fuzzy, subjective concept seems to be an impossible exercise. To prove this point, one of the questions from the interviews enquired as to what the interviewees considered 'excessive' in relation to risk-taking. Unanimously they stated that it was a very difficult concept to define, with varying answers ranging from:

> You've got to say that excessive risk-taking would be something that people would have a view on that might change, over time. What somebody feels it excessive, I suppose isn't excessive in one market, which might be very liquid, and you might have very strong views about the conviction of a particular position or portfolio. You'd look at it again, if markets were quite different and you'd think, "Well, that was incredibly excessive; I don't know what we were doing holding that risk." So it's hard to define a constant, for anybody, at any point in time. You could almost say- if you knew that, then you'd almost say, well, actually, something is excessive probably, if you ended up regretting it afterwards… but it's equally pernicious if you take a risk that everybody is comfortable about, which is enormous, it makes a fortune, and you're all happy about it, because should you be happy about it? (EMEA Head of Regulation, type B bank)

> Nobody will define it, because it just depends. Different types of firms will have a different measure of it; different market conditions will have a measure of it. Sadly, if you made a profit, in hindsight, or a loss, in hindsight, that might drive what you consider to be excessive, which shouldn't be the case, but probably is according to human nature. (Trader 20, type A bank)

> I think my metric would probably be along the lines of taking a risk that there's no obvious reason as to why you think you might be able to sustainably run a profitable business on the back of it. I think there are lots of people that basically were, to some degree, flipping coins and hoping to get lucky, and the ones that got lucky in some cases maybe got promoted, the ones that got unlucky a couple of times in a row are the ones that caused scandals. (Trader 19, type B bank)

> There definitely isn't [a definition of excessive risk-taking]. It all comes down to what parameters, the firm is putting out more and more parameters around what can or cannot be done. So, they will attempt to define a set of rules, of which every person within the firm has to work around. Those sets of rules cover everything from personal conduct, all the way through to credit, trading, regulatory hurdles… What [my bank] is doing is looking at the culture of risk-taking, holistically, not attempting to look at one specific area. Then, what is does, is it captures red flags; it has the ability, it hopes, to see risk behaviour that will create a known flag outcome that can be investigated further. (Head of Risk Management, type A bank).

> There are people who make a load of money because they're lucky. I can think of a trader who made $150m for [X] Bank on a spread trade and he looked like a genius, of course. So they paid him a load of money and he had a deferred this that and the other. Then he got interviewed by one of the other big banks and left [X] bank and went to this other big bank... He gets there, blows up, loses almost as much as he made previously over at the other company. How he got the point that he was allowed to blow up that big, I don't know, but he was lucky. Everyone thinks he's a genius. People think he's a genius, but turns out he was lucky. He goes to the next place, he's now unlucky and fired. (Head of Product Control, type A bank)

The head of product control (type A bank) suggested that it may be deliberate act on the part of the regulators to not prescribe the term 'excessive', stating:

> [A]nything that might be slightly on the line: people will err on the side of caution. If you tell people precisely where the line is, they will work out all sorts of fancy financial engineering ways of staying on the right side of the line, even though in reality, they're not. I actually think it's not a bad thing to say excessive risk-taking is not permissible because no-one knows what it means, and that's probably not a bad thing, actually.

The consensus amongst those interviewed was that 'excessive' risk-taking cannot be quantified and that there is a very fine line between what is considered normal risk-taking and 'excessive' risk-taking; this line does not usually get defined until after the event once a deal has lost large sums of money. So whilst there seems to be a lot of attention given to deals that lose large sums of money, it appears that the same attention is not given to deals that make large sums; which should not be the case, because a deal that has made a vast sum of money should also be scrutinised to assess whether that deal made money through 'excessive' risk-taking.

Traders in this thesis were also questioned about whether they believed they could take (what they considered to be) 'excessive' risk within set risk limits. The unanimous answer

was that it was certainly possible. In April 2006, the FSA[50] moved from prescriptive based regulation to principles-based regulation, believing that prescriptive standards did not prevent misconduct, and were instead becoming a burden to the industry and themselves. Therefore, the regulators allowed the banks themselves to define 'excessive' risk-taking, which according to those interviewed appears to be the correct approach, given the diversity and complexities of banks' business models. However, this is problematic as such a diffuse concept as 'excessive' risk-taking may not be an appropriate basis for regulation, considering it is almost impossible to measure compliance until after the event. Furthermore, as discussed in Chapter 2, and from discussions with traders in the study, the researcher believes that a trader's perception of 'excessive' risk-taking is socially constructed, subjective and likely to change on a day to day basis, dependent on the numerous factors discussed in Chapter 2. This makes the task of controlling for such excess very difficult for a number of reasons. First, it is a moving target, and secondly, what one individual perceives as excessive may be considered normal by another individual viewing it through a different lens.

According to policy documents, it is the belief of the regulators that the risk-taking of traders pre-crisis was 'excessive', and subsequently, they introduced new incentive controls to change this behaviour. Consequently, the researcher cannot state unequivocally whether or not the incentive controls reduced 'excessive' risk-taking, as 'excessive' cannot be quantified; what can be done however, is to assess whether there has been a change in risk-taking behaviour pre- and post-crisis as a result of the new incentive controls.

6.4.2 Risk-taking in investment firms

The consensus amongst those interviewed was that risk limits in themselves do not prevent 'excessive' risk-taking, because one could take 'excessive' risk within the assigned limits. Additionally, if a trader wanted to trade outside his risk limits he would usually gain prior approval from his seniors. In type A banks, it was reported that such approval would be given with relative ease to a senior trader. However, at the type B banks, it was observed that an agreement to trade outside limits is more difficult to attain. Moreover, some traders

[50] The FSA was the regulator responsible for UK financial services industry during the crisis of 2008. In April 2013, it was abolished due to the apparent regulatory failure of the banks during that time. The FSA was replaced with two bodies: the PRA and the FCA. The PRA's objectives are to promote the soundness of financial firms and to secure appropriate protection for policy holders of insurance firms. The FCA's objectives are to protect consumers, maintain competitive markets and ensure the integrity of the financial system.

commented that their seniors do not always fully understand the risk they are signing off on:

> I've got an example of my own situation, where I said to the boss, "I'm going to go through my position limits. This market is shafted, and I want to go shorter than I already am," and he goes, "Uh." Then I tell him why and then he says, "Okay, go for it." (Trader 13, type A bank)

And trader 4 (type A bank) said:

> So, you have the limits, and then you have the opportunity to go beyond them. The chap that made loads of money, he went all the way almost to the top of the organisation to get more risk in order to put on a position, of which he was certain, and then you have these layers of management that are all buying into the story.

And trader 24 (type A bank) stated:

> The problem is that the people who set the limits have absolutely no idea about how the business works and how and what people are trading. And that's where you get these issues; that is certainly where it stems from.

And trader 11 (type A bank), who observed:

> [T]he code has no effect, risk comes from the top; it's not like a senior trader would take on huge amounts of risk on his own - it's approved first.

Pre-crisis, a firm's risk appetite was already under the control of the FSA[51] under principle four,[52] which again required the firm maintain adequate financial resources. Traders were also set risk limits, breaches of which would then be addressed. If the risk appetite set by the board was high or 'excessive', then by default, the traders would be unwilling taking excessive risks. The crisis was not caused by a breach of risk limits; despite this, this is one of the control mechanisms that was highlighted by the regulators to avert another crisis.

6.4.3 Combined control measures

As discussed in Chapter 2, the only study to have looked at the impact of the Remuneration Code on risk-taking was that conducted by Kleymenova and Tuna (2016), who found that at bank level, risk-taking was reduced. Whilst their study offers empirical evidence of a change in banks' *overall level of risk* since the introduction of the Remuneration Code, it does not assess whether there was a change in *risk-taking*

[51] The Financial Services Authority (FSA) was the regulator at the helm of UK financial services industry during the crisis of 2008. In April 2013, it was abolished due to the apparent regulatory failure of the banks during that time. The FSA was replaced by two bodies, the PRA and the FCA.

[52] In April 2006, the FSA moved from prescriptive based regulation to principles based regulation, as they believed prescriptive standards did not prevent misconduct, and were instead becoming a burden to the industry and themselves.

behaviour at an individual level: as was the aim of the Remuneration Code and the CRD IV bonus cap. Banks could achieve overall risk reduction in their portfolios by reducing traders' individual risk limits. However, as explained in section 6.4.1, just because a trader trades within his risk limits, does not prove he has changed his risk-taking behaviour, nor does it prove that he is refraining from taking excessive risk (at least what he considers to be excessive risk).

The section that follows discusses the individual nuances of control mechanisms, and their perceived effectiveness in term of changing risk-taking behaviour according to the perspectives of those actors involved in the study.

6.4.4 Bonus deferrals

Bonus deferrals in the form of equity-based pay have been a regular feature in the compensation arrangements made by investment banks for many years, and have also been the focus of many academic studies. Despite this, consensus has yet to be achieved concerning their effectiveness or lack thereof, as a tool for mitigating excessive risk-taking. The banks involved in this thesis mostly deferred equity based products, and as discussed in Chapter 2, the issue that arose when linking employees' incentives with equity was that it subjects them to the whims of the stock market that are often beyond their control. This point was observed in the interviews in comments from traders when discussing whether they believed their trading activities could influence their bank's share price:

> I'm too small a cog in the big wheel of a massive machine to influence. The only way I could influence it is if I deliberately try to defraud the bank. (Trader 1, type A bank)
>
> I have the stock price on my iPhone, so I pay attention a little more than I used to, which is ironic, because I can't do anything about it. (Trader 16, type A bank)

In support of the findings of Acrey *et al*. (2011), and Fahlenbrach and Stulz (2011), it was found in both bank types that deferral measures had no perceptible influence on the risk-taking behaviour of traders. This is illustrated by a quote from trader 11 (type A bank):

> I'm not thinking of my deferred bonus, I'm thinking about making this years' bonus.

This sentiment was echoed by all the traders at both bank types, interviewed for this thesis. They explained that they were subject to deferral measures pre-crisis, and the only change

since then was that the deferral periods were longer. The primary reasons given for not considering their deferred bonus when trading, were that the traders have annual profit targets they need to meet to secure their current year's bonus, and also to retain their jobs. These factors overshadowed any considerations about the effect of their current trading activity on their deferred bonus pot.

Whilst deferrals were found to have no impact in terms of changing risk-taking behaviour, they were found to cause traders to be more concerned about the decisions their senior management teams make: as decisions at senior management level were believed to create the biggest risks to the value of their deferred bonus pots. This can be illustrated by a sample of quotations from the interviews:

> My problem is I am not buying three and five year papers based on my performance. I am buying it based on the management's performance, which, in general, has a very poor track record. In private equity I am happy to get paid in three and five year papers for a fund where I had direct input. (Trader 13, type A bank)

And trader 24, type A bank:

> What I am worried about on Monday morning is... okay, how do I think my senior management is? I told you my interaction with them and the problems that I saw. Are they playing jiggery pokery elsewhere in the firm? I don't know. I couldn't say for sure, but I know from my own interactions they are not averse to it. I am not sure I want to leave my management with 85% of my compensation.

The reality of a deferred bonus for a trader, is that in any typical year, they could have many tranches of a deferred scheme about to vest. On a daily basis, traders make multiple decisions that involve risk-taking, and the results of those decisions might not materialise for several years, are complex, involve many factors, and are often outside their control. This makes it difficult for traders to process all the possible outcomes from a given decision every time they trade. Moreover, as deferred bonuses are linked to the bank's share price, their values are contingent on the performance of the whole bank; which the individual trader has little to no influence over. Thus, traders view this as unjust. So whilst in an experimental setting, such as in the case of Hartmann and Slapničar's (2015) study, where the outcomes of decisions are easier to see, traders are not taking real risks.

6.4.5 Bonus cap

The effectiveness of the bonus cap as a factor for changing behaviour varied between individuals working in the different bank types. In type A banks, where the bonus cap was

found to be ineffective, this was because the banks diluted the effectiveness of the cap: initially by raising fixed salaries, and second by paying role-based allowances, as mentioned by trader 11 (type A bank):

> [N]o-one takes the bonus cap seriously, even the politicians are with us on this one, we get monthly allowances, other banks do their own thing, but it's not enforced.

As discussed in section 6.2, the UK Treasury issued a legal challenge in the European courts to get the CRD IV bonus cap dismissed, but it failed. Therefore, it is not surprising that the banks blatantly flouted the bonus cap, as it appeared they had implicit support from the UK government and UK regulators to do so.

In the type B banks, where the CRD IV bonus cap was used more widely, a change in behaviour was observed, but it was not directly related to risk-taking behaviour, more a change in motivation. Traders whose bonuses were capped reported they had no desire to take on extra risk, as they did not see any benefits from, or any upside to risk reflected in their bonuses. It is a trader's job to take risk and the risk reduction observed in the type B banks as a result of the bonus cap could denote a change in motivation to perform; as explained by Bonner and Sprinkle (2002), who claimed that linking monetary incentives to performance metrics results in greater employee effort. The traders explained that when they had met their annual profit targets they would then not do anything that could jeopardise them. In contrast, if they had not yet met their annual profit targets, then they would not take additional risk to meet them, for fear of losing their jobs. This sentiment is best illustrated in answer to the question: '*If you have already met your annual profit target would you try to surpass it?*' Trader 9 (type B bank), answered:

> I wouldn't see the benefit in my bonus, so no.

In the type B banks where the bonus cap was enforced more widely than at the type A banks, some additional unintended consequences were observed: such as demoralised employees who might not then be as productive as they ought to be:

> There is no incentive to work hard and produce more and that is really unproductive and not good for the long-term health of the bank. (Trader 12, type B bank)

And, trader 19:

> [W]here now no-one has got any incentive to do any work because they're getting these huge salaries and really they're foregoing 10%, 20% of what they might be able to maximise. But if you've already got 80% in the bank: "Yes, I'll take that, I'll just leave at six o'clock." That is why productivity has gone through the floor.

> Admittedly there are other reasons and criticisms out there but I personally think it's a massive shame. If you were running your own business, that's how you'd do it, surely. That's how you'd do it.

The bonus cap, when implemented as intended, was found to be the most successful measure changing the behaviour of traders in type B banks, but it did not necessarily function as intended. When the cap was circumvented, as in the type A banks, traders continued to take additional risks, and were rewarded for doing so. As reported in Hartmann and Slapničar's (2015) study, data from this thesis alludes to the fact that uncapped pay-per-performance systems encourage risk-taking by traders in the financial services sector. When there was no cap on the level of the bonuses they received for taking extra risk, traders continued to take additional risk and receive rewards for doing so, yet when the cap was in place, they had no desire to take extra risks, as they did not see the upside of that risk reflected in their bonuses. However, as explained above, the use of the bonus cap as a measure to change risk-taking was not consequence free. In banks where the cap was effective, risk *reduction* was evident. For traders, risk-taking is essential to economic reward; how best to balance those risks by protecting the long term health of companies is the real challenge. As discussed earlier in the chapter, an additional unintended consequence, where the cap was more in use, was that they reported an exodus of star performers to other banks or hedge funds where the cap was not applied, or only loosely applied.

In order for banks to be able to award the maximum of 200% of fixed pay as a bonus, they first required shareholder approval. The Head of Corporate Governance at an asset management firm was a large shareholder at some of these banks, and the researcher asked him what he was looking for from the banks to approve this maximum, and if he had ever turned a bank down. He responded:

> Most of the banks came to me to get the shareholder 200% approval… We approved this for all banks, mainly it was to give them the flexibility, and 100% seemed a tight rope… we wanted to give them the flexibility to do their jobs. We were going to analyse them after the event on what the returns were, and what kind of risk-taking tolerances they had. But as a shareholder who wants them to make returns, we didn't want anything to put them at a disadvantage to others, and of course their first argument was that, because this didn't affect every bank, because it was a European wide thing, and they all came with that argument that they would be ham strung versus US investment banks.

6.4.6 Clawback clauses

Twenty-two of the twenty-six traders interviewed categorically stated that the clawback clauses had no impact on their risk-taking behaviour. The excerpt below is from an email received shortly after an interview with trader 1 (type A, bank); the researcher had spent two hours speaking to him about the new incentive measures:

> As it happens, when my colleague interrupted us, it was because he needed me to price some decent sized risk, and I can honestly report that "clawback" never entered my mind once! There you go - nothing like a real time example.

Similarly, when discussing the impact of clawbacks on the risk-taking behaviour of his team, trader 3 (type A bank) stated:

> [W]ithout a shadow of a doubt they won't be worrying about clawback.

This sentiment was confirmed by trader 13, (type A bank):

> So, all of my stock that's given to me now is subject to, like, a ten-year claw-back. Now, I don't think that changes anyone's behaviour, it just makes people feel uncomfortable. I cannot see how that sub-clause is going to fundamentally change the way people think on a day-by-day basis. It's too long-winded. The regulators say it's got to have a long reach back in time, to look at misdemeanours, with hindsight, but if we all had hindsight, we wouldn't have done the trade in the first place. So, I think, when you say, "Does it affect behaviour?" I think it can't do, because no one understands what it is that they were trying to capture.

However, other claimed that clawback does to some degree impact risk-taking behaviour, stating:

> [I]f you know there's a clawback, it just makes you stop and think. A diligent person works hard to make sure the deal is done the right way in the first place, and there are sets of circumstances that you can't predict, but a clawback, when you know you're doing those… a clawback focuses the mind to be fair. (Trader 18, type B bank)

> I think some traders would look at some things differently or might look at doing different deals, or not doing certain deals because of the potential risk. (of clawback) (Trader 8, type B bank)

The majority of the interviewees claimed clawback clauses had no impact on their risk-taking behaviour. This can be explained by the fact that since the crisis, and as a direct result of the bonus cap, banks have increased their fixed salaries, paid less variable pay, and also introduced role-based allowances, as trader 14 (type B bank) put it:

> Because most of us are getting paid high fixed salaries; deferral is not really an issue anymore: there's no clawback on salary.

The focus on compliance with risk metrics at some banks also played a significant role in changing traders' risk-taking. When discussing with trader 14 (type B bank) if the clawback clause had prompted him to change his risk-taking behaviour, he answered:

> Yes, plus all the other regulations that are put in place, compliance is the biggest thing making people take less risk, not the Remuneration Code.

Similarly, trader 6, stated:

> The improvements in control functions like credit and market risk are the biggest angle stopping traders taking risk, not deferrals or clawback.

A consensus amongst those interviewed was that deferrals and clawback only serve to create an element of mistrust and fear. This is illustrated by a quotation from trader 24 (type A bank):

> If anything it just undermines trust and confidence and therefore affects – if it does affect anything, it affects everything in unknown ways.

Three type B bank traders reported that malus had been applied to the group level bonus pot, which resulted in them receiving a substantially reduced bonus. They found this demotivating, arguing that it did not matter how hard they worked or what results they produced as they were not rewarded. The Head of Corporate Governance agreed with this sentiment, arguing that clawback at group level '*[H]inders, not helps performance*'.

This researcher finds that the usefulness of the clawback clause as a measure to change risk-taking behaviour has proved largely ineffective at the majority of banks studied. This is for similar reasons to those negating the potential benefits of the deferrals measure; i.e. that when trading day to day, traders are focused on improving the current year's results without little concern for long term clawback measures. As is the case with the bonus cap, an unintended consequence of the clawback controls, when applied at a group level, is that they demotivate employees. Furthermore, as previously explained, all the traders interviewed believed they were trading with integrity pre-crisis, and so continue to trade with integrity post-crisis. What the clawback clause has achieved, is to appease the public's concerns about bankers' bonuses, showing that the regulators have taken some steps to avert another crisis. The Head of Corporate Governance claimed clawback is useful because:

> [A]s a shareholder, knowing that clawback has been used gives me confidence that the firm has got their culture right.

From informal conversations with MRTs in 2017, clawback is increasingly being used by both bank types, and thus the success of it as a measure to prevent 'excessive' risk-taking might have changed since the interviews for this thesis took place. A possible explanation for the recent increase in use of the clawback measures in banks is the introduction of the 'Senior Managers Regime' (SMR), which came into effect in March 2016. This will be discussed in more detail in Chapter 7; briefly, the SMR holds senior management personally accountable for any misconduct within their line of responsibility, including enforcement of sanctions for misdeeds.

As evidenced above, the success of a reward and compensation control is dependent upon the circumstances under which it is implemented. As discussed in Chapter 2, researching individual controls in isolation from other controls limits the conclusions that can be drawn from them (Ferreira & Otley, 2009; Grabner & Moers, 2013; Malmi & Brown, 2008; Otley, 1980; Simons, 1995). Malmi and Brown (2008), questioned:

> [W]hether the effectiveness of each control system is dependent on the existing configuration of the package? (p.297)

In the case of this study, it can be suggested that this is indeed the case: the new incentive measures have been more successful at changing the risk-taking behaviour of traders in type B banks, rather than those of type A bank traders; as changes in incentive and reward controls were reinforced by changes in the banks' risk profile, cultural controls, and cybernetic controls (targets and feedback). In the type A banks, despite board members' assertions about performance related pay being linked to risk metrics, the new measures proved ineffective because alterations to the incentive and reward controls were not complemented by parallel changes in risk cultural controls, nor cybernetic controls. Had the thesis only examined the impact of incentives and rewards on the risk-taking behaviour of traders, without exploring what else was going on within the banks, reward and incentive controls would have been judged largely ineffective. However, an alternative conclusion is offered: i.e. that the incentive and reward control is effective in type B banks, but not in type A banks, because it is "misaligned with other elements of the control package", and it is that misalignment that needs to be addressed (Malmi & Brown, 2008, p.297).

Although it is difficult to compare Hartmann and Slapničar's (2015) experimental study with this qualitative study, it is the only study to date to have examined the new controls mechanisms from a risk-taking perspective, and as such will be used here for comparison

purposes. This thesis found that similar to the high variance bonus scheme mentioned in the Hartmann and Slapničar (2015) study, the risk of a negative bonus (in the form of a clawback) is negated when there is no cap on bonuses, as was the case for the type A bank traders in this thesis. Interestingly, the opposite was found to be true in the four instances at the type B banks, where the bonus cap was more of a reality for MRTs, similar to the low variance bonus scheme in the Hartmann and Slapničar's (2015) study. In contrast with Hartmann and Slapničar's (2015) study, however, this thesis found deferrals had no impact on the risk-taking behaviour of the traders in either bank type.

6.4.7 Overall controls

Interviewees working in the control functions were asked if they had observed a change in traders' risk-taking behaviour since the introduction of the Remuneration Code and the CRD IV bonus cap. Whilst the responses regarding the type A banks' control functions were mixed: most arguing no real change had been observed, the responses from the control functions at type B banks was overwhelmingly positive in terms of observing behavioural differences. However, they could not state with certainty that this was a result of the Remuneration Code and the CRD IV bonus cap. The Head of Product Control (type B bank) explained:

> I think there's a definite change in traders' behaviour, but how much of that is because its incentive driven or regulatory driven is very difficult to determine, because since 2009 there's been a huge change in the regulatory environment, as you know. Not only have the rules changed locally, so you have increased regulation around asset usage, you're seeing traders change as a result of the environment. A big one recently is the Volcker regulation, which really tells banks what they can and can't do. I think a big thing that I've seen from my years at [my bank], over 12 years now, is a genuine focus on client-driven revenues as opposed to prop[53] trading. Because of that, businesses have had to change their business models.

The Head of Corporate Governance when asked: '*Have you observed any change in behaviour in the banks since the introduction of these regulations on remuneration?*' responded:

> It's very difficult for someone like me to say where the behaviour has changed… But definitely there's been a culture shift in the management of banks… I think the clawback mechanisms and deferment periods have definitely made people think slightly differently.

[53] Proprietary trading

Furthermore when was asked what factors he believes drive the risk-taking behaviour of traders, he replied:

> I don't think you can say it's 100% just pay, but I do think that if they believe the company is going to pay them based on certain behaviours, then that's what you'll see... If you tell someone that they will be promoted if you hit P&L targets…, then that will drive people's behaviour. If you think you may lose your job, not just that your bonus will be cut, because you're taking too much risk and putting the banks reputation at risk, then you will also change your behaviour. If you think they are only paying lip service to it, which some banks in the last 8 years have, then you will ignore it completely and get on with what really drives it.

Further examples of the change of behaviour observed in type B banks were discussed in section 6.3.

6.4.8 Summary of main findings from RQ3

The notion of 'excessive' risk-taking for MRTs is subjective and conceptually fuzzy; with a very fine line between what is considered normal risk-taking and 'excessive' risk-taking; this line is not usually defined until after the event. Thus, as the term 'excessive' cannot be quantified, the researcher could not state unequivocally whether or not the incentive controls reduced 'excessive' risk-taking. Therefore, steps were taken to assess whether there has been a change in risk-taking behaviour pre- and post-crisis as a result of the new incentive controls.

In summary, it was found that the new incentive measures have produced mixed results in terms of their effectiveness at the different banks. In the type A banks, it was found that the new package of controls appeared to have had no effect on changing risk-taking behaviour, whereas in type B banks, a change in behaviour was observed. However, the change in behaviour observed in type B banks as a result of the new controls centred on risk *reduction*, and a change in motivation to perform. Additionally, some unintended consequences of the new controls were observed in type B banks: an exodus of top performers.

In terms of individual controls, the findings indicate that bonus deferrals have no impact on risk-taking behaviour, with the effects of the CDR IV bonus cap and clawback control being contingent upon the circumstances under which they were implemented. If clawback controls and the CRD IV bonus cap were implemented as intended, and alongside a strong risk culture, they then had an increased chance of changing behaviour, as evidenced in type B banks. Whereas, when implemented in banks with a weak risk culture, they were found to be ineffective at changing behaviour. It is concluded from these findings that the

new controls were effective in one bank type but not the other, because they were aligned with other controls in the package of controls. In contrast, where new controls were found to be ineffective, it was because they were "misaligned with other elements of the control package" (Malmi & Brown, 2008, p.297). Thus, it has been argued that the use of monetary controls alone is not sufficient to change the risk-taking behaviour of MRTs.

6.5 Chapter summary and conclusion

Chapter 6 presented the findings in this thesis based on a qualitative field study. The starting point of the research project was to explore whether a link between the new incentives controls and risk-taking behaviour could be observed; no such link was found; instead it emerged that the risk culture in the organisation, specifically the 'tone at the top', was a determinant of how individuals responded to and complied with the new controls. From an institutional perspective, these cultural differences extended beyond the individual level, right through to the bank level. Although all the banks in the study operated in the same overall institutional environment, and were subject to the same institutional pressures, they faced different challenges, and as such, congruent with the findings from the institutional literature and specifically Oliver's model (1991) their responses to these pressures were decidedly different. As evidenced by the type A banks in this study, and as found by Oliver (1991) and others (Etherington & Richardson, 1994; Scott, 2014) organisations do not necessarily change their structures and control systems in the face of institutional pressures. In relation to each of these research questions, the results revealed the following:

RQ1: What were the banks' responses to the new control mechanisms?

The banks fiercely resisted the new controls mechanisms, as they threatened their core normative values. The most contentious issue for the banks was the CRD IV bonus cap. Such was the level of resistance to the CRD IV bonus cap that the banks attempted to influence their institutional environment with threats to leave the UK if they were unsuccessful. This 'threat' prompted the Chancellor of the Exchequer to issue a legal challenge to the CRD IV bonus cap in the European Court of Justice; this challenge failed. When the banks were defeated in their quest to change the regulations they introduced monthly allowances to circumvent the CRD IV bonus cap. This circumvention was implicitly accepted by the UK PRA.

A split in the data was observed regarding the different banks' reactions to the new regulations. This difference was attributed to banks having a change in leadership due to government bailouts during the crisis or large scandals at the bank. The most notable difference between the bank types related to what the researcher described as their 'risk culture', with type A banks displaying signs of a weak risk culture, and type B banks displaying signs of a strong risk culture. How these new regulations were implemented at bank level played a key role in determining how they were perceived and accepted by individual traders, and thus influenced their effectiveness as a factor changing risk-taking behaviour.

RQ2: What can be theoretically observed about the banks' responses to the new control mechanisms?

The findings indicated that the institutional pressures played a significant role in determining how the different bank types responded to and implemented the new control mechanisms, with type A and B banks' responses differing considerably. Both bank types used the non-confirming responses of *avoid* and *defy* to evade the institutional pressures they were facing. The tactic of *conceal* was used to disguise non-conformity with the CRD IV bonus cap: both bank types *loosely coupling* their formal structures from their actual work, and *ceremonially* the rules of the CRD IV bonus cap rule. This *ceremonial* conformity was also accepted as evidenced in the type A banks' response to the Remuneration Code. *Mimetic* processes were also observed in this study with both bank types introducing monthly allowances without regard for their effectiveness, or potential repercussions for their use.

From a contingency theory perspective, the banks' reactions to the incentive measures are unsurprising. A universally designed performance system forced upon the banks fails to take into account their individual circumstances. Thus, if the banks had not reacted and adapted the system to their individual circumstances, then this could potentially have resulted in a weaker financial performance.

RQ3: Did the new control mechanisms change traders' risk-taking behaviour?

This thesis highlights the issues encountered when using incentive controls as standalone tools to manage traders' risk-taking behaviour. In summary, it was found that bonus deferrals and the bonus caps had no perceptible impact on the risk-taking behaviour of traders, and that clawback provisions had a negligible impact. For traders working in type

B banks, the new incentive controls, together with the promotion of a strong risk culture by senior management teams appeared to have changed risk-taking behaviour to some extent, but more importantly the attitudes of traders towards the risk and the control functions at these banks is significantly better than that observed at type A banks. It is was found that the effectiveness of the new controls measures were contingent on the circumstances in which they were implemented, with the banks' risk culture and specifically the 'tone at the top' playing a key role in how individuals perceived and responded to the new controls. The most important factor reducing the propensity of traders to engage in 'excessive' risk-taking is the commitment of senior management to a strong risk culture, not the Remuneration Code or the CRD IV bonus cap.

An additional finding, from the actors' perspectives at least, was that there is a fine line between what is considered 'excessive' risk-taking and healthy risk-taking: 'excessive' is usually only classified as such in hindsight.

It was concluded from these findings that new incentive and reward controls were effective at type B banks because they have been aligned with other controls in packages of controls. In contrast with type A banks, the new incentive and reward controls were found to be ineffective, because they were "misaligned with other elements of the control package" (Malmi & Brown, 2008, p.297). Therefore, using monetary controls as a standalone tool to change the risk-taking behaviour of MRTs is ineffective.

This thesis uses a MRT approach to provide arguments from both the institutional literature and management control systems literature. It is evident from the findings above that the new controls measures had no perceptible impact from the actors' viewpoint in terms of changing the risk-taking behaviour of MRTs. At no point throughout any of the interviews with the many actors involved in the thesis, did any of them give even the slightest hint that their compensation structure had any bearing on risk-taking behaviour. That is not to say that it does not feature somewhere in their thought process, but it was certainly not a visible driving force. Many other factors were mentioned, such as emotions, competition, maintaining client relationships, market place and management expectations, but not compensation. Could it be argued then that using compensation regulations as a means to exercise control over something as subjective and individual as risk-taking behaviour might be a wasted effort? Broadbent *et al.* (2001), in their study of general practitioners' (GP) practices, found that using accounting and financial means as a way to

control behaviour is a fruitless task, because similar to the context of this thesis, the changes implemented were incompatible with interpretive schemes, and as such GP practices found ways to avoid these changes to protect their normative values.

Chapter 7 will present the discussions in this study, and suggest the design of an enhanced PMS, helping to rectify some of the issues highlighted in this chapter.

7. DISCUSSION

7.1 Introduction

The overarching research question posed in this thesis was:

> What were the banks' responses to the new control mechanisms, and have the new control mechanisms changed the risk-taking behaviour of traders in the UK financial services sector? If so, how and why?

In answer to this question, the primary conclusion drawn from the data was that the newly introduced incentive controls were enforced to varying degrees in different banks, and that overall they have resulted in little being done to change the risk-taking behaviour of traders. Instead, there have been some observable and unintended consequences arising from the introduction of these controls, namely diminished effort and low motivation of traders working at type B banks, evidenced as a result of the bonus cap and the malus application at group level. Whilst the new control mechanisms themselves have been largely unsuccessful at changing the traders' risk-taking behaviour, the interviews reveal the important role of risk culture in shaping traders' attitudes towards risk and the associated control functions (use of the new mechanisms being an important indicator of a bank's risk culture and thus its risk control profile). This finding is congruent with Otley's (2016) observation that culture has a '*[S]ignificant influence on the attitudes and behaviour within an organisation*' (p.12).

As discussed in Chapter 5, the stated aim of the Remuneration Code and the CRD IV bonus cap was to curb 'excessive' risk-taking, or to control it within appropriate limits, rather than to reduce it. As evidenced by the type B banks, their compliance with the Remuneration Code and the CRD IV bonus cap went in conjunction with overall bank risk reduction. Additionally, the Remuneration Code and the CRD IV bonus cap used incentives as a means to attempt to control risk-taking behaviour; however as evidenced in this study, the use of incentives as a standalone tool to control risk-taking proved ineffective, especially where the incentive control was not aligned with other controls included in the package of controls. In this study, an important control proved to be the risk cultural control.

From an institutional perspective, the banks' responses to the new control mechanisms could have been anticipated. As predicted by Oliver's (1991) typology of strategic

responses to institutional processes, the banks firstly challenged those parts of the new control mechanisms that threatened their autonomy, and after that challenge proved to be unsuccessful, they ceremonially conformed to the new control mechanisms to ensure their legitimacy and survival (as suggested by Meyer and Rowan (1977)). For this ceremonial conformity to take place, the banks' formal procedures were decoupled from their actual work practices. As suggested by Oliver's (1991) typology, not all banks in the study responded in the same way to the new control mechanisms, as their responses were influenced by their individual strategic objectives. As evidenced by the type A banks in this study, the new control mechanisms threatened their core normative values, such as the desire for a high performance culture; as such they were never complied with wholeheartedly. This lack of compliance was transmitted down from top bank level, through to individual traders, making the new control mechanisms redundant as a means of shaping traders' risk-taking behaviour. Congruent with the findings from the Broadbent *et al.*'*s* (2001) study, which discussed the use of financial incentives/disincentives to change behaviour that conflicted with core normative values, regulation failed with regard to *type A* banks.

Viewing the new incentive controls from an institutional perspective, it could be argued that even though the incentive controls threatened the banks' core normative values, through the process of normative isomorphism, the banks accepted and applied these the new controls, because that is what the public and the regulators demanded of them. In so doing they increased their legitimacy, and thus their prospects for survival. However, as evidenced by the data in this thesis, and with particular reference to the bonus cap, the banks only conformed '*ceremonially*' to this control and circumvented it by paying monthly allowances to staff, thereby allowing operations at the bank to continue as before. On this basis, the researcher argues that institutional isomorphism may provide a better framework for understanding remuneration policies within the financial services sector, rather than simply relying on the economic theories of incentive provision.

From a societal viewpoint, imposing regulations on organisations (such as banks), which are not compatible with their core normative values can be a huge waste of time and resources. A prime example of this in this thesis is the disagreement between both the banks, and the UK and EU regulators regarding the efficacy of the bonus cap as an instrument to change risk-taking behaviour. Before any such changes are imposed they

should be carefully evaluated to assess whether they comply with the core normative values of the organisations, and if not, how this issue will be addressed. This raises the question of why the regulators deemed incentive controls the most appropriate solution to the 2008 financial crisis. Could it be that regulators noted public animosity towards the 'greedy bankers' and joined in with this public witch-hunt as a means to deflect attention from their own failings during the crisis? This is not inconceivable, especially when considering the revelations that came to light in April 2017 regarding the BoE's potential involvement in the Libor[54] rigging scandal of 2008. Transcripts of conversations between a senior employee at Barclays and his Libor handler were released when a Barclays' employee stated:

> [W]e've had some very serious pressure from the UK government and the Bank of England about pushing our Libors lower. (FT, 2017a)

This was not the first allegation against the BoE regarding their role in the Libor rigging scandal: Bob Diamond, the former CEO of Barclays was forced to quit because of the scandal, stated on his departure from the bank, that the BoE were complicit in keeping Libor low (FT, 2017b). The UK treasury responded to this allegation stating that:

> The government is absolutely clear that we must learn from the lessons of the past. That is why, since the financial crisis, we have carried out wholesale reform of how the financial system is regulated in this country, including making the manipulation of LIBOR a criminal offence. We will continue to work with the UK's independent regulators to ensure that our financial sector operates to the highest possible standards. (FT, 2017a)

Aside from deflecting from their own failings, another possible reason the government and regulators focused on bankers' incentives, without any evidence that they were a contributory factor to the crisis, could be politically motivated. Post-crisis, banker 'bashing' was common amongst the public, and it could be argued that political parties wanting to be re-elected could have used this to their advantage. In all other official documents regarding the remuneration regulations, it is stated that their purpose was to reduce excessive risk-taking by controlling the inappropriate incentives that contributed to the crisis. However, in a remuneration report published by the BoE in June 2015, it is

[54] LIBOR is a rate set by 18 of the world's largest banks daily. It is an average rate at which the banks say they can borrow from other banks. It is important as it is used globally as a benchmark for other interest rates against which a large portion of the world's financial transactions are pegged. In 2012, the banks were accused of colluding and falsifying estimates of this rate in order to profit.

hinted at that they were playing to the public's outrage about bankers' bonuses when discussing the needs for banks to maintain a 'social licence':

> Following the financial crisis there was considerable public frustration about remuneration in the banking sector… in order for the markets to maintain their 'social licence' they need to operate in a fair and accountable way, working with the interests of society in mind. In regulating remuneration, the Prudential Regulation Authority (PRA) helps to maintain this social licence: the aim is to better align risk and reward by encouraging good risk management and discouraging excessive risk-taking, including via the deferral of a proportion of variable pay. (BoE, 2015b, p. 325)

To the best of this researcher's knowledge, this is the only official report by the BoE to date that discusses the regulation of bankers' remuneration in a social context. This raises the question: do the policy makers themselves believe that the Remuneration Code and the CRD IV bonus might actually change risk-taking behaviour? Or were these policies introduced purely with the aim of appeasing the public?

The researcher was given the opportunity to question two regulators regarding these and other related questions[55]; however, the meeting took place under Chatham House Rules and the regulators requested no responses be included in the thesis. The Head of Corporate Governance alluded to the social purpose of the remuneration regulations when responding to a question regarding the intention of the Remuneration Code; he stated:

> [T]he reason these regulations were important was that they were trying to raise confidence in the system, banks were just shot to pieces, politicians didn't believe them, shareholders didn't believe them, most people didn't believe them, so anything that was trying to reign it in, even if it wasn't perfect, was a sign that the authorities were trying to take control of such a financially material part of the planet.

The remainder of this chapter is structured as follows: Section 7.2 discusses the findings from the perspective of management control systems theories, sections 7.3 - 7.5 discuss the findings surrounding risk culture and the link between incentives and risk-taking, section 7.6 discusses the use of risk controls in banks' PMSs, section 7.7 discusses ideas for the design of an enhanced PMS for senior management and an enhanced PMS for MRTs working in the financial services sector, and 7.8 discusses further considerations when changing the risk-culture on trading floors.

[55] See Appendix D

7.2 Through the lens of the management control systems theories

The advantage of a qualitative study is that it offers the opportunity to explore not only *what* the impact of the new incentive controls were on risk-taking behaviour, but also *how* and *why* they were effective in some banks and not others. Hartmann and Slapničar's (2015) experimental study on the new incentive controls was useful for exploring *what* effect the new controls might have had on risk-taking behaviour, but was not able to capture any other factors attributable to the results; nor could it assist in providing answers to the question of *whether* the new measures would produce different results in different settings, and if so *why*. The findings from this thesis, utilising the contingency approach to management accounting research helped shed some light on this matter, with the theory positing that a supposed fact is only ever true under certain conditions.

Chenall (2003) argues that there is no such thing as 'contingency theory', but instead a variety of theories that can be used to explain and predict the circumstances under which an MCS will produce increased performance. This study highlighted the perils of focusing narrowly on a single control without consideration of the other controls that comprise the entire package of controls. Had this study just focused on the effectiveness of the new control mechanisms without considering what else was going on in the banks, they would have been deemed to be largely ineffective, without delivering any understanding of why. A further contribution of this thesis to the control systems theories literature, is that it highlights the contingent nature of PMSs. As evidenced by this study, depending on the context of the organisation, the introduction of a universally designed PMS into an organisation can deliver different results for individuals across an organisation, and for individuals in different organisations.

7.3 Senior management commitment to a strong risk culture

The Remuneration Code and the CRD IV bonus cap were introduced ostensibly to protect society from another financial crisis. The regulations were primarily based on the premise that CEOs had previously failed to supervise risk-taking employees appropriately. Thus, the regulators tried to change the risk culture within banks by primarily focusing on incentives. However, the evidence from this thesis suggests it was not the CEO who was at fault, rather it was senior management's own actions/inactions that contributed significantly to the failure to manage risk. Despite the stricter regulations in place for remuneration, banking scandals continue to occur and make news headlines. These events

have alerted the regulators to the fact that focusing their attention on the remuneration of bankers is not a sufficient to ward off another crisis. Therefore, and as will be discussed in more detail in section 7.7.3, in March 2016, the regulators introduced an additional regulation called the 'Senior Managers Regime': this new regime looked beyond solely using incentives as a means to control behaviour. Discussions about the current state of the industry with the Head of Risk Management at one of the type B banks highlighted the differences observed between bailed-out, versus non-bailed-out banks. He noted that:

> If you look, post 2010, it's the non-bailed-out banks that have had the crises. Standard Chartered and HSBC: on the money laundering. Goldman Sachs: on some of its practices in emerging market countries. JPMorgan: Whale crisis. Credit Suisse have some little, mini trader crises. That's the whole point. They haven't acted to clean up their internal culture, so I'm not surprised they're the ones with the crises now.

Whilst the researcher believes that applying performance metrics to regulate the behaviour of risk-taking employees plays an important role in changing the risk culture, it is senior management's commitment to a strong risk culture that is most pertinent factor. Senior management's messages must be reinforced by their actions, as there is little point in senior management professing to put clients at the heart of their business if what they are rewarding them with is sales volumes and profits. Moreover, senior management must be seen to be tough on sanctioning behaviour that does not fit in with their proclaimed philosophies, and rewarding behaviour that does: senior management must 'walk the talk'. As discussed in section 6.1, it is feasible for a bank to have a strong risk culture whilst also having a high-risk appetite; undoubtedly the two are not mutually exclusive.

Following on from the previous discussion, the key to moving from what was described in this thesis as a weak risk culture, to a strong risk culture lies with senior management's commitment to that goal. The thesis finds that it was senior management's attitude to risk that ultimately drove traders' responses to the new incentive controls, and their subsequent attitudes towards the risk and control functions. Ultimately, senior management are responsible for deciding the overall risk culture of the bank; the bank's risk appetite; profit targets; rewards; enforcing compliance with risk and other control functions; and dealing adequately when risk limits are breached. Contrary to popular belief, the data points to the fact that trader behaviour was not the root cause of the financial problems faced by the banks; rather it was the attitudes and behaviour of senior managers who demanded ever better financial performance without taking sufficient interest in how such performance

was being achieved. This pressurised traders to perform and led to significantly increased degrees of risk-taking behaviour that was not observable (or, at least, not formally observed). This behaviour was seen as problematic only when it led to huge losses. Therefore, it is concluded from this finding that that the regulators should have focused their attention more on the actions and conduct of senior management, and specifically their risk appetite, not solely on trader behaviour.

7.4 Measuring risk culture

Power (2011) showed how the 'illusion of control' can result from encouraging a compliance based approach to risk management, where the focus is on formal guidelines and procedures as a means to control. Clearly, measuring the 'success' of a risk culture through a box ticking exercise only is nonsensical. The true measure of the success of a strong risk culture resides in whether or not the risk and control functions believe they have the power and knowledge to effectively challenge the revenue generating staff, and if the revenue generating staff are willing to withdraw from a deal if they believe it conflicts with the values of the bank. As evidenced by the Lim *et al.*'*s* (2017) study, and the findings from this thesis, compliance in some banks is still treated as a box ticking exercise, with the risk management function having no genuine control over the front office income-generating staff.

As previously discussed, the concept of a risk culture is conceptually rather fuzzy. As such, trying to measure it using just simply external quantitative measures would produce meaningless results. However, just because the risk culture itself cannot be easily measured in the traditional quantitative sense, does not mean that the measures of factors that indicate a strong risk culture cannot be identified and measured. As discussed in Chapter 6, there are some measurable indicators that point towards the presence of a strong/weak risk culture in being in operation at the banks. Some of these are qualitative in nature; for example the ability of control functions to effectively challenge front office revenue generating staff. Measurement of these qualitative factors, in conjunction with more readily measurable quantitative factors such as number of control breaches, can and should be undertaken, and staff should be rewarded on the basis of compliance with them, or punished for non-compliance. Examples of how this might work in practice will be explored in section 7.7.

7.5 Incentives and risk-taking

It was the assumption that incentives have the ability to significantly influence risk-taking behaviour that formed the basis of the Remuneration Code and the CRDIV bonus cap, and thus, this thesis. Whilst examining the role that incentives play in influencing risk-taking behaviour was not the primary focus of this thesis, the focus being to explore whether the new incentive controls could influence the risk-taking behaviour of traders, questioning the validity of this assumption is imperative. If was found that if incentives do not influence the risk-taking behaviour of traders to any significant extent, then imposing controls on incentives to change risk-taking behaviour is a meaningless task. However, if it is found that incentives do influence risk-taking behaviour to a significant extent, then the question becomes '*are the right incentive controls in place to moderate this behaviour?*'; this was the focus of this thesis.

Reflecting on the findings from this thesis, and the various academic literature on the topic of risk-taking and incentives, the researcher strongly questions the validity of this assumption for traders and possibly even senior management at financial services firms; this a view that the researcher believes the regulators are now coming to accept, as evidenced by the introduction of the SMR. When discussing with the Head of Corporate Governance, factors that he has observed in his role that drive behaviour, he stated:

> [I]t's always the behaviour of the board and where they wanted to spend their capital, if they were trying to be a top ten bank, then they were trying to be a top ten bank and they would spend a lot of capital to get there, and that was driving behaviour rather than just pay.

The evidence from this thesis instead suggested that incentives are not the primary driving force behind traders' risk-taking behaviour; rather the risk culture, and specifically the 'tone from the top', are more significant driving forces guiding risk-taking behaviour, as evidenced by the effect that the change in leadership at type B banks had on their risk culture. When reflecting on the findings from the Hagendorff *et al.* (2016) study, the researcher also supports their finding that personality has a role to play in influencing risk-taking behaviour; however, in relation to this study, this appears to be more a consequence of the perspective of traders self-selecting high pressured roles that involve a high degree of risk-taking.

Lim *et al*. (2017) argued that the new balanced scorecard type approach to remuneration evident in the banks in their study is of limited effectiveness, because the awards received

for meeting financial targets outweigh the awards received for compliance with non-financial targets. However, whilst agreeing partly with this statement, in terms of the ineffectiveness of the current balanced scorecard type approach to remuneration, the conclusions from this research imply that what is driving the traders' behaviour is not incentives, rather it is the core normative values on the trading floor that are responsible for driving a high performance culture with little regard for how it is achieved. This is evidenced by the type A banks in this thesis, who displayed a weak risk culture. Meanwhile, the type B banks displayed a stronger risk culture, possibly as a result of their core normative values changing in response to a change in tone at the top from their senior managers. Therefore, placing regulatory controls on individuals' compensation as a means to change risk-taking behaviour is ineffective if the core normative values do not support the measures. To address individuals' risk-taking behaviour, a change of tone is needed at the top. The Head of Corporate Governance confirmed the importance of culture and 'tone from the top' as a means of changing behaviour. When asked what he believes can be done to make the industry stronger he replied:

> The banking standards board are trying to look at culture, but again the reason why they're failing is that they have looked at culture but they won't give anyone in the public domain access to that data; it's all anonymous. If we really are trying to go forward, we have to be able to rank banks on which ones are more progressive and which ones aren't. It's very difficult for the underlying public to do that without having access to that data, so I think culture is really important and I don't think just writing nice pieces about their culture, but real examples, and I think diversity is very important too… cognitive thinking, different backgrounds, different university backgrounds, non-university backgrounds and people who are willing to say, "I'm not very comfortable about doing this". That kind of background really sets the tone… if the tone at the top isn't set right, and I see this in media, retail, support services… if the tone at the top says something but does something differently, then everyone else will end up applying that approach as well.

Although further investigation beyond that undertaken for this thesis is required, the researcher suspects, based on the findings presented here and the evidence given by Hagendorff *et al*. (2016), incentives may not be the driving force behind the risk-taking practices of senior management. Rather risk-taking possibly arises from a combination of personality, as argued by Hagendorff *et al*. (2016), and shareholders' demands driving the risk-taking behaviour of senior management.

Chapter 1 of this thesis provided some examples of recent banking scandals where increased risk-taking behaviour and failures were deemed to be incentive driven. However, arguably individuals were not in reality driven by incentives, but were scapegoats

responding to the demands of a high performance culture created by senior management who had little concern about how results were achieved. As senior management's tone is deemed critical as a means of determining the risk-taking behaviour of individual MRTs, the section that follows offers a tentative suggestion for an enhanced PMS to encourage senior management to commit to a strong risk culture.

7.6 Introduction of risk-controls into the PMS

The evidence presented in this thesis exposes the inadequacies of using financial incentives/disincentives as a standalone tool to manage traders' risk-taking behaviour. As this thesis has highlighted, risk culture plays a significant role in changing traders' risk-taking behaviour, and as such, the use of financial incentives as a control tool must be closely aligned with the risk cultural controls in the PMS. In industries that take high levels of risk, risk cultural controls should be a key feature in the suite of management control tools, and as such, should be afforded greater significance in the management control package typology.

For traders working in type B banks, the new incentive controls, together with the promotion of a strong risk culture by the senior management team, appears to have changed risk-taking behaviour to some extent, but more importantly, the attitudes of traders towards risk and the control functions at these banks are significantly better than those observed at type A banks. As mentioned in Chapter 6, the strong risk culture observed in all but one type B bank went hand in hand with overall risk *reduction* at the banks. However, this does not need to be the norm. It is possible to have strong risk controls in place in an environment where there is a high appetite for risk: the two are not mutually exclusive. Section 6.2.2.3 provided indications of features of a strong risk culture that could be employed in any bank, irrespective of their risk appetite.

Chapter 6 discussed how some of the new controls, specifically the bonus cap and group level malus clause, have had undesirable and unintended consequences for traders working in type B banks. Therefore, the issue facing senior management at these banks types is their need to balance their commitment to maintaining the strong risk culture they have created, whilst simultaneously, motivating, promoting and rewarding their employees' superior performance. A starting point on this road could be to remove the bonus cap (when legal to do so) and also to consider the consequences of their policies to apply

malus in groups rather than at the individual level, as this has been seen to be a big factor in traders' motivation.

It would appear from the analysis of data in this thesis that the incentive controls and the risk cultural controls in operation at the type A banks conflict with the strategic objectives they publicly proclaim. The stated objectives of type A bank's strategies was to appease the public and the regulators by reducing inappropriate risk-taking and ensuring staff are rewarded, not just based on what they achieved, but on how they achieve it. However, as can be seen from a sample of the interview data, what type A banks say they are doing, and what they are actually doing is contradictory. The ultimate solution to resolving these contradictory goals lies with the senior management teams at the banks. As the overall controllers of risk culture, risk appetite and business unit profit targets, senior managers play a crucial role in changing risk-taking behaviour. If the profit targets set by senior managers are at such a level that traders believe the only way to achieve them is through taking increased levels of risk, and they are rewarded for doing so, then no deferral or clawback controls will prevent them from taking that risk. It is senior management who are responsible for ensuring realistic performance targets are set, setting 'the tone at the top' and ensuring their nominal systems are working effectively. Whatever they proclaim their strategic objectives to be, must be followed through in the actions they take when rewarding desirable behaviour and by standing tough on behaviours that are not compatible with their strategic objectives, not just financial ones. In order for this to happen, their performance metrics must be closely aligned by delivering the banks' strategic objectives. The practicalities of how this can be put into practice will be discussed in the section that follows.

7.7 Designing an enhanced PMS for MRTs in financial institutions

We are living in an era that demands the radical transformation of the global financial services industry. The 'business as usual' attitude evident in the type A banks is not a sustainable business model; it is a 'business as usual' attitude that extends to how these financial institutions incentivise and reward their employees. Before beginning a conversation about what enhanced PMS looks like for senior managers, the failings of the PMSs applied to MRTs must first be addressed, as the results from these PMSs will inform the proposed newly enhanced PMSs for the senior managers.

The question of what an enhanced PMS looks like for MRTs, is dependent upon what senior management want from their PMSs. As previously discussed, the current PMSs at financial institutions serve a number of purposes: rewarding past performance, motivating future performance, enhancing employee retention, employee rejection[56], attracting new employees, enhancing goal alignment, and changing risk-taking behaviour.

7.7.1 Issues with current PMSs in financial institutions

Before discussing what an enhanced PMS would look like we need to take a step back and discuss primary issues affecting the design of the current PMS in use in financial institutions. A key issue when using the PMS to elicit desired behaviour is the fact that there is no separation (at least according to employees' perception) of the performance and non-performance related incentives awarded. The terms performance related pay and bonuses are often used interchangeably in both the academic and practitioner literature, but they are in fact distinct terms. Performance related pay, in the true sense of the term, is pay awarded for performance that is measurable, and usually the terms of this are agreed in advance. Bonuses on the other hand, are often awarded for a variety of reasons (including performance awards), but those in the investment banking arm of the financial services sector are entirely subjective and discretionary.

As discussed in Chapter 6, another key issue with the use of the current PMS is the fact that in most banks there is little transparency regarding how the bonus amount awarded to an employee is derived. In some, but not all banks, weightings are set for the attainment of financial, business and personal goals. When an employee is informed of the bonus amount awarded to them, they are given a single number with no breakdown about how much of that relates to past performance, retention, compliance with risk-metrics and so on. The only breakdown relates to the composition of their bonus, that is, how much they will receive in cash, the amount to be deferred, and the amount to be put into equity type products.

What the regulators desired when introducing the new remuneration regulations was a PMS that promotes a strong risk culture and sensible risk-taking, and a sustainable high performance culture. As such, two primary aspects of the design of an enhanced PMS were identified: a high performance culture, and one achieved by sensible risk-taking through

[56] A tactic sometimes used by financial institutions in order to encourage an employee to leave of his own accord, is to pay a small or zero bonus.

sustainable means. With these two aspects in mind, and addressing one of the issues identified with the current PMS; i.e. the lack of transparency on how the multiple objectives are rewarded, it is the belief of this researcher that the PMS needs to separate out bonuses awarded for the attainment of performance related tasks from bonuses awarded for non-performance related factors, for example retention purposes. Addressing the other issues identified in relation to the current PMS: transparency, the researcher found lack of transparency in the bonus award process means that the individuals themselves have no clear indication of how their behaviour and performance impacts the level of any bonus they are awarded. With this being the current status quo, the banks cannot truly argue that incentives are used to promote desired behaviour if the individuals themselves are not aware of what behaviours are being rewarded. Society and regulators demand transparency around the operation of financial institutions. Thus, it is necessary to question whether it is so unreasonable for there to be transparency for those individuals who work in these financial institutions with regard to the mechanisms used to reward them? Without this transparency, it is the researcher's belief that using a PMS as a tool to elicit desired behaviour is nonsensical.

Taking a step backwards and looking specifically at the new control mechanisms introduced by the new remuneration regulations, with the primary aim of the new PMS in mind, the next step is to assess whether these newly introduced controls are aligned with the primary aims of the proposed enhanced PMS. Starting with the most controversial newly introduced control: the bonus cap, evidence from this thesis indicates that the bonus cap serves one purpose in terms of changing behaviour, i.e. to halt performance beyond a certain target when employee believes they will not be rewarded beyond that point. Clearly, having demotivated employees is not compatible with the aim of a high performance culture, therefore this needs to be addressed under the new system. Secondly, in terms of the bonus cap's ability to change risk-taking behaviour, this thesis found no evidence to support it. What the evidence did show was that risk reduction had been achieved at type B banks due to risk limits being reduced, but that risk-reduction does not equate to a change in risk-taking behaviour per se. Traders trade as they always did, but now they have a reduced risk limit to trade within and no motivation to perform beyond a certain level. Therefore, as the bonus cap does not assist with achieving the primary aims of the proposed enhanced PMS, then it would be removed under the proposed system. Next, we consider the clawback mechanisms. Currently there are two types in place: malus

and clawback. These were discussed in detail in Chapter 5; to recap: malus is the ability to take back bonuses that have been deferred, and clawback is the ability to take back bonuses already paid. Looking at the evidence from this thesis at the current point in time, little evidence exists to suggest that the clawback mechanisms successfully altered traders' risk-taking behaviour. However, it cannot be concluded from this thesis that they will not become an effective measure in the future: a particular limitation of this thesis was that it took place at a time when clawback was a relatively new and underused tool in the package of controls. The use of clawback as a control measure is being used increasingly: possibly in response to the newly introduced SMR[57], and as such its increased use may in future prove successful as a means of changing risk-taking behaviour.

Before discussing whether clawback controls should be included in the new PMS, we should first look at the issue of deferrals. The evidence from this thesis indicates that deferred bonuses do nothing to change risk-taking behaviour, nor do they promote a high performance culture. Deferred bonuses are useful for staff retention purposes, enforcing the malus clause, and some would argue, also for aligning employees' goals with the long term goals of companies. However, the evidence of the use of deferrals' ability to align employees' goals with the long term goals of the organisation is not conclusive. As previously discussed, at the time of writing, the effectiveness of the malus clause in changing risk-taking behaviour appeared to be slight (N.B. this result is not conclusive given the timing of the research). The use of the malus clause relies on there being a deferred bonus pot from which monies can be clawed back. Therefore, on this basis, deferrals of awards with the malus clause attached to them are included in the design of the enhanced PMS. Similarly, the clawback mechanism is included in the enhanced PMS, but the intention is that it only be enforced for serious employee misconduct, and not risk failure. The final control tool introduced into the current PMS of MRTs, was the requirement to comply with risk metrics. As evidenced by the data from this thesis, true compliance with risk metrics varies considerably depending on which bank type the trader works for. However, even in the banks that did comply with the risk metrics, there is no indication of to what extent this compliance contributed to the amount of bonus awarded; again pointing to a lack of transparency in the award process. In the enhanced PMS for MRTs, compliance with risk metrics will continue as a tool to promote a strong risk culture, albeit in a different arrangement to that used under the current system.

[57] This will be discussed in section 7.7.3

Another observed failing of the current PMS for MRTs relates to the timing of performance evaluations and announcements of the amount of bonus awarded. The result of the performance evaluation, in theory at least, is supposed to feed into the reward system to determine the amount of bonus awarded. However, the evidence collected suggests that at least from the employees' perspective, this link is weak. This could be largely attributable to the fact that performance evaluations often take place months before the bonus amount awarded to the employee is known. As such, employees often find it difficult to align what was discussed in their performance evaluation with the bonus award they receive. Another factor identified in this thesis is that managers often conduct their performance evaluations before the 'bonus pot' amount is known. How much the performance evaluations truly influence the amount of bonus awarded is therefore questionable on this basis, with many interviewees reporting that performance evaluations are simply another 'box ticking exercise for them'. Under the enhanced PMS for MRTs, the performance evaluation process would be expected to take place at the same time as the bonus amount is awarded, and there would be a true link between the two systems. This is key if senior management want to use incentives to elicit the desired behaviour.

7.7.2 What does an enhanced reward system for MRTs look like?

The aim when illustrating what an enhanced reward system might look like is that is should provide a contrast with the extant situation. As discussed above, one of the issues with the current reward subsystem of the PMS in financial institutions is that it operates as a 'catch all' system, with the effect that it fails to do any one thing particularly well. If one of the primary aims of the enhanced PMS is to motivate a high performance culture achieved through sensible and sustainable risk-taking, then it is this researcher's belief that the reward subsystem should be used for rewarding performance only (both financial and non-financial), the use of non-performance related measures being a standalone tool in the PMS. Therefore, focusing on a new performance related reward subsystem for PMS only, the researcher would make the following recommendations:

1. No cap on bonuses.

2. Maintain the deferral and clawback mechanisms, but limit them to individual issues, not group wide.

3. Introduce predetermined transparent weightings on the percentage of bonus awarded for the attainment of both financial and non-financial metrics.

4. Introduce predetermined transparent penalties on the current year's cash bonus for failure to comply with the required control metrics.

5. The bonus amount awarded to be notified in the performance evaluation meeting, with a true link forged between the two systems.

A key feature of an improved PMS is transparency. It should be transparent to the individual how the bonus amount awarded to them was calculated, with the bonus amount being awarded for past performance only. Transparent predetermined weightings against performance criteria should be established to prescribe financial and non-financial targets. Without these predetermined weightings, it cannot be claimed that incentives are used to elicit desired behaviour, as the individuals receiving the awards then have no clear indication of what behaviours are being awarded. These predetermined weightings should be transparent to all the stakeholders at the bank. See table 4 for a practical illustration.

7.7.2.1 Predetermined weighted penalties on current year's bonus

Predetermined weighted penalties are a novel mechanism in the PMS of MRTs conceptualised by the researcher, and thus further clarification is required of the practicalities of their use, and the rationale for why the researcher believes they would be more effective than existing controls for strengthening the risk culture at financial institutions. To give a practical example of how this would work, see table 7 on the next page.

Table 7

Sample Performance Related Incentive Award for year ended 2017

	Weightings	**£**
Total bonus awarded		**500,000**
Financial targets	60%	300,000
Business objectives	30%	150,000
Personal objectives	10%	50,000
Bonus composition		
Deferred stock		250,000
Cash		250,000
Penalties to cash award		
Risk limit breaches	20%	nil
Compliance breaches	10%	**-25,000**
Regulatory breaches	10%	nil
Audit breaches	10%	**-25,000**
Total penalty		**-50,000**
Bonus after penalties		
Cash after penalty		200,000
Deferred		250,000
Bonus awarded for 2017		**450,000**
Malus deduction		**nil**

The rationale for applying immediate penalties to the cash award of MRTs relates to one of the ideas of the original theory used in this thesis: prospect theory. In its simplest form, the theory posits that individuals dislike losses more than they like equivalent gains. Therefore, under the new PMS for MRTs described above, the fact that MRTs are penalised for non-compliance, rather than receiving an equivalent sized reward for compliance, should (in theory at least) make them more aware of the consequences of their non-compliance, ensuring they would be more likely to comply. Furthermore, as will be discussed in detail further on in this chapter, the number of MRTs reprimanded for non-compliance would be recorded and fed into the performance view of senior managers. The results of this feed would be subsequently reported to regulators under the SMR, the rationale for which will become clear in the next section.

In theory at least, the malus and clawback controls in use in the existing PMS should have the same effect as the penalties suggested above. However, as evidenced by the interviews conducted for this thesis, they do not. The researcher believes that this is due to a number of factors. First, the fact that that malus and clawback were reserved for more serious offences, and so were not frequently used. Second, because the clawback would usually be taken from deferred bonuses, which due to long range fluctuating values, causes traders not to think about it on a day to day basis. Additionally, it was reported in the thesis that many felt the value of their deferred bonus was largely beyond their control. Third, compliance with the required risk-metrics offered a reward in the form of a bonus (although an opaque one) for compliance, rather than a penalty for non-compliance. Finally, the issue of transparency, there were no weightings attached to the importance of the risk-metrics when it came to deriving the bonus awarded.

Another key aspect of the enhanced PMS for MRTs is to devote considerable attention to profits made, not just losses, to assess if they were made by taking ‘excessive’ risk-taking, or by not acting in a fiduciary manner towards clients. As discussed in Chapter 6, it was reported that in terms of excessive risk-taking, attention is usually only given to large losses, with little or no attention paid to large profits. This should not be the case, as a large profit could be achieved through excessive risk-taking or by acting in an unethical way towards a client, and therefore should not be rewarded.

With the exception of remunerating the most senior executives at banks, and the additional requirements placed on a defined set of employees’ remuneration by virtue of regulations,

banks usually operate a ‘one-size fits all’ approach when designing and applying PMSs. The researcher would argue that for certain employees, MRTs for example, how they are appraised and awarded needs to be considered differently to those for employees whose roles differ considerably. As Otley (2016) has argued, a ‘one size fits all’ approach to the design and use of PMSs within an organisation is likely to be unsuitable. Following Otley (2016), the researcher argues that the ‘one size fits all’ approach to remunerating bankers is not appropriate. If senior management truly want to use a PMS to change a bank’s risk culture and to influence the risk-taking behaviour of employees, then they need a specifically tailored system to do so.

The recommendations for the enhanced PMS for MRTs detailed above were discussed with two regulators and the Head of Corporate Governance t an asset management firm. The response from the Head of Corporate Governance was overwhelmingly positive in relation to the recommendations. Where our opinion differed was in relation to the removal of the cap on bonuses. He stated that whilst he thinks the current cap is too restrictive, he does not like the fact that banks and other sectors could then pay an unlimited bonus amount. He stated that his firm would vote against any CEO who did not have a limit on their bonus. In addition, he reasoned that whilst he does not believe it is right, the reason why banks would give just one number for a bonus, as opposed to a break down, as shown above, is because it gives people scope to argue about every individual line on their award breakdown. However he stated, that whilst it may be uncomfortable for a manager to have these discussions with their staff, they were discussions that needed to take place if you incentives are to influence behaviour.

7.7.3 Designing an enhanced PMS for senior management of investment banks

As with the discussions detailed above regarding the proposals for an enhanced PMS for MRTs, the assumption of the objectives for the design of the PMS for senior managers remains the same: that a high performance culture is achievable through sensible risk-taking.

As previously mentioned, new rules imposed by the PRA and FCA regarding the conduct of senior management came into force on March 2016. These rules were titled the ‘Senior Managers Regime’ and their aim was to ensure that senior management would be responsible for the cultures in their organisations, thus making them personally responsible for any misconduct falling within their area of responsibility. In summary, the main

intention of the SMR was to give a small number of individuals at the top of the bank statutory responsibility for the actions of those under their supervision, thereby making it easier for banks and regulators to hold these individuals to account. Under the regime, senior managers had to ensure that they were taking reasonable steps to prevent regulatory breaches.

The primary change from the old regulatory regime to the new SMR is one of individual accountability. When regulatory failures had occurred in the past, regulators held the banks to account, whereas now under the new SMR, individual senior managers are held to account. The introduction of the SMR is the first step towards strengthening the risk culture at investment banks. Although in their early stages, and already noticeable from informal conversations with actors in the industry, the number of clawbacks being used since the introduction of the SMR have increased[58]. However, as with many of the regulatory policies aimed at changing behaviour, the SMR is not without flaws. A recent example of a very serious conduct breach by the CEO of Barclays Bank, Jes Staley, highlights a major weakness of the regime. In April 2017, Barclays' board informed the PRA and the FCA of Staley's twice failed in attempts to uncover the identity of an internal whistle blower, despite being informed by the bank's information security team that it should be possible (FT, 2017c). Staley had admitted that the bank's whistle blowing policy was at the core of their culture and values, yet he undermined this policy with his own actions (FT, 2017c). Barclays' Chairman, John McFarlane stated:

> I am personally very disappointed and apologetic that this situation has occurred, particularly as we strive to operate to the highest possible ethical standards. The board takes Barclays' culture and the integrity of its controls extremely seriously. We have investigated this matter fully using an external law firm and we will be commissioning an independent review of Barclays' processes and controls to determine what improvements may be required. (FT, 2017c)

The PRA and FCA as of May 2017, have still failed to state their response on this issue, and Staley is still CEO of Barclays, which undermines the SMR. This was the first real test case for the SMR, and it is this researcher's belief that the regulators have failed at the first hurdle when handling this. If a CEO acting unethically receives no appropriate reprimand from the regulators, then it is not unthinkable to assume that those working below him would emulate his behaviour.

[58] This could be coincidental and there is no evidence to suggest a direct link between the two, however the Head of Corporate Governance informed me that it is his belief that the number of clawbacks have increased as a direct result of the SMR.

The head of corporate governance was questioned regarding his opinion of the SMR, he responded:

> I am under the SMR. I think the goal posts have moved quite aggressively into… 'Guilty before proven innocent' is a very important phrase and I think the SMR goes slightly over that. I slightly worry that you have to prove your innocence, rather than they have to prove your guilt... But do I know that my actions and responsibilities are very important now, I thought they were before but I think we've realised that they are very important and that regulators will be looking at that.

Another observable flaw of the SMR relates to the burden of proof placed on senior managers charged with control failings. In order for senior managers to escape blame for control failings, they need only prove that they took '*reasonable steps*' to prevent them. These reasonable steps are not prescriptive and can include for example: keeping minutes of meetings, and timely responses to issues. In terms of remuneration, the SMR rules are not prescriptive and banks still have the flexibility to determine how to reward or punish senior managers.

Remuneration policies for senior managers are made publicly available in banks' annual reports. On paper at least, the banks purport a holistic balanced scorecard type approach to remunerating their senior managers. However, as Lim *et al.* (2017), and this thesis found, this balanced scorecard type approach is often ineffective for various reasons; the most prominent reason being that financial performance, without due regard to how it is achieved is still in some banks the golden target for senior management. The new SMR does not address this issue effectively. Recommendations are made in the section that follows to strengthen the PMS's capacity to hold senior managers accountable for how their employees achieve financial targets.

7.7.3.1 Extension of the Senior Managers Regime

The SMR represents a good first step towards attempting to shape the risk culture at banks; however as discussed above, it is the belief of this researcher that the regime does not go far enough in attempting to change banks' risk culture: as evidenced by the recent Jes Staley scandal. At the present time, the SMR appears to be a tool for attributing responsibility for large control failings to individuals in a bank, post event. Thus, it is more of a reactive control tool than a proactive control tool. Under the current requirements of the SMR, an individual must be pre-approved of and classified as a senior manager by the PRA. To make the SMR more effective and more proactive, it should consider ways of

addressing and monitoring small day to day control issues before they escalate into big control failings. To strengthen the SMR, it is recommended that each senior manager have built into their performance review, the percentage of risk-metric breaches that have occurred by staff under their line of responsibility. Under the suggested design of the enhanced PMSs for MRTs discussed earlier in this chapter, there is a requirement to record risk-metric breaches. The objective when accounting for risk-metric breaches at the individual level has been to hold senior managers to account. If this were changed, then turning a blind eye to these small breaches would no longer be feasible for senior managers. If the number of accumulated risk-metric breaches undertaken by each senior manager were reported to the PRA, it would then be their responsibility to decide if this individual was fit to continue in their role as a senior manager.

As with the enhanced PMS for MRTs, the recommendations made for MRTs also apply to senior management, with the difference being that in conjunction with senior management receiving a reduced cash bonus for their own risk and control metric failings, they should also have a transparent predetermined penalty levied against their cash award based on the percentage of staff under their line of responsibility failing to meet the defined risk and control metrics.

In addition to senior managers being responsible for the risk and control metric failings of their staff, they should also be held accountable for monitoring any large profits made by individual trading desks, to assess if those profits were made by taking 'excessive' risk-taking, or not acting in a fiduciary manner towards clients. Again, if this is found to be the case, senior management need to act swiftly to ensure such behaviour is reprimanded so it is not repeated.

The rationale behind this level of scrutiny of a senior managers' ability to effectively lead is linked to the idea that they are not solely driven by incentives. As such, the possibility of them not being able to work at such a senior level in any bank in the future due to their control failings would hopefully motivate them to ensure proper control of operations under their supervision.

Understandably, senior managers feel a responsibility to shareholders to achieve exceptional returns; however, given the capacity of a failure in the financial system to create havoc beyond the industry itself, senior managers must be held accountable to all stakeholders and not just shareholders. With the introduction of the SMR, it appears that

the regulators are now recognising that regulating pay is not enough: conduct is a key aspect driving risk-taking behaviour. The use of deferrals and clawback are tools can be used to punish individuals for misdemeanours and appease the public around banks' 'social licence'. However as evidenced by this thesis, such measures will not drastically change risk-taking behaviours. If regulators truly want regulations that can influence the risk-taking behaviours in banks, then they need to focus more on conduct. The UK does not want to be a place where regulatory requirements are so onerous that banks do not want to post their senior executives there, but what they should want is senior executives who come with a proven track record of good conduct. The regulators need to be mindful of the level of regulation that they put in place, and should focus their attention on regulations proven to be effective, removing any that are not. As a starting point, in terms of the proposed enhanced PMS for MRTs and senior management discussed above, the regulators could suggest enhancement as tool to promote good corporate governance in banks, without making this another official requirement that banks need to comply with.

As with the recommendations for the enhanced PMS for MRTs, the recommendations for enhancements to the SMR as detailed above were also discussed with two regulators and the Head of Corporate Governance at an asset management firm. The response from the Head of Corporate Governance was very positive with regard to the recommendations and there were no areas in which a difference of opinion was apparent.

7.8 Further considerations for changing the risk culture on trading floors

As discussed in Chapter 2, factors other than incentives influence risk-taking behaviour; thus, focusing regulations on incentives simply as a means to influence risk-taking behaviour seems rather primitive. Another much debated factor designed to influence risk-taking behaviour on banks' trading floors is the number of females working on them. *If Lehman brothers had been Lehman sisters*…, has been a much discussed topic post-crisis, with Christine Lagarde of the IMF, and the Parliamentary Commission on Banking Standards calling for more women on the trading floor as a means to curb excessive risk-taking:

> The culture on the trading floor is overwhelmingly male. The Government has taken a view on having more women in the boardroom through the review carried out by Lord Davies of Abersoch and his recommendations that FTSE 100 companies increase the number of women directors who serve on their boards. If that is beneficial in the boardroom so it should be on the trading floor. The people

> who work in an industry have an impact on the culture of that industry. More women on the trading floor would be beneficial for banks. (PCBS, 2013, p.365)

Scientific studies exist to support the notion that women are more risk averse than men (Powell & Ansic, 1997); however, these studies look at the average woman and it is highly doubtful that women choosing careers in trading would sit within the average range when it comes to their love of risk. When the question of women being more risk averse than men was posed to a very senior female trader in the study, her response was a firm:

> Women are not risk averse, they are stupidity averse.

She went on to explain that she has observed that her response to risky situations differs to her male colleagues. She gave a scenario where a new piece of data emerges where the outcomes are unknown, and compared to her male counterparts, she believes she can act on and process this from a risk stance quickly, stating:

> Let me take two sides of trading: there is the flow side of trading where you can make that instantaneous decision by yourself, hit or miss. Because there are so few female traders, I think it is very difficult to generalise and really I am the only senior female trader I have ever met so I can only really talk about my success. Let's think about it… If data came in that wasn't in one of my scenarios, that I couldn't adapt into one of those scenarios, there are all sorts of isms always. But if it was a totally new piece of data that you had no idea bout, would I do risk? I do risk pretty quickly, yes. Would a bloke or would he sit on his wrist by the seat of his pants and gut feel probably not. So yes, there was a difference to how I behaved in the instant versus a bloke. Do I consider that being less risk averse? No. Is it more well thought out? Yes.

So whilst she acknowledged that her behaviour in risky situations differs from that of her male counterparts, she did not agree that her approach is more risk averse. Similarly, when the same question was posed to another female trader in this study, her response was a firm:

> I think that's a load of rubbish.

She too went on to explain her rationale for responding in this manner by stating that:

> I don't think women are naturally risk averse or risk-takers. I know women who I would consider to have been excessive risk-takers and I know women who are very risk averse. I would take tonnes of risk in my career in terms of the positions that I used to be responsible for and the amount of risk capital that I used. It was never excessive, but I don't think that's because I was a woman. I think that was just the nature of the business I was in. I can think of men and women who are good and bad risk-takers and risk managers, and it's not about the size of the risk. It's more

> about the way you look at risk, think about risk and think about the return on risk. [A]n actual trader… some idiotic woman who was trying to save $26m a year blew $9bn of the firm's capital. That was a woman, so women can be very bad risk-takers too.

Furthermore, examples supporting policies suggesting having more woman on the trading floor to alter risk culture are not backed up with solid academic or practitioner evidence, although it is what the policy makers are claiming. There is in fact some academic evidence, collected for a study conducted by McAlvanah in 2009, which claims a mix of men and women working together actually increases the likelihood that both sexes risk tolerance will increase. Therefore, we can ask: would an all-female trading floor have a lower risk tolerance than an all-male floor? According to academic studies, probably yes, but a mixed gender trading floor, if the academic evidence is to be believed, is likely to increase the risk tolerance of both genders. As McAlvanah's 2009 study was an experimental study and not conducted with traders, it is this researcher's belief that the conclusions that can be drawn from this study in relation to what actual behaviours occur on a mixed trading floor are limited; therefore, before any concrete conclusions can be reached further investigations are necessary.

The findings discussed in this and the previous chapter contribute to the literature and practices on bonus system design in the financial services sector, and control systems as a package, literature by providing empirical evidence of how cultural controls might influence the effectiveness of reward and compensation controls, and the institutional literature showing how institutionalised an activity remuneration is in the financial services industry. Given the importance of this topic to the industry, global regulators, and society as a whole, it is important that more research be conducted in this area, especially as findings to date show different types of banks are responding to regulations in different ways, thereby impacting the effectiveness of the regulations. It is the belief of this researcher that these findings should be of particular interest to regulators, shareholders, and board members, and that they could usefully impact the strategies employed to implement future regulations on compensation and risk culture.

Chapter 8 will present the conclusion to this thesis with reference to the research questions, whilst also outlining the research's contributions to knowledge.

8. CONCLUSION

8.1 Chapter overview

Chapter 8 discusses the conclusions that can be drawn from this research. First, section 8.2 summarises the findings concerning primary and subsidiary research questions. It also provides theoretically informed explanations to explain the significant differences observed by the banks in this study, with regard to the implementation of the Remuneration Code and the CRD IV. Furthermore, this section identifies the chief institutional factors which have influenced how banks operating in the same institutional environment have responded to and implemented the new controls. Next, section 8.3 discusses the thesis' contributions to the control systems literature, the institutional literature, and risk-taking literature. Section 8.4 discusses the thesis' contribution to knowledge about PMSs in the UK financial services sector. Finally, section 8.5 discusses the limitations of the thesis and explores areas for future research.

8.2 Summary of findings on the research questions and the conclusion of the thesis

The starting point in this thesis was to explore whether the controls put in place using the Remuneration Code and the CRD IV bonus cap could influence the risk-taking behaviour of MRTs (traders) working in the UK financial services sector. In order to achieve this, the researcher interviewed traders directly impacted by these new policies, and the heads of control departments who work alongside them, to shed light on how these new policies were actually playing out in the banks. In addition to exploring the effectiveness of the Remuneration Code and CRD IV bonus cap policies on traders' risk-taking behaviour, the thesis also highlighted the multifaceted and complex institutional and political processes at play concerning the remuneration policies implemented in UK based investment banks post the 2008 financial crisis.

This is a unique piece of work, as no other study has explored the true implications of these policies. Such was the uniqueness of this study that policy makers at the BoE invited the researcher to present her findings and her recommendations from the thesis.

In summary, the research found that the Remuneration Code and the CRD IV bonus cap had little effect in terms of influencing the risk-taking behaviour of traders working in the

UK financial services sector. It revealed that the policies were received and implemented in different ways by various banks across the sector, and that the partial success or failure of some of these policies in changing traders' risk-taking behaviour was a direct result of how they were received and implemented at the overall bank level. A factor crucial in terms of the operation of underlying policies, was the assumption, taken for granted in both academic and practitioner circles, of the ability of incentives to influence the risk-taking behaviour of MRTs; this is questioned by the findings obtained when researching this thesis. This thesis instead suggested that the risk culture, and specifically the tone from the top is a more significant driver of risk-taking behaviour than incentives.

In relation to the specific nuances of the policies, it was found that bonus deferrals and the bonus cap had no perceptible impact on the risk-taking behaviour of traders, and that clawback provisions had a negligible impact. Additionally, it was found that from the actors' perspectives at least, there is a fine line between what is considered 'excessive' risk-taking and healthy risk-taking; 'excessive' was usually only classified as such after the event if a material loss occurred. The thesis also provided empirical evidence showing how risk culture played out on the trading floors in the banks in the study, and found evidence that some banks whose stated policies purported to have (according to the definitions provided in this thesis) a 'strong' risk culture, had, in fact, a 'weak' risk culture, at least on the trading floor. Finally, it was found that in some banks, the balance of power between front office revenue generating staff, and back office control functions was shifting. This is a key finding, as regulators are now starting to realise the importance of an imbalance of power in contributing to bank failures, and other recent studies, Lim *et al*. (2017) for example, find that an imbalance of power remains.

It is concluded from these findings that the effectiveness of the new controls measures are contingent on the circumstances in which they are implemented, with the banks' risk culture, and specifically the 'tone at the top', playing a key role in how individuals perceive and respond to the new controls. The most important factor when reducing the propensity of traders to engage in 'excessive' risk-taking is the commitment of senior management to a strong risk culture, not the Remuneration Code or the CRD IV bonus cap. The primary aim of this thesis was to contribute to a more thorough understanding of the actual consequences of the new incentive controls on the risk-taking behaviour of traders working in UK based banks. As discussed in Chapter 7, the researcher initiated this project based on the taken for granted assumption that incentives were the main driving

force informing the risk-taking behaviour of traders. However, this thesis reveals that incentives are not the root cause of the excessive risk-taking behaviour of traders, rather, it is the desire of senior management to oversee a high performance culture that drives risk-taking. To effectively balance the need for a high performance culture with one achievable through appropriate levels of risk-taking, banks need to implement control functions with the correct power and knowledge to keep the revenue generators in check, supported by a senior management team truly committed to a strong risk culture.

Failures in the financial services industry still have the power to cause turmoil for people in all walks of life across the globe. Several years on from the last crisis, scandals in the financial services industry continue to be a source of controversy and public furore. If banks continue to operate in the same fashion as they did pre-crisis (which appears to be the case for type A banks), then we should not be surprised if we see history repeating itself. Despite tightening the capital requirements of banks, changes to remuneration policies, and the introduction of the SMR, this thesis readily identified the failure of current regulatory policies to change the risk-taking behaviour of traders in UK based banks, further highlighting some of the unintended consequences of such policies. The UK banking sector accounts for a significant proportion of the employment and tax revenues for the UK, and thus the government and regulators must ensure they balance the need to protect the economy with proper support for the sector. Forcing banks to comply with endless policies and regulations that have no benefits to the banks or society overall only results in adding unnecessary costs to the banks' operations and forces some banks to game the system or look for more favourable alternative locations in which to run their operations.

Regulators' obsessive focus on using remuneration as a tool to control banks' risk-taking is masking the real issues at play; i.e. senior management's demands for a high performance culture with little regard for how that performance is achieved. In order to change this attitude, the regulators need to look at ways of ensuring senior management are truly committed to a strong risk culture, not just paying lip service to it. As discussed in Chapter 7, this thesis put forward a recommendation to enhance the SMR by ensuring that senior management are held accountable for the results of the internal systems they implement.

The implications of these findings are crucial for policy makers, banks' boards, shareholders, and designers of PMSs, as they will help them to develop policies that can have a genuine impact by eliciting the desired behaviour from employees and the senior managers at banks. Regulation for regulation's sake is not productive for any stakeholder or bank, or indeed for society. The findings from this thesis suggest that future regulation should focus on conduct, and not incentives as a means to protect society from another crisis.

8.3 The thesis' contribution to risk-taking, controls systems, and institutional literature

This thesis has made several contributions to the institutional literature concerning risk-taking and controls systems. Each of these literature streams will be discussed separately in the section that follows.

8.3.1 Risk-taking literature

The most prominent contribution of this thesis to the risk-taking literature is that is contested the assumption that incentives are a key driver of traders' risk-taking behaviour. As discussed in the Chapters 6 and 7, this thesis found no evidence (academic or practitioner) to validate such an assumption. Rather, what emerged, and another key contribution of this thesis, is the fact that the risk-culture on the trading floor appears to be the more dominant driving force in terms of risk-taking behaviour of traders. Further contributions to the risk-taking literature are provided by the elusive nature of the frequently used term 'excessive' risk-taking. As evidenced by this thesis, even those in the industry, the concept of what 'excessive' risk-taking actually is, is highly subjective and not easily measurable until post event, usually after large losses have occurred. The thesis argued that the same attention should be directed towards large profits as that given to large losses, in order to assess if they were achieved through 'excessive' risk-taking. A further contribution of this thesis to the risk-taking literature is that it provided definitions of factors that indicate a strong and a weak risk culture on trading floors of banks. These definitions may prove helpful to researchers wanting to explore this topic further. The final contribution of this thesis to the risk-taking literature is that it offered empirical evidence showing how the risk-culture is playing out on the trading floors of a number of UK based investment banks, with signs of both weak and strong risk cultures in operation.

8.3.2 Controls system literature

This thesis provided several contributions to the controls systems literature. First, it provided empirical evidence showing the contingent nature of PMSs where different results are found when the same PMS is implemented in different contexts. Second, it provided empirical evidence of the use of risk controls in the PMS of UK based investment banks and how they operate in practice; to the best of the researcher's knowledge, this is the first study of its kind to do so. Third, it provided empirical evidence highlighting the potential dangers that arise when exploring the effectiveness of a single control type without considering the effects of the wider package of controls on observed results. Fourth, it highlighted the increased prominence of a risk-culture as a control mechanism, and constitutes a first step towards understanding the impact of risk cultural controls as measures within an overall package of controls. Fifth, it highlighted the significance of the weak link between the performance evaluation system and the reward system of MRTs. Sixth, it provided empirical evidence detailing the effectiveness of the three new control mechanisms to change the risk-taking behaviour of traders. Finally, it found that in some banks (type A) there remains a critical imbalance of power between the front office revenue generating staff, and the back office control departments responsible for over sight of their activities. However, it found that in the type B banks there was a noticeable shift in power from the front office revenue generating staff, and the back office control functions. This is the first study that shows the changing nature of the power shift observed in the type B banks. This represents an enormous improvement in the risk culture at the type B banks, and is something type A banks should try to emulate.

8.3.3 Institutional literature

This thesis provides a number of contributions to the institutional literature. First, it provides empirical evidence detailing the nature of the institutional pressures faced by the UK financial services industry in relation to their remuneration policies; it also details how institutional pressures can impact the effectiveness of regulations in the sector. Second, it provided an empirical contribution in support of Oliver's (1991) typology, by showing how banks operating in the same environment, and faced with the same institutional pressures, respond differently to those pressures. Furthermore, it provided empirical evidence to explain Oliver's idea of escaping institutional pressures by way of

concealment, the first of its kind in the management accounting literature to do so (to the researcher's knowledge). Third, it provided empirical evidence from the UK financial services sector in support of Meyer and Rowans' (1977) idea that organisations will often comply with *institutionalised myths*, often *ceremonially* to ensure survival. Fourth, a further contribution is that there has been no empirical evidence until now in the accounting literature specifically dealing with the tactics of concealment (as discussed in Oliver's (1991) typology). Fifth, this thesis concluded that incentive provision in the financial services industry in the UK is best viewed through an institutional lens rather than through the lens of economic provision. Sixth, as regulatory changes frequently occur in the financial services industry, the enhanced understanding gained from the results of this thesis on the interactions and responses between the various actors in this industry might usefully assist with the implementation of future regulatory initiatives. Finally, it could be argued that this thesis provides a snap shot of the change process within UK financial institutions.

8.4 Thesis' contribution to knowledge of PMSs in the UK financial services industry

This thesis provided insider knowledge regarding the actual workings of PMSs in the UK financial services industry, beyond that proclaimed in banks' annual reports. It highlighted the fact that the reality of PMSs in the UK banks appears very different to that which is reported externally. The thesis also discussed the flaws in the current PMSs from the actors' view points, and made suggestions for enhancement to the PMSs of both MRTs and senior management under the SMR. These suggested enhancements could provide practitioners and regulators with the necessary tools to address the flaws highlighted in the existing PMS, and fulfil the regulators' request to truly align incentives with risk management.

8.5 Limitations and future research

The findings from this thesis must be interpreted in light of their potential limitations. As explained in Chapter 3, all research paradigms have limitations with the qualitative paradigm, and that chosen for this thesis is no exception. A criticism of qualitative research is its reliance on the subjective interpretations of phenomena by the actors in a study, and the subjective interpretations of the researcher when analysing that data. A further limitation of this thesis is that the findings are a result of interviews with thirty-four

bankers working at ten different banks. Whilst the researcher is confident that the interviews provided adequate data saturation, there is a possibility that interviews with additional banks might have provided further explanations for the observed phenomenon that were not discovered. This is a known limitation of qualitative research. The researcher attempted to address this limitation by discussing her findings with industry experts outside the ten banks in the study: two regulators, two policy makers from the BoE, and the Head of Corporate Governance at a large UK asset management firm.

The aim of this thesis was to provide thick explanations for the study of remuneration practices for MRTs in the UK financial services sector, thereby limiting the generalisability of these findings beyond the UK financial services sector. Furthermore, remuneration in the UK financial services industry is evolving rapidly, due to the fast changing policies imposed by the regulators. Therefore, as the data for the thesis was collected during the period April 2014 - August 2015, the validity of the observations in this research applies to this period only.

At the time of the study, clawback as a control measure had not yet been strictly enforced in type A banks; thus limiting the conclusions that could be drawn regarding its effectiveness as a mechanism to change risk-taking behaviour. As previously discussed in informal conversations with MRTs, clawbacks are being increasingly used in both bank types. Therefore, to help guide future research, it may prove useful to repeat this type of study in a few years' time when more clawbacks have been enforced. Also, it would be interesting for this study to be repeated in a country such as the USA where different policies (one such policy bans proprietary trading) were implemented at investment banks to reduce 'excessive' risk-taking, to assess if their regulatory policies have been more successful in changing risk-taking behaviour, and if so how and why. Additionally, as discussed in Chapter 7, this thesis took as a given, in the initial phase of this project, the idea that incentives influence risk-taking behaviour to a significant extent. However, the evidence presented in this research questions the extent to which incentives do actually influence the risk-taking behaviour of both MRTs and senior management. This is a topic that warrants further detailed investigation, because if it is found that incentives are not the main driving force of MRTs' and senior managements' risk-taking behaviour as suggested herein, then imposing further controls on incentives to change risk-taking behaviour would be nonsensical.

The findings of this thesis provide a substantial contribution to the literature by revealing real world institutional effects of bonus system design in the financial services sector, risk culture and control packages, and so could usefully influence the strategies employed to implement future regulations on compensation and risk management.

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APPENDICES

A Interview questions for pilot study - traders

1. Do you have an annual P&L target?
2. Is it an individual or a team target?
3. Do you have any non-financial metrics? How much weight is placed on them in regard to the bonus you receive?
4. How is compliance with these non-financial metrics measured?
5. Since 2008, have you noticed any changes to your P&L targets?
6. Have you ever been under target in terms of your P&L target?
7. If you are approaching year end and you have not met your P&L target, how do you react?
8. If you have achieved your P&L target prior to year-end, does that influence the way you trade for the remainder of the year?
9. Is your bonus discretionary?
10. What % is your bonus compared with your total compensation?
11. What % of your bonus is deferred and for how long?
12. Are you aware of the PRA's regulations regarding malus and clawback clauses?
13. Do you know of anyone in your company or in your circle that has had their bonus clawed back?
14. Do you believe that the company would ever clawback your bonus?
15. On what grounds do you think your firm would go through with the clawback clause?
16. Do you believe that the decisions you make directly in your day to day role can influence the bank's share price?
17. When trading on a day to day basis, do you think of the implications of those trades on your deferred bonus?
18. When you are trading on a day to day basis, are you concerned about the implications those trades could have in terms of clawback?
19. Does the bonus cap change how you now trade when compared to how you used to trade pre-cap?

20. Are you receiving a monthly allowance?
21. Are there any factors that pressurise you into doing something against your better judgement?
22. What, if any, implications have there been on your trading behaviour due to the Remuneration Code, in your opinion?
23. Do you have plans to leave your existing company or industry, if yes why?

B Interview questions for main study - traders

1. How would you define excessive risk-taking?
2. Do you think it is possible to take excessive risk within your set trading limits?
3. What are the implications for you or your team if you breach your trading limit?
4. Are you aware of the PRA's regulations regarding malus and clawback clauses?
5. Have you noticed any change in the trading behaviour of your colleagues since the introduction of the Remuneration Code?
6. Do you believe that the company would ever clawback your bonus?
7. When trading on a day to day basis, do you think of the implications of those trades on your deferred bonus?
8. When you are trading on a day to day basis, are you concerned about the implications those trades could have in terms of clawback?
9. Does the bonus cap change how you now trade compared to how you used to trade pre-cap?
10. Are there any factors that pressurise you into doing something against your better judgement?
11. Did your compensation/appraisal process change post-2008? If yes, tell me how.
12. How is your own and your team's performance assessed?
13. Are you required to meet any non-financial metrics? If yes, tell me about them.
14. How much weight is placed on meeting non-financial metrics?
15. What is your view of the risk and control functions in your bank?
16. What is your view about the regulators?

C Interview questions for main study - control departments

1. How would you define excessive risk-taking?
2. Do you think it is possible for traders to take excessive risk within their set trading limits?
3. What are the implications for those traders who breach their trading limits?
4. Have you observed any changes in traders' attitudes post-2008?
5. How seriously do you think your department is taken by front office staff?
6. How are top producers treated when they breach the various control measures?
7. In your opinion, how important do you think front office compliance with non-financial metrics are when it comes to deciding on bonuses and promotions?
8. Do you believe the Remuneration Code and bonus cap are effective measures for changing traders' risk-taking behaviour?
9. Have you observed any cultural changes in the bank post-2008?
10. What is your view about the regulators?

D Interview questions for main study – regulators

1. Can you explain the term 'social licence' in reference to remuneration regulations?
2. How were the new regulations constructed? Were they evidence based?
3. Do you have any evidence to show that since the new controls were implemented 'excessive' risk-taking has been reduced?
4. How do you assess whether the controls put in place are working as intended?
5. Policy document X[59] states that remuneration policies in the banking sector were a contributing factor to the crisis because they incentivised excessive risk-taking. What evidence do you have that it was remuneration policies that contributed to the crisis?
6. Prior to implementing these controls, did you have any evidence that they actually work?
7. Let's take deferrals for example, the policy document discusses the 'agency problem' and the use of deferrals to help with that problem, but do you believe this works for individuals below the SMT level, whose individual actions have little influence over the bank's share price?
8. In your opinion, do you believe that these new controls can change risk-taking behaviours, or do you believe they are more of a politically motivated reaction to the crisis?
9. What other factors do you believe drive excessive risk-taking?
10. Post-crisis, and despite the numerous regulations introduced since then, scandals continue to occur in the financial sector: London Whale for example. Why do you think the numerous regulatory change initiatives have not prevented these scandals?
11. Do you believe you have the correct knowledge and resources to effectively monitor these firms? These firms were monitored by the regulators before the crisis, what is different now?
12. Do you have a good relationship with the banks? Do you think they respect you?
13. What about your relationship with the bailed out banks? Any observable differences?
14. With Brexit, what will happen to the CRD IV bonus cap, will the UK keep it?

[59] Kept anonymous to protect the identity of the interviewees.

15. It came to light this week that Barclay's CEO broke conduct rules in relation to whistle blowing under the Senior Managers Regime, how do you think this should be dealt with?

E Interview questions for main study – Head of Corporate Governance

1. Are you familiar with the Remuneration Code and the CRD IV bonus cap? What is your opinion of those policies?
2. Regulations on remuneration have been in place for several years now, do you think they are effective?
3. Do you believe incentives for MRTs drive their risk-taking behaviours? What about the incentives of senior management?
4. Are there any other factors driving risk-taking behaviours?
5. Are you familiar with the SMR? What is your opinion of it?
6. Do you think the regulators have introduced the right controls to change behaviour?
7. In your opinion, what influence do the regulators over changing risk-taking behaviours?
8. What evidence, if any, do you have that these controls are effective?
9. Do you have any dealings with banks that were bailed out during or after the crisis? If yes, have you observed any differences between the behaviour of employees in those banks and the banks who were not bailed out?
10. In your opinion, what do you think is wrong with the industry, and how would you address it?
11. It has been reported in a policy document from the BoE that they believed the imbalance of power between the front office revenue generating staff and back office control functions contributed to the crisis. Do you see any evidence of this imbalance in the banks you deal with?
12. In terms of this 'imbalance of power', do you see any differences in the behaviour of the bailed out versus the non-bailed out banks.
13. 'Risk' culture, is a term frequently used to explain the various failings at banks. What do you think risk culture is, and in your opinion, are there features that can distinguish between a strong and weak risk culture in operation at a bank?

14. In your role as a Head of Corporate Governance for a firm who owns shares in many of these banks, how do you assess whether firms' risk appetite is set at the correct level?
15. In your role, you have a say on the remuneration policies of these banks. What factors do you consider when voting to accept or reject banks' proposed remuneration policies?
16. Barclay's CEO, Jes Staley is under investigation for a whistle blowing scandal. How do you think this should have been dealt with?
17. Do you think the failure of the PRA to swiftly address this issue weakens the SMR?

F Details about the interviews

Role	**Duration of interview**	**Length of time in the industry**
Trader 1	1 hr 50 mins	15 years
Trader 2	1 hr	13 years
Trader 3	2 hrs 45 mins	20 years
Trader 4	1 hr 30 mins	12 years
Trader 5	1 hr 30 mins	10 years
Trader 6	2 hrs 50 mins	16 years
Trader 7	1 hr	15 years
Trader 8	1 hr 20 mins	11 years
Trader 9	2 hrs 55 mins	23 years
Trader 10	50 mins	15 years
Trader 11	2 hrs 10 mins	15 years
Trader 12	1 hr 15 mins	12 years
Trader 13	55 mins	14 years
Trader 14	2 hrs 30 mins	15 years
Trader 15	1 hr 15 mins	12 years
Trader 16	1 hr 5 mins	20 years
Trader 17	1 hr 10 mins	20 years
Trader 18	2 hrs 5 mins	16 years
Trader 19	1 hr 20 mins	12 years
Trader 20	1 hr	10 years
Trader 21	1 hr 15 mins	13 years
Trader 22	1 hr 25 mins	19 years
Trader 23	1 hr	15 years
Trader 24	2 hrs 50 mins	20 years
Trader 25	1 hr 20 mins	11 years
Trader 26	1 hr 15 mins	15 years
EMEA Head of Risk Management 1	2 hrs 10 mins	20 years
EMEA Head of Risk Management 2	1 hr 10 mins	16 years
EMEA Head of Risk Management 3	1 hr 30 mins	25 years
EMEA Head of Risk Management 4	1 hr 45 mins	20 years
EMEA Head of Regulation	1 hr 20 mins	15 years
Global Head of Regulation	2 hrs 24 mins	31 years
EMEA Head of Product Control 1	2 hrs 10 mins	22 years
EMEA Head of Product Control 2	1 hr 30 mins	25 years
Partner at accountancy firm	2 hrs 5 mins	25 years
Regulator 1	1 hr 50 mins	10 years

Regulator 2	1 hr	4 years
Head of Corporate Governance at Asset Management Firm	1 hr 40 mins	20 years

G Consent letter for participants

PARTICIPANT CONSENT FORM - INTERVIEWS

- I have read the information sheet relating to this study
- I have had an opportunity to ask questions and discuss this study
- I have received satisfactory answers to all my questions
- I understand that my words may be quoted in the researcher's final PhD thesis, reports, publications and other research outputs, but neither I nor my organisation will be named
- I understand that I am free to withdraw from this study at any time (until such date as this will no longer be possible, which I have been told)
- I agree to take part in this study

Signed (participant)	Date
Name in block capitals	
Signature of researcher	Date

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