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The Risk Management Function in the Financial Sector-

How Independent are Chief Risk Officers in Swedish Banks?

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Abstract

Title: The Risk Management Function in the Financial Sector - How Independent are Chief Risk Officers in Swedish Banks?

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Five key words: Enterprise Risk Management (ERM), Chief Risk Officer (CRO), Risk Management (RM), independence, financial sector.

Purpose: The purpose of this thesis is to measure the level of independence of the CRO function in the four major Swedish banks.

Methodology: By undertaking a deductive reasoning and a qualitative approach, the CROs of the four major Swedish banks have been interviewed. We have constructed a scoring system, based on the publication *Principles for Enhancing Corporate Governance*, published by the Basel Committee on Banking Supervision (BCBS). From this regulation we constructed seven criteria to measure the level of independence in each bank's risk function. The scoring system was supplemented with a scale of the level of independence ranging from zero to twelve points, where a full score of twelve points is required in order for the bank to be considered as having excellent independence in the CRO function.

Theoretical Perspectives: The thesis covers theories around the relationship between risk and return to describe the built-in conflict in the financial sector. Further the centralized approach of ERM is reviewed. Window dressing around ERM is also discussed. Further, publications and guidelines by the BCBS as well as the Swedish "Finansinspektionen" is used as a theoretical ground.

Empirical Foundation: Interviews were completed with the CROs in each of the four major Swedish bank.

Conclusions: Two of the investigated banks have an excellent independence in the CRO-function. One bank has eleven points and is considered as satisfactory, close to excellent. The fourth bank gains five points and shows a weak level of independence in its CRO-function.

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Maria Helmersson Patricia Pålsson

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1. Introduction

The previous and still ongoing turmoil in the economy is a subject relevant all over the world; we are facing a credit crisis. The origin of this crisis is widely debated and of course there are many different perspectives. According to Kashyap, Rajan and Stein (2008) the explanation for the credit crisis in the US is twofold. Firstly, banks have used complex products in an attempt to transfer risks from their balance sheets with the actual outcome of increased risks due to the complex construction of these products. Secondly, they financed these complex products with short-term borrowing, making the banks' balance sheets very dependent on liquidity. The results of this kind of behavior have been proven to cause major consequences; one example is the crash of Lehman Brothers in the US.

In 2008, the historical investment bank Lehman Brothers collapsed, an event sending shocks into the rest of the economy. According to the bibliography about the Lehman Brothers crash, one of the reasons behind the collapse was the amount of risk the investment bank accepted (Williams, 2010). This seems to be in accordance with the theories mentioned above from Kashyap et al. (2008). However, the credit crisis has not restricted its effect only to the US, also in Sweden the financial sector had its victim. In 2010, HQ Bank was forced to file for bankruptcy by the Swedish Supervisory Authority, due to taking on too much risks as well as a lacking risk management (FI.se, *a*).

At the same time, lacking oversight and governance have been proven to be the cause of reporting scandals even in the non-financial sector, such as the collapses of Enron and WorlCom (Rockness and Rockness, 2005). The question lies in whether these events could be avoided with better risk control and risk management (RM)?

According to Lam (2000), events already in the 1990's, such as the collapse of Barings Bank and Confederation Life, have put more focus on RM. The increased focus ascending from these events is one of the reasons to why new ways in controlling risks have been developed. According to Nocco and Stulz (2006), a firm can cope with risks in two ways; a centralized or a decentralized manner. The decentralized approach handles the risks separately and is also called traditional risk management, whereas in the centralized approach the risks of the firm are managed as an entity all together. Further on, this centralized method is called Enterprise Risk Management (ERM) and is taking on

a holistic approach compared to the traditional "silo"-approach.

Appointing a Chief Risk Officer is one step of the process to implement ERM into the corporation (Pagach and Warr 2007). The appointment of a Chief Risk Officer (CRO) is also considered to signal that the corporation takes ERM seriously (Liebenberg and Hoyt, 2003). The CRO should have distinct responsibilities for the RM function within the organization to maintain proper risk handling. (BIS.org, *a*) Therefore, the CRO plays an important role in the RM function within the organization and is of interest to further scrutinize.

This thesis will investigate the CROs of the four Swedish major banks. It is thereby restricted to the financial sector and these four banks' CRO function; the non-financial sector is excluded. The main reason to only explore the financial sector is due its high regulatory pressure. These regulations require certain standards; do the banks fulfill these prerequisites? Also, the financial sector is highly interlinked with the rest of the economy and a lacking RM in the financial sector could therefore also affect the rest of the economy negatively. Furthermore, the outcome of HQ Bank indicates that the issue of financial firms' deficiencies in RM is relevant in Sweden. In this thesis we aim to do an empirical study on the Swedish financial sector. By looking at the four major banks we aim to investigate the organizational structure of ERM. Do the Swedish major banks satisfy the current standards?

One of the most influential regulations in the financial sector is referred to as Basel. Basel is a statutory international framework stated by the Basel Committee on Banking Supervision (BCBS) with objectives of improving the supervision of banks (BIS.org, *a*). Due to the fact that Basel only is a guiding framework, it is in the hands of the Swedish Supervisory Authority (Finansinspektionen, FI) to legislate these frameworks in Sweden (FI.se, *c, d*). According to the BCBS financial firms should have an executive position, a CRO or equivalent, with an overall responsibility of the RM. Furthermore the work of the CRO needs to fulfill certain criteria such as independence, stature, access to the board and adequate documentation. (BCBS, 2010) Because of this regulatory pressure on the financial sector, it is of interest to scrutinize the RM function in Swedish banks further. Is the ERM implementation meeting the requirements of the BCBS or is the CRO just a way to window dress the firm?

2. Problem Definition

> *"A firm faces a built-in conflict between managers and traders who are paid to take risk and the risk managers who are paid to prevent excessive losses from occurring."*
> (Williams 2010, page 50)

The quote above from William's review (2010) of the Lehman Brothers crash clearly captures the essence of the problem of RM facing a financial firm. The problem of RM is based on the conflict explained by William's (2010) derived from the different objectives of the trader and the risk manager (further referred to as the CRO). While traders' main goal is to take on risk to increase the possibility of increased return (also indicating potential losses), the main objective of the CRO is to minimize the risks exposing the firm.

Why is this conflict a problem? The aspect of the trader, aiming to take on more risk to maximize the return, is a necessity for financial firms to earn profit. It is however crucial to remember that the risks are a threat to the organization if not handled correctly and to mitigate this potential danger the firm hires a CRO. In this thesis it is stated that one problem in this conflict is that the CRO who is seeking to optimize the risks exposing the firm could be ignored and neglected in his or her work due to the profit pressure on trading. From this perspective it is reasonable to believe that it might be a problem for the CRO in a financial firm to get enough attention and mandate for his or her work. The goal of the trader to take on more risk is explained by the relationship between risk and return, in accordance with the Modern Portfolio Theory (Ogden, 2003).

According to Diamond and Rajan (2009), banks' risk culture has changed toward a more risk taking behavior. This indicates the relevance of this conflict. The conflict is exacerbated by the incentive system in the financial sector. Traders are premiered when taking on risk and thereby increasing the possibility of profit making for the company, meanwhile the CROs are not premiered for decreasing the level of risk but instead they might lose their jobs in times of increased risk exposure (Williams 2010). This problem is highlighted by the guiding principles from the BCBS (2010), saying that the long-term risks of the banks have increased due to the compensation system.

> *"Banks should have an effective internal controls system and a risk management function (including a chief risk officer or equivalent) with sufficient authority, stature, independence, resources and access to the board."* (Principle 6; BCBS 2010, page 17)

Yet a problem facing banks is the possible lack of independence of the CRO and the RM process. As stated by the quote from the BCBS (2010), the CRO or equivalent must have distinct responsibility for the RM function and should thereby be appointed in larger banks. According to the BCBS (2010) it is of utmost importance to preserve the independence of the CRO. The BCBS further explains (2010) that as an independent CRO, he or she must have direct access on a regularly basis to the board and the committee of risk.

A deficient independence of the CRO may arise from dual hatting. Dual hatting (explained in section 6.2.1.2) refers to the situation where an appointed CRO also inflicts in other responsibilities of the firm, i.e. the CRO would also serve as the CFO or chief auditor. Furthermore, the CRO should not have any financial responsibilities such as operational or revenue-generating functions as it also would conflict with the independence of the CRO. The problem arising from dual hatting might be compromised work due to contradictive goals of different positions. (BCBS, 2010)

The reporting lines of the CRO might be a possible threat against the CRO's independence. The reporting lines of the RM process and the reports by the CRO are covered in the BCBS (2010). If the reporting lines of the CRO are not independent it could amount to compromised work as certain information regarding risks may be lost due to deficiency and dependencies in the reporting lines. The reporting lines of the CRO are an issue also discussed by Culp (2001). According to Culp, there is *"a violation of the independence criterion for a CRO to report to a CFO."* (Culp, 2001, page 235). The reason behind this is the fact that the CFO position is in charge of issues such as interest rate risks, therefore the CFO function has an impact on the risk profile of the corporation. If the CRO reports to the CFO there is a potential situation where the CFO can ignore the risk report and thereby eliminate the independence of the RM function. As stressed by the BCBS, there is a need for independent reporting lines; by adding the description from Culp we see that there is risk of violated independence if the CRO is reporting to the

CFO.

A lacking independence of the CRO can impose negative outcomes on the organization and as an illustration we have the Swedish HQ Bank. HQ Bank showed inadequate means to handle risk and severely broke some of the regulations for Swedish banks stated by the Swedish Supervisory Authority (FI) (FI 2010). According to FI (2010), their inadequacies in trading and a deficient RM combined with taking on too much risk came to jeopardize their survival. Amongst some of the problems was the poorness of their management's handling of risk and one of the gravest problems was the lacking independence in the reporting lines and of the CRO. FI filed for a forced liquidation of HQ Bank as a consequence of their lacking actions in the RM function, which also came to cost them their bank authorization (FI.se, *a*). This failure shows the importance of an independent RM function and is one of the rudiments of this thesis.

Do Swedish banks have the required independence in the CRO function to fulfill the regulations by the BCBS?

3. Statement of Purpose

The purpose of this thesis is to measure the level of independence of the CRO function in the four major Swedish banks.

3.1 Contributions

This thesis aims to study the importance of an independent CRO and we are the first to score the level of independence of the CRO in the four Swedish major banks. Even if the importance of independence is highlighted in the regulations by the BCBS, there is no evidence of how these regulations are complied in reality in organizations. This is where we contribute by investigating how the regulations are realized.

3.2 Target Readers

This thesis is of interest for many different parties. First and foremost, it is relevant for stakeholders of the financial sector; owners, customers, board members and employees. Secondly, due to the important role of the four major banks in the Swedish economy and the interdependence to other sectors, it is of interest for analysts, smaller banks as well as

non-financial firms. Thirdly, it is of interest for academics and researchers of finance in order to research this vital subject more closely and distribute the relevance of the problem in this subject.

4. Literature Review

To fulfill the purpose of this thesis, relevant theories need to be explained. To capture the essence of the built-in conflict described in the problem definition, the relationship between risk and return is used. This is followed up with ERM as a way to handle risks as well as theory regarding window dressing.

4.1 The Relationship Between Risk and Return

In the problem definition it is stated that traders aim to take on more risk, meanwhile CROs aim to minimize it. This is explained by the relationship between risk and return. According to the Modern Portfolio Theory (MPT) investors have an adverse attitude towards risk, meaning they are avoiding risk. In the same time, the MPT states that investors tolerate risk if they are compensated for bearing the risk. Therefore, the MPT says that investors want to maximize their utility function in a combination of risk and expected return. (Ogden, 2003)

By applying this on the situation in financial firms discussed above, a clearer picture can be captured of why traders are willing to maximize risk; they are seeking to maximize return. This is the foundation for the conflict discussed in the problem definition. Traders want to take on more risk to maximize the potential return, an attitude that is in strong conflict with the goal of the CRO who aims to minimize the risk. Understanding the background of this conflict also makes it more obvious why scandals, such as the crash of Lehman Brothers in the US and the crash of HQ Bank in Sweden, have occurred. According to the author of the bibliography about the collapse of HQ Bank, there were strong contradictions between the “risk-hungry” traders and the risk function (Neurath, 2011). More simply put, when there is too much focus on increasing return to maximize profit, there is a possibility that the risk controlling function is undermined.

4.2 Enterprise Risk Management

There are broad theories around ERM and how ERM creates value. This is however beyond the scope of this survey and interested readers are further directed to researchers such as Culp (2001). This study takes on an organizational perspective where focus is upon the centralization of RM and risk ownership.

4.2.1 Centralized vs. Decentralized Approach

In the traditional RM approach each risk is considered as a stand-alone risk, whereas in the ERM approach the risks are viewed together in an integrated framework. Therefore RM is considered as a decentralized way to handle risk, in contrast to ERM that is considered as a centralized approach. (Nocco and Stulz, 2006) Another way to interpret the traditional RM is that risks are handled by a silo-approach (Lam, 2000). In the decentralized approach, risks were handled in the different units of the organization where they actually arose. For example, the business managers were responsible for their units' business risks. Further on the credit unit was responsible for credit risk and trading managers were responsible for risks associated with trading. This decentralized approach has been proven to be ineffective, explained by the linkage between all different risks of the organization; risks cannot be handled isolated. (Lam, 2000)

The importance of a centralized approach is even greater in the financial sector, due to its built-in conflict stated in the problem definition. If the risk-hungry traders in the trading unit are supposed to handle the risks themselves, we can question its outcome since this unit wants to maximize risks. To illustrate this we can look at HQ Bank where the trading unit overvalued its trading portfolio with hundreds of millions SEK, affecting the overall risk profile (Neurath, 2011). The consequences of this behavior forced the bank to liquidation, as discussed before.

Another aspect of the centralized approach involves the entire organization. The centralized approach is thereby supposed to involve the entire board as well as senior management. This involvement generates a higher attention towards the risk function of the organization.

4.2.2 Risk Ownership

The importance of one specific person being responsible for an organization's risk is well established in ERM theories. Therefore, the appointment of a CRO is a way for corporations to signal the commitment to implement ERM. (Liebenberg and Hoyt, 2003)

Culp (2001) uses a creative description around risk ownership. He uses a fictive situation when someone collapses in a heart attack in public. It is likely to assume that even if people will gather and try to help, no one will take the actual responsibility of helping out with for example calling the ambulance. The same logic lies behind risk ownership and the appointment of a CRO. The CRO is supposed to be responsible for handling risks in the corporation and have the utmost responsibility to avoid the "heart attack"-situation. (Culp, 2001)

4.3 Window Dressing

As stated before, the appointment of a CRO is considered to be a general signal that the corporation takes ERM seriously. ERM is considered as one way to respond to internal factors such as increase shareholder value. (Liebenberg and Hoyt, 2003) From this, there is a natural incentive for a corporation to appoint a designated CRO. The appointment signals to the market that it has an implemented ERM. Still, there is a possibility that the corporation implements a CRO without fully implementing ERM. One way to do this is by appointing a CRO but not giving this position sufficient mandate required. This indicates that the corporation is window dressing their RM.

Window dressing in the RM function might be a problem due to lacking effects of the CRO function. Therefore, window dressing is a potential threat against the independence of the CRO. For the financial sector, it is even more severe due to the previously discussed linkage between banks and the economy. As discussed in the case of HQ Bank (Neurath, 2011), the position in charge of the RM function did not have enough mandate and the consequences were devastating. This is a good illustration of when a corporation appoints a CRO without the required mandate and therefore a lacking RM function. This is one way for corporations to window dress its RM function and would thereby indicate an ineffective RM function. The theories regarding window dressing is important to consider when evaluating the CRO position as the purpose of this thesis is to

capture the independence in this position.

5. Regulatory Authorities

In this chapter important regulatory authorities as well as their publications are clarified. The BCBS is explored because of the international operational coverage and the fact that they were the first to enlighten the issue around the independence of the CRO. This was revealed and clarified under the turmoil of the crisis of 2007 (BIS.se, *b*). Due to the BCBS´s absent force of law, they cooperate with the legislative authorities in every country. For Sweden this is represented by the Swedish Supervisory Authority, FI, which is why they also are of interest to further explore.

5.1 The Basel Committee on Banking Supervision and its Publications

Throughout this thesis, Basel is referred to as the guiding regulation; therefore it is of importance to elaborate on this subject of theory. The definition of the CRO and the problem around dual hatting is derived from these regulations explained further. Also the importance of an independent RM function and CRO is stressed by the BCBS.

5.1.1 The Founding of the Basel Committee on Banking Supervision and its Authority

The Central Bank Governors of the Group of Ten Countries established the BCBS at the end of 1974 and are currently located in Basel, Switzerland. The Committee generally meets four times per year on a regularly basis, and reports to the Central Bank Governors and Heads of Supervision of its member countries (its oversight body), where they seek their confirmation for major decisions. (BIS.org, *a*) The member countries can be seen in appendix 1.

The decisions and conclusions of the Committee are not intended to have legislative power and they do not have any formal supranational supervisory authority. However, the Committee provides broad supervisory standards and guidelines as well as recommendations applicable and adjustable to every nation's own standards. All nations apply these standards formed to their existing regulations and often apply their law of force i.e. capital requirements for the banking sector. For Sweden the cooperation stands

between the BCBS and FI and through this channel the BCBS influences the Swedish legislation. (BIS.org, *a*)

5.1.2 The Objectives of the Basel Committee on Banking Supervision

As stated by the name of the committee, they provide a forum on the matters of banking supervision. Decisions and issues handled cover a wide range of financial matters. One of the major topics has been to close the gaps in international supervisory coverage with the help of two principles; no foreign banks should escape supervision and the supervision should be adequate. In order to realize this they have issued a series of publications. (BIS.org, *a*)

The purpose of the committee is to improve the comprehension and the importance of banking supervision and develop this issue across countries. To achieve this objective they mediate information and encourage a common understanding of the matter. (BIS.org *a*)

5.1.3 Publications by the Basel Committee on Banking Supervision

The Committee and its oversight body have established a reform program for the banking sector as a response to the financial crisis of 2007. The new global standard derived from this crisis is denoted as Basel III and addresses the firm specific and broader systematic risk. The Basel III regulation is an enhancement of the previous published Basel I and Basel II. (BIS.org, *b*)

The focus for this thesis lies in one of the Committee´s publications, the *Principles for Enhancing Corporate Governance* (BCBS, 2010). This publication covers parts that are directly linked to the purpose of this thesis. As this publication covers a wide range of standards and regulations, emphasis will lie in parts of the publications that are relevant to this thesis.

5.1.4 Principles for Enhancing Corporate Governance by the Basel Committee on Banking Supervision

The publication of the *Principles for Enhancing Corporate Governance* by the BCBS (2010) is intended for banking organizations and was also announced as a response to the financial crisis. It is intended to provide support and assistance to banking supervisors,

and is used as a reference point for encouraging stable corporate governance enforcement in the participating countries by the banking organizations. (BIS.org, *c*)

There is a vital mediation between the bank and the rest of the economy. A weak corporate governance in banks in a combination of taking on too much risk can be transferred into the rest of the economy. The failure of Lehman Brothers is an illustrative example. Due to this important mediation it is relevant to explore this publication as it is intended to minimize this and instead lead to enhanced corporate governance. (BIS.org, *d*) Enhanced corporate governance would thereby lead to less frequent negative outcomes on the economy. The publication is outlined in six fundamental areas:

1. *"The role of the board"*
2. *"The qualifications and composition of the board"*
3. *"The importance of an independent risk management function, including a chief risk officer or equivalent"*
4. *"The importance of monitoring risks on an ongoing firm-wide and individual entity basis"*
5. *"The board's oversight of the compensations systems"*
6. *"The board and senior management's understanding of the bank's operational structure and risks"*

(BIS.org, *e*)

Each fundamental area consists of a set of principles and is placed under each standard according to its relevance. Concentration will be of the third standard; "*The importance of an independent risk management function, including a chief risk officer or equivalent*" as it is directly linked to the purpose of this thesis. In this publication the regulations of this standard are put under principle six. (BCBS, 2010)

> *"Banks should have an effective internal controls system and a risk management function (including a chief risk officer or equivalent) with sufficient authority, stature, independence, resources and access to the board."*
> (Principle 6; BCBS 2010, page 17)

Under this principle there are further eleven regulations explaining how this principle can

be achieved, as displayed in table 1 below. This is derived from the *Principles for Enhancing Corporate Governance* (BCBS, 2010) and is the focus for this research. *Principles for Enhancing Corporate Governance* can be found in appendix 2.

Table 1

The regulations under principle 6 cover following aspects:
The basics of the RM process and how internal control should be designed as well as its importance
The importance of the CRO and its authority, the avoidance of dual hatting and the reporting lines of the CRO
The scope of responsibilities and the importance of the independent CRO and RM function.
The resource and qualification requirements of the RM process

5.2 The Swedish Supervisory Authority, Finansinspektionen (FI)

The Swedish Supervisory Authority "Finansinpektionen" (FI) plays a major role in the Swedish financial sector since it has legislative power. FI also cooperates with the BCBS and is why it is of interest to further explain.

5.2.1 The Founding of the Swedish Supervisory Authority and its Authority

Finansinspektionen (FI) was merged from the two government instruments "The Private Insurance Supervisory Service" and "The Bank Inspection Board" in 1991. FI is a public authority that is answerable to the Ministry of Finance with legislative power in Sweden. Reasons to further scrutinize FI is partly due to its legislative power and its effective monitoring of financial firms. (FI.se, *b*)

To operate in the financial sector a corporation requires a granted permit by FI. FI also has the actual power to withdraw the permission from financial firms to operate in the financial sector as in the case of HQ Bank. For financial reporting by financial companies, FI also conducts in certain rules needed to be followed. (FI.se, *c*)

5.2.2 The Objectives of the Swedish Supervisory Authority

FI's main objective is to endorse stability and efficiency in the financial sector in Sweden as well as engage in efficient consumer protection.

FI supervises and monitors companies active in the Swedish financial sector as well

as analyses ongoing financial trends. Further investigations and monitoring in suspected cases of offences and share price manipulations is also performed by FI, also seen in the case of Swedish HQ Bank. This also includes monitoring of the disclosure of full and clear information to consumers, and for this function to operate correctly. Investigations also cover Swedish companies located in European Union.

FI also has collaboration with international authorities and the cooperation of greatest interest for this thesis is the cooperation between FI and the BCBS. Most of the regulations published by the BCBS are incorporated in Swedish law by FI. (FI.se *c, d*)

5.2.3 Publications by the Swedish Supervisory Authority

As mentioned in the previous section the main objective is to endorse stability and efficiency in the financial sector in Sweden. This is achieved by issuing regulations and guidelines (also known as FFFS) and to evaluate whether the current legislation needs to be improved. These regulations are in compliance with the Swedish law, EU regulations and international regulations. (FI.se, *d*)

The regulations in FFFS cover a wide spectrum for the financial sector and the regulation relevant for this thesis is the 2005:1 (*"General Guidelines regarding governance and control of financial undertakings"*). The 2005:1 focuses on encouraging good quality of governance for financial companies and is intended for financial corporations under supervision, which includes the four major Swedish banks that are scrutinized in this research. FI clarifies how financial firms can achieve high quality governance through these guidelines. This can be considered as a Swedish legislated version of the *Principles for Enhancing Corporate Governance* by the BCBS mediated by FI. (FI.se, *e*)

> *"§ 3 The undertaking should contain a composite function for independent risk control. The function should inform the board of directors, management and other persons who require the information."*
>
> FFS 2005:1 Chapter 4 p.4

The quote above is extracted from the FFFS 2005:1 and states that the RM function of the financial firm should be independent. In contrast to the publication by the BCBS the FFFS 2005:1 does not clarify how the RM function should operate in order to be considered as independent, nor does it cover how the reporting to the board of directors and other management should proceed.

> *"The function should be answerable to the managing director. It may also be situated so that it is answerable to another senior officer who possesses sound knowledge of the undertaking's risks and is directly subordinate to the managing director. Such person shall not, however, be responsible for the day-to-day business operations."*
>
> FFFS 2005:1 Chapter 4 p.4

Further, as can be seen in the quote above, the RM function should be answerable to the managing director, which in the Swedish version of FFFS 2005:1 is explicitly entitled as CEO. This is in line with what is stated in the publication by the BCBS. However the 2005:1 is vague in its description as the RM function also can be answerable to another senior officer, but it is still not further explained in detail how this should be implemented nor the conflicting roles of the CRO and the CFO. This differs from the publication by the BCBS that specifically expresses the attributes of the CRO as well as how an independent RM function should be achieved.

6. Definition of Independence

This thesis relates to certain key terms where description is needed in order to certify a complete overview of the subject. In this chapter descriptions regarding the term independence and the CRO will be made. As this thesis investigates the independence of the CRO it is vital to explain what is aimed with the independence term as well as the attributes required of the CRO.

6.1 Independence

> *"Independence: the fact or state of being independent"*
>
> *"Independent: free from outside control; not subject to another's authority,*
>
> *not influenced by others; impartial"*
>
> Oxford Dictionaries *(oxforddictionaries.com)*

The literal explanation of independence, as stated in Oxford Dictionaries, is highly applicable when referring to the CRO. The words used to describe the state of being independent above is the same words used in the regulations by the BCBS when describing the attributes of the CRO. The dictionary explanation can be interpreted further:

Free from outside control; not subject to another's authority: The CRO has power and resources to handle the organization's risks in the best way possible without external restrictions as well as any contradicting roles of the CRO.

Not influenced by others; impartial: The CRO has power and resources to handle the organization's risk in the best way possible without external or internal intermediates.

The independence in terms of ERM, applied on the CRO, can therefore be summarized as to the extent the CRO has possibilities to actually effect the RM in the organization.

6.2 Definition of the Chief Risk Officer

As mentioned before, the appointment of a CRO is a strong signal of an implementation of ERM (Liebenberg and Hoyt, 2003). James Lam introduced the title CRO in 1993. As a risk manager at GE Capital, Lam was in charge of all aspects of risk facing the firm. The position did not have any title at that time, but influenced by ongoing appointments of many Chief Information Officers Lam introduced the title CRO. When Lam described the tasks incorporated in his work, he mentioned responsibilities of market, credit and operational risks in all functions besides sales and trading. (Lam, 2000)

6.2.1 Attributes to the Chief Risk Officer

Throughout this thesis, the CRO is defined as outlined by the principles of the BCBS (2010) who stresses the importance of the presence of a CRO. The reason to focus on the description made by the BCBS is easily explained by the fact that this authority is an important operator in the financial sector. Since the focus is upon financial firms, it is of importance to consider the effective regulations in this sector.

6.2.1.1 The Importance of Independence in the CRO function

> *"Large banks [...] should have an independent senior executive with distinct responsibility for the risk management function and the institution's comprehensive risk management framework across the entire organisation. [...] the role of the CRO should be distinct from other executive functions and business lines responsibilities, and there generally should be no 'dual hatting'."* (BCBS 2010, page 17-18)

As the quote above states, the BCBS (2010) defines the CRO as a senior executive, who is independent and directly responsible for the comprehensive RM throughout the whole financial organization. The CRO should also be separated from the business line responsibilities and the CRO should not conduct in dual hatting.

The *Principles for Enhancing Corporate Governance* (BCBS, 2010) clearly points out how the independence of the CRO is of utmost importance. The perspective of independence is also discussed by Culp (2001):

> *"...it is generally a violation of the independence criterion for a CRO to report to a CFO."* (Culp, 2001, page 235)

Culp states that if the CRO reports to the CFO, there is a potential threat against the independence of the CRO. He explains this by the fact that the CFO engages in interest rate risk and therefore is able to affect the risk profile of the entire firm. Furthermore, the principles say that the CRO should not have any other responsibilities that can affect the revenue-generating functions of the firm (BCBS, 2010).

6.2.1.2 Dual Hatting

Further explanation around dual hatting is vital as it is stated by the BCBS (2010) to interfere with the independence of the CRO. The clear disadvantages with dual hatting in terms of the CRO is that the independence of the CRO is threatened. One reason is that the CRO might not anymore be impartial as well as other tasks might get more attention and time at behalf of the RM.

The definition of dual hatting by the BCBS (2010) can be interpreted directly as wearing two hats meaning that one person would be having two separate responsibilities. As shortly described before, the BCBS refers dual hatting to the state where the CRO is assigned with other responsibilities than those regarding RM. Usual incentives for firms to involve in dual hatting are because of resource saving in terms of less staff, thereby less costs if one person completes a two man job. This is why dual hatting is tempting from a cost efficient perspective.

It is clearly stated by the BCBS that the CRO should not be dual hatted and thereby not have any other financial responsibilities such as operational or revenue-generating functions. And most importantly is for the CRO to not to be assigned as CFO or chief auditor due to the effect on the CRO independence. However, the BCBS also states that in smaller organizations it can be reasonable that some positions have more than one function, due to resource constraints. However, the take away from the discussion is that the different functions of the CRO are never allowed to be contradictive; the goal of the positions has to be compatible. (BCBS, 2010) The CRO position should operate closely to the business unit to be able to detect and correct mistakes, however it is crucial that this position is separated from the business unit in terms of generating revenue. This can be reflected in the natural built in conflict described in the problem definition; traders want to take on risk but the CRO is needed to mitigate those risks or otherwise it can be assume that there will be an excessive risk taking.

Once again we can illustrate this theory with a real world example. The former executive in charge of risk in former HQ Bank could definitely be referred to as dual hatted. She was responsible for too many areas at the same time, which could be interpreted as she was supposed to evaluate and scrutinize her own work. (Neurath, 2011) This was not an effective way to manage risks, and the consequences have already been

repeated many times in the text above.

6.2.1.3 Interaction with the Board and the Stature of the CRO

> *"[...]the independence of the CRO is paramount. While the CRO may report to the CEO or other senior management, the CRO should also report and have direct access to the board and its risk committee without impediment. [...] Interaction between the CRO and the board should occur regularly and be documented adequately. "* (BCBS 2010, page 18)

The BCBS also says that the CRO should have direct access to the board. The direct access to the board is of importance to fulfill the independence. If other management functions have the possibility to interact in the reporting lines of the CRO, it can be assumed that the outcome can be affected. This weakens the outcome of the RM function and jeopardizes the entire firm. The Principles also state that the interaction should be undertaken on a regular basis and be documented in a proper manner.

> *"The risk management function [...] under the direction of the CRO, should have sufficient stature within the bank such that issues raised by risk managers receive the necessary attention from the board, senior management and business lines."* (BCBS 2010, page 18)

In the quote above, we see that according to the BCBS, the role of the CRO must gain the needed attention to fulfill his or her task. This aspect of the role of the CRO is interesting to consider since the position of the CRO might be totally ineffective if the position does not have any power. If the CRO does not gain enough attention when he or she is reporting, the position can be seen just as a way for the firms to window dress its RM. It is also of importance to consider the attention towards the work of the CRO internally.

6.2.1.4 Business line independence

> *"While it is not uncommon for risk managers to work closely with individual business units [...] the risk management function should be sufficiently independent of the business units..." (BCBS 2010, page 18)*

Another important factor regarding the CRO position is the interaction with the business lines. It is essential to work closely with the business units of the organization in order to be able to understand the risks in the firm. However it still needs to be independent from the revenue generating parts of the firm.

7. Methodology

In this chapter we describe the methodology used for the research of this thesis. The methodology has been divided into four areas: execution of research, completion of data, validity and reliability. The execution and compilation sections only explain the course of action briefly, all motivation and argumentation behind the logic of the chosen methodology is discussed separately under validity and reliability.

7.1 Execution of Research

As a starting point for this study we have researched the theories and regulations around the CRO and the financial sector. From these regulations we have stated seven different criteria that will be used in a scoring system to measure the level of independence. The scoring system will be further described under section 7.2.1. The criteria used to measure the level of independence will be further explained in section 7.2.2 and are also shown in appendix 3.

In order to gather information needed to fulfill the purpose of this thesis we have used a qualitative data collection through interviews. As the purpose of this thesis aims to investigate the independence of the CRO, the CRO was the targeted object. Therefore we have interviewed the CRO of each of the four Swedish major banks.

Three of the interviews were open-faced in the sense that we visited the offices of these CROs. The fourth interview was undertaken over telephone, mainly due to time

constraints from the object's perspective. All interviews have been carried out in the CRO's own office environment with the consideration of the context-effect (see section 7.4.3) and were executed in the same way lasting for approximately one hour.

7.2 Completion of Data

From the one hour recorded interview we have transcribed the material into text. In accordance with what Jacobsen says (2002) we started out with a transcription of what has been said word for word. This text have been annotated and thereafter we made a compilations made of every interview. With the foundation of the criteria in the scoring system, we have clear categories for our analysis.

7.2.1 Scoring System

Since the purpose of this thesis is to investigate how independent the CROs in the four Swedish major banks are, we have to be able to actually score different levels of independence. It is important that we are able to not just conclude whether a CRO is independent or not, we also have to capture the level of independence. To fulfill this we constructed a scoring system, which is the foundation to determine the level of independence.

We have derived the criteria for the scoring system from Principle 6 of the *Principles for Enhancing Corporate Governance*, as can be seen in appendix 3. The idea behind these criteria is simple; if they are meet fully we can consider the CRO to live up to the standards set by the BCBS and therefore we can consider the CRO to be fully independent. If failing in any of the criteria, the total level of independence of the CRO will be reduced. From this methodology we aim to fulfill the purpose and capture the level of independence of every CRO. With the scoring system we have worked through the interviews in a very systematic way. Points have been given to the different CROs depending on whether they meet a certain criterion or not.

7.2.2 Criteria to Determine the Level of Independence

As can be seen in section 6.2.1, the *Principles for Enhancing Corporate Governance* have clearly stated certain attributes of the CRO. With this as the foundation we have

formulated seven criteria, which the CRO should meet to be considered as fully independent, summarized in table 2 below.

Table 2

Factors to determine the level of independence of the CRO		
	Criteria	**Point(s)**
1	The CRO: a) has distinct responsibilities for the RM function b) does not engage in dual hatting	**2**
2	The CRO is separated from the CFO in mainly two distinct ways: a) the CRO does not report directly to the CFO b) the CRO is not hierarchically subordinated the CFO	**2**
3	The CRO reports and has direct access to: a) the board b) the risk committee	**2**
4	Interaction between the CRO and the board: a) occurs regularly b) is documented adequately	**2**
5	The CRO experiences that he or she has the sufficient stature and authority to receive necessary attention	**1**
6	The CRO shows an awareness of the need of independence by discussing the importance of independence when explaining the RM work in the organization	**1**
7	The CRO function operates: a) closely with the business lines of the corporation b) independently from the business lines of the corporation	**2**
Total		**12**

7.2.2.1 Distinct Responsibilities to Avoid Dual Hatting

The first criterion is to have distinct RM responsibilities and to avoid any contradicting positions. This criterion focuses on the person in position of CRO; the person in position of CRO should not be in any other position with functions contradicting to RM. As explained in section 6.2.1.2, dual hatting is a threat against the independence of the CRO. This criterion can give a maximum of two points: one point for the distinct responsibility of the RM work and one point if the CRO does not conduct in dual hatting.

7.2.2.2 Separation of the CRO Function from the CFO Function

The BCBS states that *"While the CRO may report to the CEO or other senior management..."* (BCBS, 2010, page 18) it does not say that the CRO should not be

reporting to the CFO. However, this is an issue discussed by Culp. Culp states: *"it is generally a violation of the independence criterion for a CRO to report to a CFO."* (Culp, 2001, page 235). We have incorporated this into our evaluation and therefore we have focused on this twofold. Firstly, to be totally independent the CRO should not report primarily to the CFO. This is explained by the fact that the CFO has mandate to change the risk profile of the company (Culp, 2001). Another factor, closely linked to the previous factor, is that the CRO should not be hierarchically subordinated to the CFO since this might be a violation of the independence. If the CRO is hierarchically subordinated the CFO, we believe there is a risk that the work of the CRO might be too influenced by the CFO. Since this criterion captures two aspects, it generates a maximum of two points.

7.2.2.3 Reporting and Access to the Board

The CRO should have direct access to the board and the risk committee to be considered as fully independent. Since this factor reflects two aspects it can generate two points. This indicates that if the CRO interacts with the board but not further with the risk committee, it will only be credited with one point and vice versa. The interaction with the board is also reflected in the fourth factor where the regularity between the CRO and the board is evaluated. Since the board governs the work in the organization, this interaction is essential. In the interaction with the board we have to consider two aspects of importance. The first aspect is that the CRO and the board meet regularly; the second aspect is that this interaction is documented in a proper manner. Each of these aspects can generate one point and thereby a maximum of two points.

7.2.2.4 The Stature and Authority of the CRO

As clearly stated by the BCBS, the CRO has to gain enough attention to ensure mandate in his or her work. To measure this factor we focus on how the CRO perceive his or her own stature and authority. This is an important factor to measure since a lack in stature of the CRO indicates that the position might be a way to window dress the RM. The connection between stature and authority in the work of the CRO and how much mandate he or she gets is pretty clear. This criterion captures one aspect of the CRO and can generate a maximum of one point.

7.2.2.5 Awareness of Independence

The guidelines state that the CRO position should be independent. Since the need of independence is crucial for the CRO, the CRO should show an awareness of this in the description of how his or her organization works with RM. If the CRO highlights the importance of independence when discussing his or her RM work, we can consider it to be a sign of awareness around the importance of independence. This criterion can generate one point.

We are fully aware that this criterion as well as the previous 7.2.2.4 can be considered as somewhat subjective but still these two criteria are important to consider. The factor of subjectivity will be discussed further under the validity section.

7.2.2.6 Interaction Between the CRO Function and the Business Lines

The last factor of importance when scoring the level of independence is whether the CRO function works closely with the business unit or not. This factor is vital since it is questionable if an isolated CRO function really is able to manage risks arising in the business lines. As stated by the BCBS, the CRO function needs to understand how the business works to mitigate risks from these units.

However, this factor also include the important aspect of independence; even if the CRO function works close to the business unit it still has to be independent from the revenue generating area. Therefore, this criterion captures two aspects and can generate a maximum of two points; each of the discussed aspects can generate one point. This criterion focuses on the entire CRO function as a unit unlike the first criterion that solely focuses on the person in the CRO position.

7.2.3 Compilation of Results

From the factors discussed above we have credited the different CROs depending on whether they meet certain criteria or not. In table 2 we have collected the factors determining the level of independence. The total amount of points available is twelve. In order to grade the different levels of independence, we have constructed a scale of independence.

7.2.4 Scale of Independence

The different CROs will be credited depending on how well they meet certain criteria. As mentioned before the total sum of the scoring system is twelve points. By adding the points from every criterion of independence each bank will get a total sum of points and they can thereafter be placed in the scale of independence as shown in table 3 below.

Table 3

Scale of Independence	
Excellent independence	12
Satisfactory independence	9-11
Insufficient independence	6-8
Weak/Failed independence	3-5
No sign of independence	0-2

A total score of less than three indicates no sign of independence. To show any sign of independence in the corporation the scoring system requires three points. Thereby a minimum score of three points or more is needed in order to show any independence at all, even if it is weak or failed.

The points for the scale have been determined equally over the different levels of independence and are constructed with a three points level. The logic behind this is explained by the fact that it should require equal effort in order to reach the next level of independence. This is apart from the last level of independence, which only can be achieved by acquiring a full score on all of the criteria to be able to be excellent. This is because all of the criteria should be met in order to be fully independent and thereby excellent. This is explained by the fact that banks are important players in the economy and should be able to meet high standards; in the banking sector we cannot compromise on quality.

The second best level of independence is called satisfactory. This level can still be considered as enough to meet the criteria set by the BCBS and can be considered as independent. However it still has room for minor improvements. The middle level indicates an insufficient level of independence. This means that the CRO fulfills at least half of the scores, however it lacks in certain criteria and is considered as a unsatisfactory

independence.

The three points level system is constructed because the criteria only can generate either one or two points altogether. This indicates that to reach a higher level of independence, the banks have to fulfill more than one criterion. For example, the CRO can simply not only discuss the importance of independence and believe that he or she has the sufficient stature within the organization as it only credits one point each. This would only generate two points and the CRO would still be in the same level of independence. He or she must therefore also show other signs of independence by scoring on any of the other criteria. By constructing the scale of independence in this manner we can correctly explore the level of independence in each bank and categorize the banks depending on the score received.

7.3 Validity

According to Jacobsen (2002) the validity for the research is of great importance and is intended to prove the validity and relevance of the gathered data. The validity reflects that it is independence we are measuring.

7.3.1 Deductive reasoning

According to Jacobsen (2002) the methodology can either take on a deductive or inductive reasoning. For our methodology the deductive reasoning is best suited as we derive our purpose based on the theories around the subject. For the deductive reasoning the theories are used as a starting point for the empirical study. This is done in order to research whether the reality is in line with the theory. The opposite, the inductive approach, is hard to undertake since it is considered as more or less impossible to research the empirical situation without the theory as a foundation (Jacobsen, 2002). When we aim to research the empirical situation in the financial sector, we have to start with relevant theories to make sure that we actually study aspects of interest. As our study focuses on the financial sector, a sector highly regulated, it is of even greater importance to use the deductive reasoning to assure that we include the current frameworks. By researching the theories and regulations around the financial sector before our empirical study, we are able to investigate whether the regulations are

followed or not. With a theoretical foundation we therefore are able to collect and interpret the results from the empirical study in an effective way.

A disadvantage with the deductive reasoning is that we may focus only on the empirical information sustained from a perspective that meets our previous expectations from the selected theories and bias of the stated purpose (Jacobsen, 2002). This would result in too narrow information collection and indicates that there is a potential pitfall where theories of interest are left out, affecting the outcome of the study. However, as stated before, since the financial sector is highly regulated, one strong way to minimize the risk of lacking parts is to analyze the current regulations and frameworks. Therefore, we have built our study on the widely recognized framework stated by the BCBS.

7.3.2 Qualitative approach

For this thesis we have conducted a qualitative data collection instead of a quantitative approach. To meet the purpose of this thesis we have followed through with individual case studies through interviews with the CRO of each bank.

The qualitative approach is suitable when aiming to investigate details, patterns and contexts, as well as when aiming to reach an understanding of a situation and why it occurs (Jacobsen, 2002). Further on, Jacobsen highlights the fact that a qualitative approach indicates openness towards the objective investigated which makes it credibly in terms of internal validity. Jacobsen also mentions that the qualitative approach is flexible, an important factor since it allows us to capture interesting aspects meaning that we are not fixed to certain numbers or questions. The openness as well as the flexibility is captured in the design of the interview questions by keeping an open structure.

Negative aspects with the qualitative approach are that it requires a lot of resources. In this study, we have had to put a lot of effort into contacting the different CROs, however it has not constrained the time available to fulfill this study. Another disadvantage with the qualitative approach is that we restrict ourselves to few entities (Jacobsen, 2002). This is a conscious decision since we have focused on the four major banks in Sweden. The reason behind this is that the entities investigated are powerful players in the financial sector; a study excluding these four banks would lower the validity of this study.

7.3.3 Collection of Qualitative Data through Interviews

The focus of our study is the CRO of the four major banks in Sweden; therefore we have a finite number of persons, which makes the individual interview feasible. According to Jacobsen, individual interviews are suitable when aiming to investigate few entities; when interest lies in the opinions of one special individual; and also when investigating how the special individual interprets something (Jacobsen, 2002). Since our aim is to fulfill all of these three criteria, it is yet another incentive of going through with individual interviews and is a valid approach for data collection.

7.3.4 Selection of Interview Objects

For this thesis we have restricted ourselves to the four Swedish major banks. We have chosen to focus on theses four major banks due to their impact on the Swedish economy. Since these four banks are the leaders of the financial sector in Sweden they can also be considered as role models, which is why they are of most interest to scrutinize.

As our thesis aims to investigate the independence of the CRO of each bank, it is natural to do so by scrutinizing the role as well as knowledge and awareness of independence by the CRO. As we aim to scrutinize the role and function of the CRO it is best suited to have the CRO as the targeted interview object.

It would also be possible to examine a risk chief in the RM function that is subordinated the CRO, however it is not of the same great relevance. As focus is upon the role of the CRO it is his or her awareness and knowledge around the RM function that has the greatest relevance. Even if the subordinated risk chief can show an awareness of the importance of independence it does not automatically imply that the CRO, in charge of RM, shares the same understanding and it does therefore not bring the same validity to this research. By interviewing the CRO we receive the direct information from the CRO, instead of collecting this from a secondary source. This is the reason why only the CROs have been targeted as interviewing objects.

To remain a high validity it is also of importance that all of the interviewed objects share the same position. For this research it is therefore essential that all interviewed objects are entitled as CRO for the RM function and is not mixed i.e. two of the interviewed objects would be entitled as CRO and the remaining two would be entitled as

risk chief subordinated the CRO. This factor of validity has been taken into consideration and thereby all of the four interviews for this research were completed with the CROs of each Swedish major bank. This strengthens the validity for this research and makes our gathered data valid and comparable amongst the four banks.

7.3.5 Design of Interview Questions to Measure Independence

To fulfill the purpose of this thesis we had to consider the design of the questions used in the interviews. We have based our interview questions on the definition and description of the CRO as can be seen under section 6.2. For the design of the interview questions we have been working through the definition of the CRO and the criteria for this position, outlined by the BCBS (2010) as discussed previously.

As the BCBS describes how the CRO and risk function of the bank should be carried out, these are the criteria we investigate through the questions and it allows us to examine how the bank works with risks. The questions were designed to study how the CRO carries out his or her work accordingly with Principle 6 by the BCBS (2010). The questions were based on the criteria that should be met to be considered as independent as can be seen in appendix 3. The questions asked can be seen in appendix 4. This is also the foundation for the scoring system, which will be developed under the following section.

By designing the questions based from the guidelines by the BCBS we are able to capture relevant aspects, proving the validity of the gathered data. The questions were exactly the same and carried out in the same manner in order to remain consistent and are therefore directly comparable. We can therefore validate that we are measuring independence in accordance with the publication by the BCBS.

To be neutral and avoid directing the answers in any direction, we have not used the term independence in our interviews. This was reflected in the design of the questions. By avoiding the term independence we increase the validity since we do not direct the objects in any direction. Instead we let the objects answer without restrictions.

7.3.6 Embellishment of Answers

The main risk of data collection through interviews are consequences such embellishment answers i.e. the interviewed object engages in window dressing. This implies that there

might be a difference between what the object says he or she does and what he or she actually does, partially explained by overconfidence. This can also compromise the result of the study as the interviewed object might say and do in accordance of what we expect from them. The main risk of embellished answers is mitigated through the neutral design of our interview questions as we do not mention or bring up the term independence. In this way the CRO has the possibility to show the real awareness of independence without us directing the answers and they were not forced. This is applied as it also strengthens the objectivity.

A possible outcome of embellished answers is that the data is not being truthful. One way to strengthen the validity is to validate the results with other sources (Jacobsen, 2010). In order to follow up on the answers by the CRO, background checking is conducted through public information before each interview. We also validate some of the answers after the interviews, by examining organizational schemes of each organization through public information, such as annual reports, in order to make sure that the information retained is truthful.

7.3.7 Scoring system

According to Jacobsen (2002) it is of utmost importance to be critical but still open minded when interpreting the results in order to maintain validity. To fulfill this aspect, we constructed the scoring system before doing the interviews. By doing this we are not manipulating the scoring system to meet the results from the interviews.

The scoring system also enables us to be systematic in the interpretation since the criteria are either fulfilled or not. This minimizes the risk of ambiguity in the result compilation.

In the scoring system, each criterion has been credited with the same amount of points. Some aspects include two criteria, and they amount to a total of two points. This system indicates that every criterion yield either zero or one point. By doing this we are once again systematic and are minimizing the ambiguity.

The fact that we credit each criterion with one point indicates that each criterion is weighted with the same importance. For example, the interaction with the entire board is equally important in the scoring system as the perceived stature of the CRO. This

indicates that the crucial factor that the CRO interacts with the board is equally weighted as a subjectivity aspect (discussed further under section 7.3.6.1). One could argue that the vital interaction with the board should be weighted to have for example the double impact as the perceived stature. However, weighting the criteria differently brings certain problems where the main problem is how to set the weighting. For example, should the interaction with the board be considered as double or triple importance than the perceived stature? To minimize the impact of this kind of subjectivity that is generated when using different weights, we have used a scoring system that is not weighted i.e. all criteria are of the same importance. This is a preferable method in research due to a minimization of subjectivity (Arvidsson, 2003).

7.3.7.1 Aspects of Subjectivity in the Scoring Criteria

In the scoring system, all scoring of each criterion is based on the interviews. Criteria five and six can be considered as subjective since they measure the awareness of independence of the CRO as well as how the CRO perceives his or her stature and authority within the bank. In contrast to the other criteria they do not evaluate a certain procedure, such as reporting lines. Instead they evaluate how the person in the position of CRO perceives a certain aspect. These two criteria are therefore totally subjective since they are entirely based upon the personal opinion of the person entitled as CRO.

A clear disadvantage with this aspect is that the subjective opinion of the CRO does not necessarily need to match the actual situation in reality. The perception of having authority within the bank does not directly prove that the CRO is having this stated authority in reality. In the same way, it is not a proof of the CRO being independent if he or she highlights the importance of independence.

There are two main reasons why these aspects are incorporated. Firstly, the subjectivity is not isolated in the sense that we do incorporate this aspect in the overall picture. This indicates that the subjective aspects are not the single factor to determine the level of independence. In fact, the two subjective aspects only generates a maximum of two points together, indicating less than a fifth of the total score. This indicates that if missing out on the two subjective aspects, the CRO can still generate ten points corresponding to a level of independence as satisfactory.

Secondly, the subjective factor is necessary to incorporate in the scoring to be able to

map out the entire situation. Let us consider the criterion where we aim to measure the awareness of independence. Even if the members of the board are aware of that the CRO function needs to be independent, the independence has to be highlighted even in the actual function. Since the person in position as CRO is in charge of the entire RM function of the organization, we consider it as highly relevant that this aspect is incorporated also in this line. Regarding the perceived authority, one could argue that the CRO might say he or she has the needed authority and gains enough mandate but still in reality be ineffective. However, if the CRO perceives that he or she is receiving enough attention it makes it more likely that he or she actually has enough stature within the bank. Therefore this aspect still has to be incorporated as we aim to understand the current situation.

Last but not least, it is interesting to once more highlight the fact that the interviews have been undertaken in the same way in each of the four banks. From this we can conclude that although the scoring in some sense incorporates an aspect of subjectivity, this subjectivity is identical to every bank in the analysis, which reduces its impact.

7.3.8 Objectivity

In order to remain objective, the measured criteria for the independence through the interviewed questions and the scoring system were determined before the interviews.

Reason to set the scoring system previous the interviews is due to the fact that the scoring system is derived from the regulations by the BCBS and we want to measure the independence in accordance to these regulations.

The information obtained and data gathered was read and analyzed individually between the two authors in order to not influence each other.

We also want to emphasize the importance of our impartiality as authors. We are not researching this subject on the behalf of any of the four banks in this research. We also want to stress that we are not related to the banks and we do not put any focus on which bank having a certain result, instead we aim to gain an objective and impartial result for the research. This is of importance when compiling the result since we have been able to keep a neutral and impartial attitude.

7.4 Reliability

Except from the validity, the reliability has to be considered to ensure reliable results (Jacobsen, 2002). For this study, the focus of the reliability is that the interviews have been undertaken correctly where we have to consider aspects such as design of interview questions, execution of interviews and the context effect.

7.4.1 Design of Interview Questions Using an Open Structure

Jacobsen (2010) mentions two ways of how an interview can be conducted in terms of structure, the sealed structure and the open structure. The sealed structure is more fixed in terms of questions and possible answers meanwhile the open structure is more flexible and more dialogue-like.

For our purpose, it is essential to have an open structure where the object has a possibility to give free answers. This is of additional importance since we use a deductive method as previously discussed under section 7.3.1. To be able to capture all of the facts from an interview the interviews were implemented with an open structure instead of a sealed structure. The open structure has more possibilities of capturing many aspects. The risk of an open structure interview is that the purpose of the interview might not be fully captured; the interview might not bring any result due to lacking relevant data as the discussion might span beyond the discussed subject. The sealed structure can further bring risks of neglecting important and relevant data.

The risk of an open structure is as mentioned before, the risk of not being concise and it is important to remain to the subject and the fulfilling of the purpose of the thesis. Not only are the questions well designed but we also practiced follow up questions in order to achieve a well-dressed interviewing technique.

7.4.2 Execution of Interviews

The interviews lasted for approximately an hour. The reason we have used this time period is threefold. Firstly, the CROs in our study are busy executives with full schedules. From this perspective we had to restrict the time to be able to get the interviews done, a too time consuming interview would be deterrent risking the execution of them. The second reason we have one-hour interviews is explained by the fact that we have to restrict ourselves to keep us to the relevant subject. Even if we could have

conducted interviews for several hours, we would risk getting away from the core topic of our study. The third reason for our one-hour interview is that Jacobsen states (2010) than when the interviews are more than one and a half hour, there is a risk of lacking attention from the object.

The questions have been sent to the CRO one week before each interview, an act to make it possible for the CRO to contemplate the questions. All four interviews have been tape recorded to make it easier to study the answers.

7.4.3 The Context Effect

One aspect to consider when doing interviews is the context effect ("kontexteffekten"), saying that the context in which the interview takes place is of importance when interpreting the outcome. According to this theory there are two contexts in which the object can be interviewed: the natural context such as at home, or the artificial context such as at work or in a laboratory. While a natural context tends to generate more "natural" and true answers, the artificial context might generate artificial answers. (Jacobsen, 2002). To illustrate this reasoning we use an example of a stressed receptionist. By interviewing this person at his or her workplace, it is more likely we will get answer that reflects the stress. If the receptionist has left the office and is interviewed at home it is a possibility that he or she has had time to relax and therefore we get a totally different picture of the current situation. The context effect is therefore important to take into consideration as different settings may influence the object being interviewed (Jacobsen, 2002).

Since we aim to get answers to questions relating to whether the CRO is independent or not, we believe the office context is the most suitable. We believe that the attributes of the CRO that we want to scrutinize also derives from the work place, i.e. by doing the interviews in this context we will minimize the risk that the CRO leaves the "role" he or she has at the workplace.

The setting of the interview can bring different results especially if not consequent among all of the interviews. In our case, one of the interviews was conducted via telephone. However, the context of this interview was equal to the interviews since the object confirmed he was in his office during office hours. The risk of our chosen

surrounding is that the CRO might not feel comfortable stating all of its opinions and thoughts in the work area. However, this risk is considered lower than if the setting would be set at the objects home, as it might lead to overconfident answers, which are in the opposite direction.

The risks of the context effect (Jacobsen, 2002) were minimized through choosing the right setting of the interview based on the nature of the position of the CRO. As the subject being interviewed is evolved around the work of the CRO the natural setting is the work place of the CRO. This setting remains consequent for all of the four interviews. This minimizes the risk of the CROs being overconfident in own home environments. As the work place setting also carries an opposite risk, implicating that the object might not dare tell the truth, the interviews were carried out behind closed doors.

8. Empirical review

Due to promised confidentiality in the presentation, the banks are noted as bank A, B, C and D. The denotations of the banks have been randomized. In order to not reveal the banks' identities we will generally review the empirical data and not describe each individual bank further. Since the focus of this study is to measure the level of independence, we have to focus on this aspect. However, we do believe there are some interesting characteristics captured from the interviews that will be discussed briefly. In section 8.1 below we present a brief description of the characteristics of the four CROs. The descriptions are a good way to get background information of the CRO function in the four major Swedish banks.

8.1 Characteristics of the CRO

By only touching the surface of our analysis we can clearly see some patterns. These are aspects such as gender, age and previous work experiences. In each of the four banks all of the CROs are men in the same age range. The four CROs also have the similar background regarding previous work experience. Their previous positions were mainly responsibilities for the credit risk area.

8.1.1 History of the CRO position

Two out of the four banks implemented the position CRO before the crisis of 2007. The other two banks implemented the position CRO after the crisis of 2007, partly as a response to the crisis as well as due to increased regulations. The reason behind the implementation can also be explained by other factors.

One of the CROs shares that at his bank there was a mutual perception of the necessity to collect all different risk types and make it the responsibility of one person. Furthermore, he also emphasizes that the implementation of the CRO position gave a clearer link between the risk function and the executive function of the bank. Another CRO is also mentioning this issue when he describes one of the main reasons behind the implementation, as that someone had to "own" the process.

Another description highlights the importance to coordinate all different kinds of risk to improve the RM at the bank. The main reasons behind the CRO implementation are compiled in table 4 below.

Table 4

Reasons behind implementation of the CRO position
One person in the group executive having the overall responsibility of the bank's risk-taking
Clearer linkage between the RM function and the executive function
Formalize the RM work to easier show the stakeholders of the bank that the RM work is undertaken in a systematic way
One person owns the RM process
Coordination of all different kinds of risks within the bank

8.1.2 The Natural Conflict in the Banking Business

As stated in the beginning in the problem definition, financial firms face a built in conflict between traders that are willing to take on risk while the CROs aim to minimize it. Is this something the CROs of the four major Swedish banks also experience?

All of the interviewed CROs describe this conflict as essential in the banking sector. One of the CROs says that the importance is to find the balance between these two aspects, and also stresses that the RM function exists just to be a counterweight to the risk

taking behavior. Another CRO describes this potential conflict as a natural part of the banking business. He describes this by saying that regardless of their positions within the bank, they all have the same goal.

The third CRO also stresses that the conflict of interest is natural in the bank. The business units want to do good business and the RM function wants to control that the business is undertaken in the right way and that no excessive risk is taken. However, he experiences this as such a natural part of the business that he would not use the word "conflict". From the fourth CRO we also get the description of this conflict as natural in this business area. He emphasizes the relevance of setting guidelines and policies to avoid people from acting without knowledge of the rules. From the interviews we can conclude that the theoretical statement that there is a built-in conflict in the financial sector is highly relevant even in the Swedish major banks.

8.2 Compilation of Level of Independence

From the overall description above, we will now further analyze the different banks more. We now entitle the different banks as A, B, C and D in order to live up to the confidentiality. Every criterion in the scoring system will be discussed and this is the foundation for the scoring under chapter 9.

8.2.1 Distinct Responsibilities for RM and Avoided Dual Hatting

8.2.1.1 Bank A

The CRO of bank A has the overall responsibility of RM. He describes this responsibility as a full time risk work, which also involves the task of coordinating the risk work within the bank.

8.2.1.2 Bank B

The CRO of bank B has the overall responsibility of RM. He also has another function within the bank, however he emphasizes that this does not include any kind of business responsibilities in terms of revenue generating issues.

8.2.1.3 Bank C

The CRO of bank C has the overall responsibility of RM within the bank. He does not have any other function at the bank apart from the risk area.

8.2.1.4 Bank D
The CRO of bank D has the overall responsibility of RM. He describes that this responsibility involves making sure that the risk work is correctly undertaken in the rest of the organization.

8.2.2 Separation of the CRO Function from the CFO Function

8.2.2.1 Bank A
The CRO of bank A is hierarchically subordinated to the CEO. He reports directly to the CEO.

8.2.2.2 Bank B
The CRO of bank B is hierarchically subordinated to the CEO. He reports directly to the CEO.

8.2.2.3 Bank C
The CRO of bank C is hierarchically subordinated to the CEO. He reports directly to the CEO.

8.2.2.4 Bank D
The CRO of bank D is hierarchically subordinated to the CFO. In an organizational perspective, he describes there is a straight line to the CFO and a dotted line to the CEO. He mainly reports to the CFO but he also reports directly to the CEO in some circumstances where the CFO only is informed of this report.

8.2.3 Reporting and Access to the Board

8.2.3.1 Bank A
Except from reporting to the CEO, the CRO of bank A also reports directly to the board on a quarterly basis. He also reports to the Risk and Capital Committee of the board. This reporting is more frequent than the reports to the board and is undertaken on a monthly basis. He emphasizes that he and some of his subunits also report on a daily basis. The reporting to the board and the CEO is documented and filed in eternity.

8.2.3.2 Bank B
The CRO of bank B reports on a daily basis to the CEO. He also reports directly to the board and weekly to the senior management. The board meets regularly around two times every quarter. Every time he interacts with the board, the risks are documented in a risk report. The CRO of bank B also interacts with the Risk and Capital Committee of the

board. This interaction is more frequent than the board interaction and in this Committee they have the ability to discuss on a more detailed level.

8.2.3.3 Bank C

The CRO of bank C reports to the CEO but also directly to the board. The board meets monthly and at this meeting the CRO presents a documented risk report. He also interacts with the Risk and Capital Committee. The CRO also reports every fourteen days to the senior management.

8.2.3.4 Bank D

The CRO of bank D reports mainly to the CFO and the CEO. He also documents his work and sends reports to the Risk and Capital Committee of the board. However, the CRO does not interact directly with the board, instead the CFO takes the reports of the CRO to the board.

8.2.4 The Stature and Authority of the CRO

8.2.4.1 Bank A

The CRO of bank A perceives no difficulties in receiving the necessary attention in his work. He says that it is due to the fact that he is a part of the senior management, giving him stature within the bank. Another factor he mentions as a reason for authority is his long career within the bank.

8.2.4.2 Bank B

The CRO of bank B describes the CRO position as a strong and appreciated function. He emphasizes the good risk culture in the bank and that there are consequences for persons going beyond the guidelines and policies of risk. He expresses that the business line is really listening to the CRO function.

8.2.4.3 Bank C

The CRO of bank C experiences he receives enough attention. He mentions that it is a common understanding within the bank that they want to be a low risk organization. He also highlights the fact that they have a good dialogue between the risk function and the business function.

8.2.4.4 Bank D

The CRO of bank D experiences his job, as a CRO is easy in terms of receiving attention for his work. He explains this by the fact that there is a strong risk culture within the bank. He describes that they all think in terms of risk and that he has no difficulties of

receiving enough attention and respect. The CRO also highlights the importance of gaining mandate from the executive function to make sure that the position has an effect, a mandate he experiences that his position has.

8.2.5 Awareness of Independence

8.2.5.1 Bank A

The CRO of bank A mentions that the risk function of this bank is independent. He also stresses the importance of an independent risk function as well as an independent and impartial monitoring function. The CRO further explains that the risk function also is independent from the business unit of the bank.

8.2.5.2 Bank B

The CRO of bank B mentions that the CRO position has been reorganized in order to be more independent from the CFO function. Other reorganization has also been made in order to separate certain functions from the CFO function to the CRO function in order to achieve good independence. The CRO also shares that his own independence is of importance and that the risk function is totally independent from the business unit of the bank.

8.2.5.3 Bank C

The CRO of bank C mentions that he himself is independent in that sense that democratic decisions regarding risk are not always made; he makes the ultimate decision. By this he means that even if the CEO for example would not agree on a certain important risk decision the CRO is still able to mediate this risk to the board and make this decision without his consent. However this does not usually happen but he still has this possibility in order to maintain his independence.

8.2.5.4 Bank D

The CRO of bank D does not mention the risk functions' independence nor his own. The subject of independence does never occur during the interview.

8.2.6 Interaction Between the CRO Function and the Business Lines

8.2.6.1 Bank A

The CRO of bank A mentions that the base of the bank's RM occurs in the operative unit, meaning the business units. The risk function is divided into different areas in order to focus on different areas in the bank, working close with the business lines. The business

unit is however still responsible for its own risks and everything must go through the risk function of the CRO, and the CRO explains and stresses that this risk function is still very independent from the different business lines.

8.2.6.2 Bank B

In bank B the business lines and business managers are responsible and own their own risks. The RM function of the CRO provides established guidelines and regulations applied for the bank. This is done in order for the business managers to follow and know what types of risks are taken in the bank, and further there are people working with risk from the CRO function located in the business units. The CRO further shares that the RM function that he is responsible for are communicating and working closely with the business unit however he also mentions that they still are independent from the business unit.

8.2.6.3 Bank C

The CRO of this bank mentions that his risk function is controlling the business lines by controlling the risk appetite determined by stress tests. He also emphasizes the need of setting rules and policies regarding the RM in the bank. Also every business unit has workers from the CRO function in order to work closely with the business unit, however the CRO does not discuss that this close cooperation is independent.

8.2.6.4 Bank D

The CRO of bank D mentions that the most important part of their risk work occurs in the business lines of the bank. The RM function does therefore work closely with the business lines of the bank. However, the different business units are still responsible for and own their own risks. The CRO does however not enlighten the importance of this unit being independent from the business line in any manner.

9. Results and Analysis

The empirical review in the previous chapter is the foundation when scoring the level of independence of each bank. This scoring will be presented in this chapter.

9.1 Scoring and Motivation

The scoring to measure the level of independence is presented in table 5 below. As

mentioned, all of the scores were based on the interview summaries compiled under section 8.2 and are the ground for when a bank receives points. If points are generated the bank fulfills the criterion in accordance with the empirical review of section 8.2. However, motivation will be provided when the bank does not receive a full score or any points at all on a criterion.

Table 5

Score for each Bank for every Criteria					
	Criteria	Bank			
		A	B	C	D
1	The CRO: a) has distinct responsibilities for the RM function b) does not engage in dual hatting	2	2	2	2
2	The CRO is separated from the CFO in mainly two distinct ways: a) The CRO does not report directly to the CFO b) The CRO is not hierarchically subordinated the CFO	2	2	2	0
3	The CRO reports and has direct access to: a) the board b) the risk committee	2	2	2	1
4	Interaction between the CRO and the board: a) occurs regularly b) is documented adequately	2	2	2	0
5	The CRO experiences that he or she has the sufficient stature and authority to receive necessary attention	1	1	1	1
6	The CRO shows an awareness of the need of independence by mentioning the importance of independence when explaining the RM work of the organization	1	1	1	0
7	The CRO function operates: a) closely with the business lines of the corporation b) independently from the business lines of the corporation	2	2	1	1
Total Score		12	12	11	5

As seen in table 5 banks A and B received a full score on each criterion and they do therefore both place themselves as a RM function with "Excellent Independence" at a score of twelve points each. Both banks clearly display that they deserve all of the points earned in accordance with section 8.2.

Bank C received a score of eleven points and this does thereby place them as a RM function with "Satisfactory Independence" and only missing excellent by one mark. Reason to why bank C does not receive a full score on the seventh criterion is because the CRO does not highlight the importance of independence from the business lines when explaining the close interaction with this unit.

Bank D received a score of five points and this places them as a RM function with "Weak/Failed independence". On the second criterion the bank does not receive any points as the CRO is directly subordinated the CFO and reports directly to CFO. For the third criterion the bank only receives one point as CRO reports and have access to the risk committee but not to the board. As there is no access to the board by the CRO, the bank does naturally not receive any points on the fourth criterion. The CRO does not discuss the importance of an independent RM function nor his own independence and does therefore not receive any points on the sixth criterion either. Just like bank C, bank D mentions the importance of the close interaction between the RM function and the business lines of the bank but not the importance of still being independent from the business lines. Thereby bank D receives only one point instead of two. As mentioned, this generates a score of five points. The summary of the scorings can be seen in table 6 below.

Table 6

Bank	Category Placement	Score
A	Excellent Independence	12
B	Excellent Independence	12
C	Satisfactory Independence	11
D	Weak/Failed Independence	5

As we can see in the table above, two out of the four interviewed banks have an excellent level of independence since they both generate twelve points. One of the banks has a satisfactory independence in the CRO function but still very close to excellent. However one of the banks' CRO function has a weak or failed level of independence.

9.2 Analysis

From the previous section we can conclude that three out of the four Swedish major banks have an independent CRO function. It is however interesting to note that one of the Swedish major banks has failed in their independence in the CRO function.

While three of the banks show a similar pattern, the fourth bank is distinctly separated in this aspect. This diversion is derived from the previous completed scoring. However the question still remains, what is the reason behind this remarkable difference and what are the possible implications?

The main factor behind the low level of independence for bank D is how the CRO function is related and interlinked to the CFO function. As shown in the empirical review in section 8.2, the CRO of bank D interacts closely with the CFO function. As seen in section 8.2.2.4 where we review the relation of the CRO to the CFO of bank D, we see that the CFO is both reporting to the CFO as well as is hieratically subordinated to the CFO. This indicates that there is a potential situation where the CFO of bank D actually affects the CRO too much.

As mentioned throughout this thesis there is a conflict between the role of the CFO and the CRO. Most importantly the CRO should not report to the CFO in accordance with what Culp (2001) states. As the CRO of bank D both reports and is subordinated the CFO it directly conflicts with the independence of the CRO. Not only does this weaken the independence of the CRO in bank D but also it can generate potential threats to the organization. As the CFO is hierarchically superior the CRO, he or she can influence the CRO to great extent. The CFO is also evaluating the job of the CRO the influence of the CFO is strengthened. As the responsibilities of the CFO differs and are a conflict of interest of the responsibilities of the CRO it is a threat to the RM function. Based on the theoretical parts from this study we can thereby conclude that there is a potential problem in the risk work of the CRO in bank D as the work may be compromised.

Yet another factor of concern regarding the relationship between the CRO and the CFO relates to the board interaction. As stated in this thesis the interaction between the CRO and the board is of utmost importance to guarantee an independent RM function. This is an important aspect as the information regarding the risks in the organization is important therefore it should be delivered directly to the board.

In section 8.2.3.4 it is described how the CRO of bank D reports to the Risk and Capital Committee, however, he does not report directly to the entire board. This duty lies upon the CFO. The CRO is reporting to the CFO who then forwards this report to the board. This indicates that the CFO function is an intermediary between the CRO function and the board and further confirms the weak independence of the CRO as mentioned in the previous paragraph. This is the direct opposite to what is stated by the BCBS around the reporting lines, as mentioned under chapter 5 and also in appendix 2.

This type of dependent reporting line indicates that not only can the CFO alternate the risk report but also is he or she able to embellish it before presenting it to the board in order to improve the conditions for the CFO function. From the independence perspective, this is a vital disorder. If the CRO reports to the CFO, meanwhile the CFO is responsible to report the RM work to the board, the question lies in how can bank D actually assure that the work of the CRO is presented to the board at all and if so, is it correct?

The problems around this kind of dependent reporting line can be crucial and affect the organization negatively. Bank D can therefore easily overlook important risks due to this impediment. This could further lead to greater negative outcomes as seen in the case of HQ Bank previously discussed. The failure of HQ Bank partly resulted due to an ineffective CRO and due to dependencies in the reporting lines. The presented risks by the CRO were overlooked by the rest of the management and noted when it was too late which led to a collapse. Even if we do not imply that bank D is the next HQ Bank, the possibility of a negative outcome by overlooking important risks still remains.

Another factor of interest to discuss regarding bank D is the lack of showing an awareness of the need of independence in the CRO function. It is interesting to note that the CRO of bank D is the only one of the interviewed CROs who is not showing an obvious awareness of the importance of independence. The subject of independence was not discussed once when discussing the RM function and his own work within the bank. This is unlike the other three banks that actually stressed this importance. Even if this criterion is only one of seven it is still quite noteworthy. Being aware of a problem can be considered as already being halfway solving it, as it thereby can be controlled and managed. The results from the scoring of bank D does not only show that the CRO is not

independent but they are also unaware of the importance of being independent which implies an even greater risk to the organization. Still, simply an awareness of the importance of independence does not directly imply that the CRO and the RM function are independent. However the unawareness is still a great risk as the risks around not being independent are unpredictable and unknown to bank D.

Bank A and bank B both shows an excellent independence in the CRO function. This is easily explained by the fact that they do meet all criteria in the scoring, derived from the 6th principle by the BCBS. The main difference between bank A and B in the excellent class and bank C in the satisfactory class, close to excellent, is the factor of independence in the interaction with the business lines.

Bank C is considered as having a satisfactory level of independence, very close to excellent. The only point bank C missed out was on the last factor. In the description of the interaction with the business lines, the CRO describes the work as close. However he does not emphasize the need of independence between these two divisions.

An interesting question to ask is regarding bank A, B and C. Is everything perfect just because the outcome of the scoring? From the scoring we state that the independence is currently impeccable in these three banks. But in the fast changing environment ascending from the crisis, we have to highlight the fact that independence is no guarantee that the bank is protected against negative outcomes in the future. The independence is a sign that the banks are more likely to have an effective RM, which is a factor of importance in fast changing times. However, these three banks still need to continuously maintain this level of independence.

To take it one step further it is interesting to consider the previously discussed Lehman Brothers and HQ Bank. What would a scoring of the RM function of these two organizations result in if they were to be undertaken before the collapses? The answer to this question will unfortunately remain unknown but it is worthwhile to think about. In the case of Lehman Brothers and HQ Bank, the most influencing factor behind the failure was that the RM function was overlooked when it actually was needed. This indicates that when the RM function should be even more empowered, the outcome was the opposite. This is perhaps easy to state when looking back in the past. This suggests that it is important for all banks, even the three banks with an impeccable independence, to

continuously maintain an independent RM function. In the end it is all about spreading the awareness of independence of the RM function throughout the entire organization to make sure that the RM function is not neglected in times when it really is needed.

As stated previously, one of the four major Swedish banks separates itself from the other three in terms of independence. According to our analysis the core to this difference lies in the close relation between the CRO and the CFO. The CFO encroaches on the territory of the CRO and it is interesting to take this one step further. What is the possible explanation behind this?

One possible reason might be that the CRO function serves as a different role in bank D. Still the CRO function of this bank cannot be considered as fully independent from the CFO function. The CRO function is more a subdivision of the CFO function. One way to interpret this is that bank D has organized this position differently and dependent of the CFO.

Another way to interpret the result of the independence in bank D is that it actually engages in window dressing. If this is the case, the reasonable explanation behind the lacking independence is that it does not have any actual effect in reality and is only a way to window dress to satisfy stakeholders. There is a risk that the CRO function is not gaining the necessary attention it should.

The most likely explanation is that bank D actually is unaware of its lacking independence in its RM function. This can be considered as even worse than if they were aware of this, since it indicates that one of the major Swedish banks believe they have an effective RM function when it in reality is ineffective.

The organization of this position is up to the bank itself to decide, however it is questionable if it fulfills its purpose as it is today. Our study suggests that bank D has failed to fulfill the independence in this position in accordance with the scoring we have constructed.

Further on it would be of interest to include FI in the analysis. As stated in the regulatory review in section 5.2.3, FI states in their FFFS that the CRO should be independent, but they do not state how this independence should be achieved. According to our scoring system, we see that bank D fail in their independence of the CRO function; bank D's CRO function is not fulfilling the requirements from FI.

In this aspect FI could improve the clarity in its regulations. FI should be clearer in the definition of what independence indicates as well as how this should be achieved. In the *Principles for Enhancing Corporate Governance* by the BCBS, it is clearly stated what independence is as well as how this is supposed to be achieved. This is exemplary and we think FI should implement a clearer definition of how independence is supposed to be reached and what it implicates.

We are aware of the fact that our scoring system is one way to measure independence, and maybe not the only way, but still according to our scoring system bank D is not meeting the criteria from FI and BCBS. Therefore, FI should follow up on this and except from clarifying its guidelines FI should also as ask bank D to improve its CRO function. As today, in terms of the aspects discussed regarding FI's regulations, these can be seen as a way for FI to window dress. The reason behind this statement is that FI does have a regulation and its existence cannot be questioned, however the actual impact of this regulation is questionable.

10. Conclusion

From this research we can draw the conclusion that three out of the four Swedish major banks have an independent RM function with a designated and independent CRO. One of the banks does however not fulfill the criteria measured in this thesis and it is thereby concluded to not be independent. At the same time we have concluded that FI has a shortage in its description of independence.

10.1 Future Research

This research explores the level of independence of the CRO in Swedish Banks and is also applicable on an international level. As this subject is not widely researched it does thereby provide a variety of directions for further research. In our opinion this subject can be researched further in two main directions.

The first direction would be to investigate a greater number of financial firms, most preferably small, medium and big financial firms. By doing this type of research various characteristics of the financial firms can be drawn as well as the level of independence. Also, window dressing should be considered as it might occur in small financial firms

due to limited resources. From this a comparison can be made between the levels of independence amongst the financial firms and the different characteristics of the firms.

The other direction would be to apply this type of research on non-financial firms. Since non-financial firm differs greatly from financial firms it is crucial to adjust the research to fit non-financial firms i.e. by not using Basel. Instead the CRO and RM function can still be investigated but we suggest that there is more focus on dual hatting, as mentioned by Culp (2001), with inflicting responsibilities from the CFO. It is also of further interest to develop whether window dressing occurs in non financial firms due to the fact that this a sector less regulated.

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b *http://www.bis.org/bcbs/basel3.htm*

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c *http://www.fi.se/Folder-EN/Startpage/About-FI/What-we-do/*

dhttp://www.fi.se/Folder-EN/Startpage/About-FI/What-we-do/International-work/

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"Independence: the fact or state of being independent"
"Independent: free from outside control; not subject to another's authority not influenced by others; impartial"
Oxford Dictionaries (oxforddictionaries.com)
www.oxforddictionaries.com

12. Appendices

Appendix 1

Member Countries of the Basel Committee of Banking Supervision

Argentina,
Australia,
Belgium,
Brazil,
Canada,
China,
France,
Germany,
Hong Kong SAR,
India,
Indonesia,
Italy,
Japan,
Korea,
Luxembourg,
Mexico,
Netherlands,
Russia,
Saudi Arabia,
Singapore,
South Africa,
Spain,
Sweden,
Switzerland,
Turkey,
United Kingdom,
United States.

The present Chairman of the Committee is Mr. Stefan Ingves, Governor of Sveriges Riksbank.

Collected from http://www.bis.org/bcbs/history.htm
[2012-03-19]

Appendix 2

Principles for Enhancing Corporate Governance, Principle 6

C. Risk management and internal controls

Principle 6

Banks should have an effective internal controls system and a risk management function (including a chief risk officer or equivalent) with sufficient authority, stature, independence, resources and access to the board.

Risk management vs. internal controls[1]

69. Risk management generally encompasses the process of:

- identifying key risks to the bank;
- assessing these risks and measuring the bank's exposures to them;
- monitoring the risk exposures and determining the corresponding capital needs (ie capital planning) on an ongoing basis;[2]
- monitoring and assessing decisions to accept particular risks, risk mitigation measures and whether risk decisions are in line with the board-approved risk tolerance/appetite and risk policy;
- and reporting to senior management, and the board as appropriate, on all the items noted in this paragraph.

70. Internal controls are designed, among other things, to ensure that each key risk has a policy, process or other measure, as well as a control to ensure that such policy, process or other measure is being applied and works as intended. As such, internal controls help ensure process integrity, compliance and effectiveness. Internal controls help provide comfort that financial and management information is reliable, timely and complete and that the bank is in compliance with its various obligations, including applicable laws and

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[1] While risk management and internal controls are discussed separately in this document, some supervisors or banks may use "internal controls" as an umbrella term to include risk management, internal audit, compliance, etc. The two terms are in fact closely related and where the boundary lies between risk management and internal controls is less important than achieving, in practice, the objectives of each.

[2] While the design and execution of a bank's capital planning process may primarily be the responsibility of the chief financial officer (CFO), the treasury function, or other entities within the bank, the risk management function should be able to explain clearly and monitor on an ongoing basis the bank's capital and liquidity position and strategy

regulations.[3] In order to avoid actions beyond the authority of the individual or even fraud, internal controls also place reasonable checks on managerial and employee discretion. Even in very small banks, for example, key management decisions should be made by more than one person ("four eyes principle"). Internal control reviews should also determine the extent of an institution's compliance with company policies and procedures, as well as with legal and regulatory policies.

Chief risk officer or equivalent

71. Large banks and internationally active banks, and others depending on their risk profile and local governance requirements, should have an independent senior executive with distinct responsibility for the risk management function and the institution's comprehensive risk management framework across the entire organisation. This Executive is commonly referred to as the CRO. Since some banks may have an officer who fulfils the function of a CRO but has a different title, reference in this guidance to the CRO is intended to incorporate equivalent positions. Whatever the title, at least in large banks, the role of the CRO should be distinct from other executive functions and business line responsibilities, and there generally should be no "dual hatting" (ie the chief operating officer, CFO, chief auditor or other senior management should not also serve as the CRO).[4]

72. Formal reporting lines may vary across banks, but regardless of these reporting lines, the independence of the CRO is paramount. While the CRO may report to the CEO or other senior management, the CRO should also report and have direct access to the board and its risk committee without impediment. Also, the CRO should not have any management or financial responsibility in respect of any operational business lines or revenue-generating functions. Interaction between the CRO and the board should occur regularly and be documented adequately. Non-executive board members should have the right to meet regularly - in the absence of senior management - with the CRO.

73. The CRO should have sufficient stature, authority and seniority within the organisation. This will typically be reflected in the ability of the CRO to influence decisions that affect the bank's exposure to risk. Beyond periodic reporting, the CRO should thus have the ability to engage with the board and other senior management on key risk issues and to access such information as the CRO deems necessary to form his or her judgment. Such interactions should not compromise the CRO's independence.

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[3] See *Framework for Internal Control Systems in Banking Organisations*, Basel Committee on Banking Supervision, September 1998, available at www.bis.org/publ/bcbs40.htm.

[4] Where such "dual hatting" does occur (eg in smaller institutions where resource constraints may make overlapping responsibilities necessary), these roles should be compatible --for example, the CRO may also have lead responsibility for a particular risk area-- and should not weaken checks and balances within the bank.

74. If the CRO is removed from his or her position for any reason, this should be done with the prior approval of the board and generally should be disclosed publicly. The bank should also discuss the reasons for such removal with its supervisor.

Scope of responsibilities, stature and independence of the risk management function

75. The risk management function is responsible for identifying, measuring, monitoring, controlling or mitigating, and reporting on risk exposures. This should encompass all risks to the bank, on- and off-balance sheet and at a group-wide, portfolio and business-line level, and should take into account the extent to which risks overlap (eg lines between market and credit risk and between credit and operational risk are increasingly blurred). This should include a reconciliation of the aggregate level of risk in the bank to the board-established risk tolerance/appetite.

76. The risk management function --both firm-wide and within subsidiaries and business lines-- under the direction of the CRO, should have sufficient stature within the bank such that issues raised by risk managers receive the necessary attention from the board, senior management and business lines. Business decisions by the bank typically are a product of many considerations. By properly positioning and supporting its risk management function, a bank helps ensure that the views of risk managers will be an important part of those considerations.

77. While it is not uncommon for risk managers to work closely with individual business units and, in some cases, to have dual reporting lines, the risk management function should be sufficiently independent of the business units whose activities and exposures it reviews. While such independence is an essential component of an effective risk management function, it is also important that risk managers are not so isolated from business lines - geographically or otherwise - that they cannot understand the business or access necessary information. Moreover, the risk management function should have access to all business lines that have the potential to generate material risk to the bank. Regardless of any responsibilities that the risk management function may have to business lines and senior management, its ultimate responsibility should be to the board.

Resources

78. A bank should ensure through its planning and budgeting processes that the

risk management function has adequate resources (in both number and quality) necessary to assess risk, including personnel, access to information technology systems and systems development resources, and support and access to internal information. These processes should also explicitly address and provide sufficient resources for internal audit and compliance functions. Compensation and other incentives (eg opportunities for promotion) of the CRO and risk management staff should be sufficient to attract and retain qualified personnel.

Qualifications

79. Risk management personnel should possess sufficient experience and qualifications, including market and product knowledge as well as mastery of risk disciplines.[5] Staff should have the ability and willingness to challenge business lines regarding all aspects of risk arising from the bank's activities.

Collected from Basel Committee on Banking Supervision 2010. The Principles on Enhancing Corporate Governance. Basel, Switzerland: Bank for International Settlements Communications.

[5] Some firms have found it to be a sound practice to encourage or require staff to serve in both business line and risk management roles, on a rotational basis, as a requirement for career development. Such an approach can have several benefits, including giving risk management stature within the bank commensurate with business lines and other functions, promoting firm-wide dialogue regarding risk, and ensuring that business lines understand the importance of risk management and that risk managers understand how business lines operate

Appendix 3

Extracts from the BCBS and Culp Covering the Aspects of the CRO's Independence			
"71. Large banks [...] should have an independent senior executive with distinct responsibility for the risk management function and the institution's comprehensive risk management framework across the entire organisation. This Executive is commonly referred to as the CRO. [...] Whatever the title, at least in large banks, the role of the CRO should be distinct from other executive functions and business line responsibilities, and there generally should be no "dual hatting" (ie the chief operating officer, CFO, chief auditor or other senior management should not also serve as the CRO)." (BCBS) *"[...] it is generally a violation of the independence criterion for a CRO to report to a CFO." (Culp p.235, 2001)*	*"72. Formal reporting lines may vary across banks, but regardless of these reporting lines, the independence of the CRO is paramount. While the CRO may report to the CEO or other senior management, the CRO should also report and have direct access to the board and its risk committee without impediment. [...] Interaction between the CRO and the board should occur regularly and be documented adequately." (BCBS)*	*"76. The risk management [...] under the direction of the CRO, should have sufficient stature within the bank such that issues raised by risk managers receive the necessary attention from the board, senior management and business lines." (BCBS)*	*77. [...] the risk management function should be sufficiently independent of the business units whose activities and exposures it reviews. While such independence is an essential component of an effective risk management function, it is also important that risk managers are not so isolated from business lines - geographically or otherwise - that they cannot understand the business or access necessary information. Moreover, the risk management function should have access to all business lines that have the potential to generate material risk to the bank." (BCBS)*
Criteria to Determine the Level of Independence Derived from the Extracts Above			
1. The CRO has: a) distinct responsibilities for the RM function b) separate responsibilities from the revenue generating business lines and thereby do not engage in dual hatting	3. The CRO reports and has direct access to: a) the board b) the risk committee	6. The CRO experiences that he or she has the sufficient stature and authority to receive necessary attention	7. The CRO function operates: a) closely with the business lines of the corporation b) independently from the business lines of the corporation
2. The CRO is separated from the CFO in mainly two distinct ways: a) the CRO does not report directly to the CFO b) the CRO is not hierarchically subordinated the CFO	4. Interaction between the CRO and the board: a) occurs regularly b) is documented adequately		
	5. The CRO shows an awareness of the need of independence by discussing the importance of independence when explaining the risk management work of the organization		

Appendix 4

Interview Questions for the Chief Risk Officer

1. When did the organization implement the position Chief Risk Officer (CRO)?

2. Which factors were the reasons for the implementation of the position CRO?

3. In addition to your role as the CRO, do you have any other positions in the organization?

4. How would you like to describe the way you work with risks in the organization?

5. In the position of CRO, where in the organization are you situated? If we consider an organization schedule, where do you operate?

6. To whom, and how often, do you report as a CRO?

7. Who reports to you and how often? How many people and which positions do they have?

8. If you face a problem or want to discuss something regarding the risk work, from whom do you seek advice?

9. Who evaluates your work as a CRO and how often?

10. Are you experiencing any conflicts of interest regarding how risks are being handled between different units in the organization?

11. How do you experience that the work of the CRO is perceived in the rest of the organization?

12. During your time as a CRO, has there been any reconstruction regarding how the organization works with risks?

13. How do you work to minimize the risk that any person/unit/office goes outside the of the risk management framework?

14. How did you perceive the outcome of the risk work during the crisis in 2007-2009?

15. What is your impression of how the risk work operates today? Or in what ways can it be improved?