Risk culture

Under the Microscope
Guidance for Boards

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Contents

Foreword

For over 25 years the Institute of Risk Management has provided leadership and guidance to the emerging risk management profession with a unique combination of academic excellence and practical relevance. The Institute's profile continues to grow internationally with heightened interest in the management of risk across government, public and business domains.

This board guidance on risk culture is our latest contribution to thought leadership in the field. The continuing parade of organisational catastrophes (and indeed some notable successes) demonstrates that frameworks, processes and standards for risk management, although essential, are not sufficient to ensure that organisations reliably manage their risks and meet their strategic objectives. What is missing is the behavioural element: why do individuals, groups and organisations behave the way they do, and how does this affect all aspects of the management of risk?

> "Problems with risk culture are often blamed for organisational difficulties but, until now, there was very little practical advice around on what to do about it."

Problems with risk culture are often blamed for organisational difficulties but, until now, there was very little practical advice around on what to do about it. This paper seeks to give guidance in this area, drawing upon the wealth of practical experience and expert knowledge across the Institute. It aims to provide advice to organisations wanting greater understanding of their own risk cultures and to give them some practical tools that they can then use to drive change. It should be of interest to board members, executive and non-executive, risk professionals, HR professionals, regulators and academics.

This short document summarises our approach to risk culture for those working at board level. There is also a longer companion document - Risk Culture: Resources for Practitioners - which covers the detailed thinking behind the concepts and models that we have found to be useful. This remains a developing area and we do not consider that we have written the last word on the subject – we expect to see more models and tools and in particular sector and issue-specific work emerging in the future.

I am particularly grateful to Alex Hindson, my immediate predecessor as IRM chairman, who has been the driving force behind this work and who has brought together the wide ranging thoughts of a diverse project group plus a global consultation into a coherent paper.

I would also like to thank our sponsor Protiviti for supporting the design and print of this document, as well as contributing to the content. IRM is a not-for-profit organisation and such support is invaluable in helping us maximise our investment in the development and delivery of world class risk management education and professional development. Our thanks also go to those other organisations and associations from around the world who are endorsing this document and commending it to their members.

Richard Anderson
Chairman,
The Institute of Risk Management

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These days it feels as though we read about another failing in corporate standards almost every day. Maybe it has always been the case but it appears that when the dust settles and the enquiry is over the causes of the failure boil down more often than ever to culture. The term risk culture is bandied about by regulators, politicians and the media. Why does it appear so hard to get risk culture right and what does it look like when we do? Protiviti is delighted to support this new piece of thought leadership from the IRM and looks forward to engaging in the resulting debate with its members and with the wider business community to bring solutions to this topic to the front of the business agenda.

Peter Richardson
Managing Director
Protiviti

What does a good risk culture look like?

An effective risk culture is one that enables and rewards individuals and groups for taking the right risks in an informed manner.

A successful risk culture would include:

1. A distinct and consistent tone from the top from the board and senior management in respect of risk taking and avoidance (and also consideration of tone at all levels)
2. A commitment to ethical principles, reflected in a concern with the ethical profile of individuals and the application of ethics and the consideration of wider stakeholder positions in decision making
3. A common acceptance through the organisation of the importance of continuous management of risk, including clear accountability for and ownership of specific risks and risk areas
4. Transparent and timely risk information flowing up and down the organisation with bad news rapidly communicated without fear of blame
5. Encouragement of risk event reporting and whistle blowing, actively seeking to learn from mistakes and near misses
6. No process or activity too large or too complex or too obscure for the risks to be readily understood
7. Appropriate risk taking behaviours rewarded and encouraged and inappropriate behaviours challenged and sanctioned
8. Risk management skills and knowledge valued, encouraged and developed, with a properly resourced risk management function and widespread membership of and support for professional bodies. Professional qualifications supported as well as technical training
9. Sufficient diversity of perspectives, values and beliefs to ensure that the status quo is consistently and rigorously challenged
10. Alignment of culture management with employee engagement and people strategy to ensure that people are supportive socially but also strongly focused on the task in hand.

Take any public meltdown (for example, MPs' expenses, press standards, LIBOR manipulation, Enron, the space shuttle disasters) and many of the these features will be notably absent.

Case study

In May 2012 JPMorgan Chase disclosed a multi-billion-dollar trading loss on its "synthetic trading portfolio". By its own admission the events that led to the company's losses included inadequate understanding by the traders of the risks they were taking; ineffective challenge of the traders' judgment by risk control functions; weak risk governance and inadequate scrutiny (Dimon, 2012). According to the New York Times, individuals amassing huge trading positions were not effectively challenged, there were regular shouting matches and difficult personality issues.

(New York Times, 2012)

What do we mean by risk culture?

Risk culture is a term describing the values, beliefs, knowledge and understanding about risk shared by a group of people with a common purpose, in particular the employees of an organisation or of teams or groups within an organisation. This applies whether the organisations are private companies, public bodies or not-for-profits and wherever they are in the world.

We propose the use of a simple A-B-C approach (Institute of Risk Management, 2012) as helpful in understanding how culture, and hence risk culture, works in practice.

- The Culture of a group arises from the repeated Behaviour of its members
- The Behaviour of the group and its constituent individuals is shaped by their underlying Attitudes
- Both Behaviour and Attitudes are influenced by the prevailing Culture of the group

The culture in an organisation arises from the repeated behaviour of its members. These behaviours are shaped by the underlying values, beliefs and attitudes of individuals, which are partly inherent but are also themselves influenced by the prevailing culture in the organisation. Culture is therefore subject to 'cycles' which can self-reinforce in either virtuous, or vicious, circles. Culture is more than a statement of values – it relates to how these translate into concrete actions. Everyone will have had direct experience of the different cultures in different places of work, even in organisations apparently working in similar circumstances. We would expect to find that the culture of, for example, a video game company would contrast significantly with that of a government department. Equally there would be cultural differences between two different government departments and two different video game companies.

"Risk culture" refines the concept of organisational culture to focus particularly on the collective ability to manage risk, but the wider organisational culture itself is an active backdrop determining, and itself influenced by, risk culture. Taking each step in the model:

- Risk attitude is the chosen position adopted by an individual or group towards risk, influenced by risk perception and pre-disposition
- Risk behaviour comprises external observable risk-related actions, including risk-based decision-making, risk processes, risk communications etc.
- Risk culture is the values, beliefs, knowledge and understanding about risk, shared by a group of people with a common intended purpose, in particular the leadership and employees of an organisation.

One of the many challenges in addressing culture is that people naturally gravitate to others like themselves so the culture of an organisation can self-propagate if recruitment processes and environment remain unchallenged.

Every organisation has a risk culture (or indeed cultures): the question is whether that culture is effectively supporting or undermining the longer-term success of the organisation.

"Culture is an environment, a petri dish in which certain behaviours and characteristics are allowed to flourish or not."

John Harvie
Director,
Protiviti Insurance and Business Operations Improvement

Why is risk culture so important?

All organisations need to take risks to achieve their objectives. The prevailing risk culture within an organisation can make it significantly better or worse at managing these risks. Risk culture significantly affects the capability to take strategic risk decisions and deliver on performance promises. Organisations with inappropriate risk cultures will inadvertently find themselves allowing activities that are totally at odds with stated policies and procedures or operating completely outside these policies. An inappropriate risk culture means not only that certain individuals or teams will undertake these activities but that the rest of the organisation ignores, condones or does not see what is going on. At best this will hamper the achievement of strategic, tactical and operational goals. At worst it will lead to serious reputational and financial damage.

Problems with risk culture are frequently found at the root of organisational scandals and collapses. Following the financial crisis, the Walker report into the corporate governance of UK banks concluded, "The principal emphasis is in many areas on behaviour and culture, and the aim has been to avoid proposals that risk attracting box-ticking conformity as a distraction from and alternative to much more important (though often much more difficult) substantive behavioural change" (Walker, 2009). The Baker report (Baker, 2007) into the BP Texas City explosion in 2005 concluded that deficiencies in leadership, competence, communications and culture led to the circumstances that caused the death of 15 people.

Risk culture is not always about taking too much risk: certain cultures may be so good at developing and implementing formal processes and frameworks that they stifle the risk-taking necessary for successful innovation. In other situations, the prevailing culture can make it virtually impossible to embed the risk attitudes and behaviours that guide appropriate action outside of rules and policies, ultimately leading to uncontrolled risk taking.

Some key differences between national cultures are amplified by the uncertain nature of risk. For example, in some cultures, 'yes' means best efforts to meet a plan rather than the certainty of event it means in others. Equally, in Eastern cultures, there is also a far more developed sense of shame than there is in Western cultures and this can have a significant effect on both managing and reporting risks, with good and bad points attributable for each cultural type. Perhaps less well known and given it is important to ensure everyone 'buys in' on risk matters, in African cultures this will mean each party having time and opportunity to share their views, even if just to agree with what others had said. In contrast, in Europe and North America, we tend to accept what has been said and only raise alternative points in added dialogue. Again these must be seen as differences rather than as a right and wrong way, as each approach has its good and bad points.

Over recent years significant progress has been made in developing rules, frameworks, processes and standards for managing risks. However the business press everyday confirms that these disciplines are not in themselves sufficient to make a tangible difference to the success or failure of organisations. Rules can be misunderstood and misapplied, inadvertently or deliberately. The 'missing link' in understanding how to balance risk and reward successfully in decision-making is the organisation's risk culture.

What can the board do about risk culture?

Corporate governance requirements around the world are increasingly demanding that boards of organisations should understand and address their risk cultures. The board has a responsibility to set, communicate and enforce a risk culture that consistently influences, directs and aligns with the strategy and objectives of the business and thereby supports the embedding of its risk management frameworks and processes. This starts with the risk behaviours, attitudes and culture of the board itself and reaches down through the organisation.

The board needs to ask:

- what is the current risk culture in our organisation and how do we improve risk management within that culture?
- how do we want to change that culture?
- how do we move from where we are to where we want to be?

Research carried out by IRM (Institute of Risk Management, 2012) indicates that little consensus has yet emerged amongst risk professionals on the best way to help the board approach the analysis of risk culture. Most organisations adopt informal evaluation techniques or avoid doing so at all.
IRM is therefore offering the approach in this document as a practical framework for addressing these challenges. We recognise that this is a rapidly developing field and we are seeking to provide a useful contribution to what remains an insufficiently understood aspect of making risk management of strategic value to organisations.

"The issues with which companies were grappling included understanding their exposure to risk and how this might change, identifying the information and assurance that the board needed to carry out its role, embedding the right risk culture throughout the company, and the increased velocity of risk which had highlighted the importance of effective crisis management."

(Financial Reporting Council, 2011)

Case study

An inappropriate risk culture isn't always about taking too much risk. Eastman Kodak was a trusted leading brand for over a hundred years. But its strategic failure to reinvent itself and exploit digital technology led to a descent into Chapter 11 bankruptcy.

Its culture meant that Kodak avoided risky decisions, and instead developed procedures and policies to maintain the status quo rather than adapting to the changing external environment.

(Mendes, 2007)

Understanding the risk culture in an organisation

"People, present and past, make the place"

Although there is no single right way to measure risk culture, there are a number of diagnostic tools available that can be used to indicate and then track the risk culture in an organisation. The mix of tools and the order of their deployment will depend on the context of the organisation and its risk management maturity. We set out the details of the models, tools and approaches that we have found useful in our companion document Risk Culture: Resources for Practitioners.

IRM has defined a Risk Culture Framework around which to analyse, plan and act to influence risk culture within any organisation. We look at the effects of predisposition towards risk and personal ethics in shaping attitudes and behaviours and we look at the role of organisational cultures. Figure 1 below attempts to distil what is a complex and interrelated set of relationships into a simple and high level approach to looking at the various influences on risk culture. Risk culture is the sum of multiple interactions. At the lowest level, each individual's personal predisposition to risk contributes to their ethical stance, how they behave and make decisions. Group behaviours and the underlying organisational culture also influence risk culture.

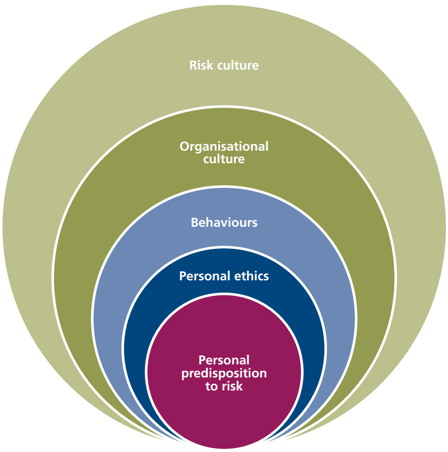

Fig 1 IRM Risk Culture Framework

The individual level

There may be concern that the culture of the organisation is attracting and encouraging individuals whose inherent ethical stance or risk-taking predisposition may be at odds with the board's commitment to high standards of integrity in dealing with all stakeholders. Taxi drivers and airline pilots are routinely given personality tests to determine how effectively they can exhibit self-control under stress – we should be ready to look at other key staff, managers and board members in the same way.

Personal predisposition to risk

Every individual comes to an organisation with their own personal perception of risk. People vary in all sorts of ways and this includes their predisposition towards risk. Personality research identifies two specific traits that contribute to this:

- The extent to which people are either spontaneous and challenge convention or organised, systematic and compliant;
- The extent to which people may be cautious, pessimistic and anxious, or optimistic, resilient and fearless.

It is possible to measure predisposition to risk by use of personality assessment tools. Their basic rationale is that, with regard to risk taking, people vary enormously. In culture building terms, the balance in risk types and their representation either across the organisation or within departments is a factor in shaping culture. A number of psychometric tools can facilitate this and one such tool, the Risk Type Compass™, places individuals into one of eight risk types and can provide an overview of the risk landscape and the prevailing risk culture. At the boardroom level, the balance of risk types has a significant influence on team dynamics and affects the collective perception of risk, willingness to take risks, inter-personal perceptions, information sharing and decision-making.

Personal ethics

Organisations need to pay attention to the ethical profile of those working in their business. Every individual comes with their own balance of moral values and these have great influence over the decisions they make on a day-to-day basis. Psychometric tools can be used to assess moral values. One such tool, Moral DNA™ evaluates ten core moral values (e.g. courage, prudence, trust, fairness, honesty) that map to three ethical consciences, significantly influencing individuals' decision making:

- ethic of obedience (rule compliance, spirit of the law etc.)
- ethic of care (empathy, concern, respect etc.)
- ethic of reason (wisdom, experience, prudence etc.)

"…only 55% of all respondents could say definitively that they would not engage in insider trading if they could make $10 million with no risk of getting arrested."

(Labaton Sucharow, 2012)

Used across an organisation such a tool can assess the overall ethical biases. At an individual level, it can highlight tendencies that have been shown to be prevalent in poor decision-making, leading to reputational disasters. Interestingly, analysis of the results of these tests over a large number of individuals shows that the preference for decision making based on the ethic of obedience (or rule compliance) increases when they go to work. However the ethic of care becomes suppressed, as shown in Figure 2 below. People at work become less likely to think, question or challenge instructions.

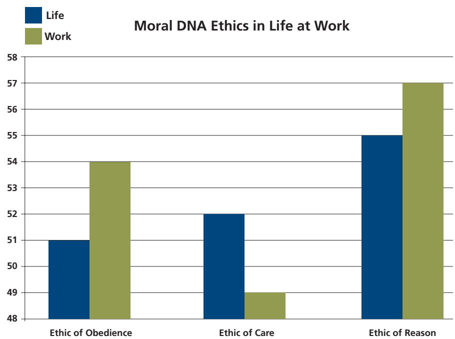

Fig 2 Individual Ethics in Life and at Work

The organisational level

Individual values and beliefs and attitudes towards risk contribute to and are affected by the wider overall culture of the organisation. We have found it useful to employ a sociability vs. solidarity model (Goffee and Jones, 1998) (also called the "Double S" model) which considers culture in relation to two key dimensions:

- sociability (people focus - based on how well people get on socially); and
- solidarity (task focus - based on goal orientation and team performance).

The model identifies four distinct organisational cultures (see Figure 3), described as:

- Networked (high on people focus, low on task focus)
- Communal (high people, high task)
- Mercenary (low people, high task)
- Fragmented (low people, low task).

This Double S model offers a cultural view of the organisation and a useful complementary diagnostic. In particular it is good at predicting the success with which structured approaches to managing risk are implemented in organisations. Strong sociability ensures a sense of cohesion and common purpose in working across organisational boundaries. Strong solidarity is helpful in ensuring that risk mitigation plans are acted upon.

Each culture in the model, even in its most positive form, has both an upside and a downside in respect of risk management performance. However, research undertaken by the IRM (Institute of Risk Management, 2012) indicates that organisations should seek to strengthen both their sociability and solidarity ratings in order to implement risk management more effectively. Low scores on either factor create a barrier to the effective management of risk.

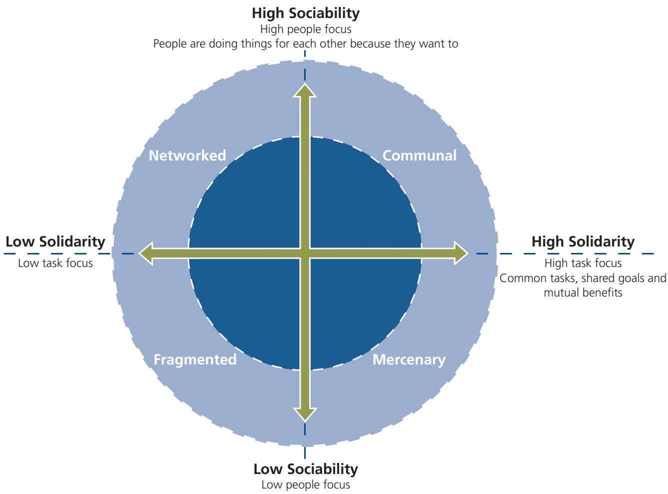

Fig 3 Sociability v Solidarity (Double S) Model

Improving risk management within the existing organisational culture

In the short term, it may be necessary for boards to focus on improving risk management within the existing culture by understanding that culture and then designing a culturally sensitive enterprise risk management programme.

So, for example, to drive engagement with risk management in an organisation with a 'Networked' culture (with high levels of social interaction and low tolerance for rules and procedures) participative risk workshops may be a successful tool. By contrast, in an organisation with a 'Mercenary' culture, regular reporting and risk information systems might be implemented more successfully. The drive here is to 'go with the grain' of the existing organisation culture.

Changing a risk culture

IRM believes that it is possible for an organisation to drive change in its risk culture. This requires a clear understanding of the current culture and the desired 'target' culture. It requires recognition that this is a major change programme and requires discipline to see it through.

The culture change should be treated as a change management project in its own right, with appropriate allocation of board time and resources. A culture cannot be rewritten simply by mandating that the values or ideology of an organisation have changed.

The organisation must approach the risk culture change as a project, with a set of objectives, a design for intervention and with regular review of both progress and outcomes. Change can be implemented by pulling on certain 'levers' to make noticeable change in important areas. Risk management will need to work closely with HR on a number of key change areas.

We recognise that risk culture is not a precise science - there is no 'recipe book' answer. However there is a range of well recognised models, tools and approaches that have been proven in certain situations to be valuable in supporting and sustaining culture change. In our companion document Risk Culture: Resources for Practitioners we set out more detail about these approaches. We recommend that these resources are included within the work of risk professionals.

Successful change ultimately requires awareness that the board itself, and the executive management, are an integral part of the existing risk culture. Sustained change in the risk culture needs to start at the top and may require a reappraisal of approaches consistent with bringing greater diversity of thinking into the boardroom.

To change a risk culture, we have to be able to describe the vital aspects of that culture. Risk culture remains challenging to measure but, as sometimes attributed to the late Professor Peter Drucker, 'If it can't be measured it can't be managed'.

Case study

In March 2005 a fire and explosion at the Texas City refinery owned by BP killed 15 workers and injured 170 others. The subsequent enquiry found deficiencies in leadership, competency, communications and culture.

(Baker, 2007)

IRM Risk Culture Aspects Model

This model (see Fig 4), developed by the IRM, identifies eight aspects of risk culture, grouped into four themes, key indicators of the 'health' of a risk culture: aligned to an organisation's business model. Diagnosis can be by means of a simple questionnaire or structured interview techniques. A gap analysis provides pointers to areas of strength and weakness and hence allows prioritisation and focus to be brought to what can be a difficult set of issues to grasp.

The focus is on identifying tangible actions that be taken to address areas of concern, drawing from a tool kit. The model presupposes a continuous improvement approach where a risk culture is moved incrementally and performance tracked over time. It is important to recognise where positive culture cycles need to be reinforced, and vicious cycles broken, to make a step-change improvement.

This approach, set out diagrammatically below in Figure 4, requires the organisation to self-assess in the areas of:

Tone at the top

- risk leadership - clarity of direction
- how the organisation responds to bad news

Governance

- the clarity of accountability for managing risk
- the transparency and timeliness of risk information

Competency

- the status, resources and empowerment of the risk function
- risk skills - the embedding of risk management skills across the organisation

Decision making

- well informed risk decisions
- appropriate risk taking rewarded and performance management linked to risk taking.

Fig 4 IRM Risk Culture Aspects Model

The risk culture aspects model links with the sociability vs. solidarity analysis through planned action to address deficiencies in the current culture. The interventions required may relate to driving an increase in the levels of sociability and/or solidarity and pushing the organisation into a position more conducive to effective risk management.

The risk culture aspects model specifically links the aspects shown in red in the diagram to greater impact on sociability and the blue aspects to improvements in solidarity. More detail is provided within our companion document Risk Culture: Resources for Practitioners on how to deploy these concepts.

Ten questions a board should ask itself

1. What tone do we set from the top? Are we providing consistent, coherent, sustained and visible leadership in terms of how we expect our people to behave and respond when dealing with risk?
2. How do we establish sufficiently clear accountabilities for those managing risks and hold them to their accountabilities?
3. What risks does our current corporate culture create for the organisation, and what risk culture is needed to ensure achievement of our corporate goals? Can people talk openly without fear of consequences or being ignored?
4. How do we acknowledge and live our stated corporate values when addressing and resolving risk dilemmas? Do we regularly discuss issues in these terms and has it influenced our decisions?
5. How do the organisation's structure, processes and reward systems support or detract from the development of our desired risk culture?
6. How do we actively seek out information on risk events and near misses – both ours and those of others - and ensure key lessons are learnt? Do we have sufficient organisational humility to look at ourselves from the perspective of stakeholders and not just assume we're getting it right?
7. How do we respond to whistleblowers and others raising genuine concerns? When was the last time this happened?
8. How do we reward and encourage appropriate risk taking behaviours and challenge unbalanced risk behaviours (either overly risk averse or risk seeking)?
9. How do we satisfy ourselves that new joiners will quickly absorb our desired cultural values and that established staff continue to demonstrate attitudes and behaviours consistent with our expectations?
10. How do we support learning and development associated with raising awareness and competence in managing risk at all levels? What training have we as a board had in risk?

Case study

Staff at Barclays repeatedly filed misleading figures for interbank borrowings. First, between 2005 and 2008 - and sometimes working with traders at other banks - they tried to influence the Libor rate, in order to boost their profits. Then between 2007 and 2009, at the peak of the global banking crisis, Barclays filed artificially low figures. This tactic sought to hide the level to which Barclays was under financial stress at a point where their peers were being forced to accept state funding. When the scandal came to light it led to the resignation of the bank's chief executive Bob Diamond, along with Barclays chairman Marcus Agius. Barclays was fined £290m by UK and US regulators for rigging Libor and investigations are continuing. Barclays have set up an independent review to assess the bank's current values, principles and standards of operation and determine to what extent those need to change. It will also test how well current decision-making processes incorporate the bank's values, standards and principles and outline any changes required.

(BBC Website, 2012)
(Barclays Press Release, 2012)

What do we do next?

We set out below the steps that need to be taken to start on a programme of risk culture change.

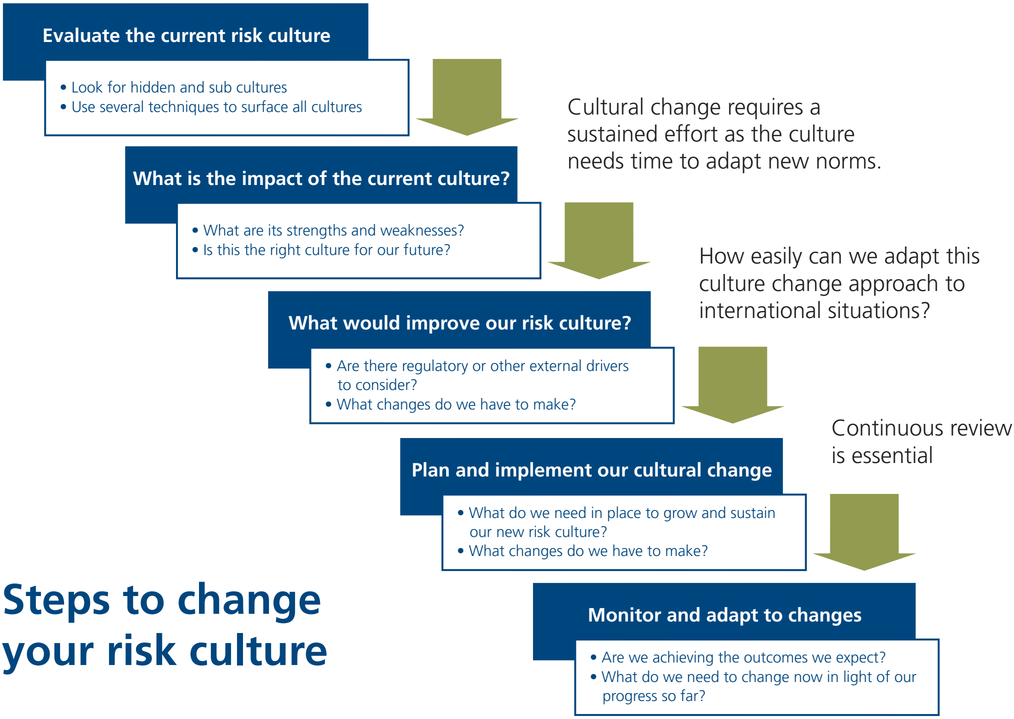

Fig 5 Steps to change your risk culture

This summary guidance is backed up by a more detailed document Risk Culture: Resources for Practitioners which gives the tools and techniques to take forward these ideas on risk culture and includes a number of case studies. These resources can be found on the IRM website **www.theirm.org**

Who are the IRM?

This work has been led by members of the Institute of Risk Management, which for over 25 years has been providing leadership and guidance to the emerging risk management profession. In its training, qualifications and thought leadership activity, including seminars, regional and special interest groups, the Institute aims to bring together sound academic work with the practical experience of its members working in many diverse types of organisation worldwide. IRM would like to thank everyone involved in the background research and in making input to the project group working on these risk culture guidance documents.

Case study

The failure of the Royal Bank of Scotland (RBS) in 2008 imposed large costs on UK citizens. The subsequent report produced by the Financial Services Authority concluded that the cause of the collapse was poor decision making on the part of the management and board (exacerbated by shortcomings in regulation and supervision). The report said that "Individual poor decisions can result from flawed analysis and judgment in particular circumstances: many of the decisions that RBS made appear poor only with the benefit of hindsight. But a pattern of decisions that may reasonably be considered poor, at the time or with hindsight, suggests the probability of underlying deficiencies in: a bank's management capabilities and style; governance arrangements; checks and balances; mechanisms for oversight and challenge; and in its culture, particularly its attitude to the balance between risk and growth."

(Financial Services Authority, 2011)

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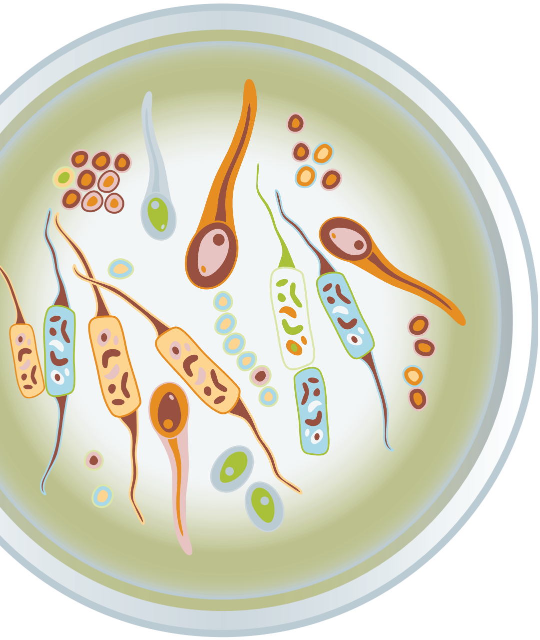

Do you want to find out more about risk culture?

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RISK CULTURE CONFERENCE

**22 January 2013,
London UK**

to pre-register your interest email

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