

# INTELLIGENT RISK

knowledge for the PRMIA community



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Professional Risk Managers' International Association





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letter from the chair



Justin M. McCarthy  
Chair, PRMIA



Kraig Conrad  
Executive Director, PRMIA

It is with great delight that we present another edition of iRisk to the PRMIA global network. In these pages we explore risk culture, an often discussed topic for risk programs and a topic of increasing interest to regulators. It is our hope that this edition advances dialogue within your organization to further your efforts to build sound culture.

We thank Sergio Galanti, managing partner at Inveniat Consulting, for his dedication to PRMIA and his hard work providing editorial direction for this edition. It is dedication like his and that of the legions of other volunteers that make our global network so strong.

in this edition

In “Risk Culture – What it is and how to Cultivate it,” Matthew Dive, PRM, shares his views on the interplay of human nature and individual personality in guiding behavior. He proposes this interplay is challenged by gaps where there are no controls and limits, and that is when unacceptable behavior is more likely to occur. Dive reinforces the principles of tone setting at the top of the organization, the difficult task of incentives and measurement, and managing consequences of bad behavior.

The gaps are further explored in “Influencing Your Organization’s Risk Culture,” by Mark Trembacki, who discusses what falls outside of frameworks as that is where culture is tested. Trembacki supports key principles, such as an organization supporting through action its desired culture, with a view on finding ways for frameworks to be flexible enough to serve their primary purpose while closing gaps.

In “Risk Culture – A Recipe for Success,” Helen Carmody adds the importance of communications and values that foster opportunities to challenge thinking and practices. She notes that there needs to be a balance, as building a sound risk culture can be like baking a cake; an organization needs the right ingredients, in the correct proportions, with the precise amount of time.

In “The Four Pillars of Risk Culture,” Adam Litke reframes what is risk process versus risk culture by discussing principles of transparency, challenge, humility, and curiosity. He offers his views that risk culture is not about what one does, it is about how they do it and what they are thinking when they do it.

In “The Next Big Step Forward in Risk Management,” Dr. Jonathan Allenby, Colm Fitzgerald, and Dr. Monika Smatralova take a deep look at agency risk and its role in culture. They provide some initial thoughts on solutions, invite you in to their dialogue, and set the stage for their next article.

And finally, on a different topic, there is a briefing from Bob Mark on the latest in the FinTech event series at the San Francisco Chapter. In addition to the challenges and learnings discussed in the article, FinTech risk managers are adding customer acquisition to their focus.

### proposed Bylaw update

PRMIA C-Suite, Sustaining, and Contributing members have the opportunity to vote on proposed bylaw updates. The updates were proposed by the PRMIA Nominating Committee and approved by the Board of Directors. The updates are intended to ensure continuity of a highly-performing Board that is representative of its membership, allow the size of the Board to expand to meet strategic needs, reorganize Board positions to enhance leadership continuity, and establish term limits.

**Vote on Bylaw Updates by July 19, 2016 at [prmia.org/bylaws16](http://prmia.org/bylaws16)**

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### strategy update

We are pleased with the progress of our strategic planning process. As we noted in the last edition of iRisk, the Board has agreed on a strategy framework that includes a process by which tactics are developed by our Global Committees. Tactics development is nearly complete, and the budget and annual workplan will go before the Board for approval this month. The new plan goes into effect July 2016, and you will begin to hear more about that plan at Chapter events.



The strategy divides efforts into quadrants in order to further our growth in service of our profession. These quadrants center on PRMIA as the portal to our network of more than 50,000 professionals around the world.

- Global Perspective: cater to the diverse needs of our global membership efficiently and effectively
- Learning & Development Leader: be the leading provider of learning and development across key attributes and functions of risk management
- Central to Profession: be the global thought leader for risk professionals
- Strong Community: foster a strong sense of community among PRMIA membership, associated groups, and practitioners

### increasing our reach

We have been on the road visiting Chapters and spreading the word about what’s new at PRMIA while broadening our coverage of risk.

In April, Kraig joined the San Francisco Chapter for an event on FinTech risk management and compliance to hear their challenges and further understanding of how PRMIA can serve risk managers at these businesses. At the event, practitioners from FinTech companies shared lessons learned and dialogue on the industry.

In May, we traveled to China to meet with banks, regulators and trainers in efforts to expand the reach of PRMIA learning and development. We have a tremendous opportunity to serve the growing community of members in the region who strongly embrace our practitioner-led and competency-based training and events.

There were many trips over the last quarter, including visits with Chapters in London, Montreal, Munich, Netherlands, New York, San Francisco, and Washington DC. We look forward to seeing you in person at the next event for an update on how PRMIA is improving service to the community.



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For those in Canada, be sure to attend the PRMIA Canadian Risk Forum, September 20 - 21, 2016 in Toronto. And, for those in the EMEA region, look for the soon-to-be-announced PRMIA EMEA Risk Summit in London this November. Visit [prmia.org/events](http://prmia.org/events) to learn more.

And, be sure to check the schedule for events at our 45 Chapters around the world. Visit [prmia.org/chapters](http://prmia.org/chapters) to learn more and join practitioners in your local community.

As we do with each edition of *iRisk*, we invite you to be join us on our journey to serve the global risk profession. You are why the organization exists. Please raise your hand to volunteer, if you are not already serving, to add your voice to dialogue on the future of PRMIA.

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## 🍰 risk culture - a recipe for success

by **Helen Carmody**

Like baking a perfect cake, establishing a strong risk culture is the result of choosing the right ingredients, mixing them in the right proportions, and baking for the right amount of time. A risk-aware culture is integral to effective risk management, which aims to minimize the possibility of loss while achieving objectives. Taking some risk is inevitable, and good risk management can deliver significant benefits.

When baking, the greater the effort you put into sourcing quality ingredients and weighting them accurately, the better the result is. The finished product is simply the result of the contributing components. Similarly, a risk-aware culture is the result of combining four key ingredients:

- Values – they are key to a company success. Values differ from company to company, and they need to be embedded in all aspects of operational activities. Company values are important to employees: a high level of employee engagement comes from the alignment of personal with company values so it is crucial that values are clear, relevant, and well communicated.
- Communication – it is important that senior management ensures organizational risk objectives are aligned to company values and both are clearly communicated to the organization. Risk policies and frameworks, including risk appetite and tolerance levels, ensure consistent risk management across the company regardless of responsibility, personal preference, or pay grade. Ongoing and targeted training is essential to support the communication of risk requirements and helps embed the desired risk-aware culture. Communication of expectations needs to be proactive and regularly reiterated to stay “front of mind”.
- Incentives and disincentives – they are used to encourage compliance with risk management frameworks and minimize limit breaches. Remuneration, non-monetary recognition, and development opportunities are good examples of incentives, and they need to be aligned with company values and organizational objectives. Short-term goals need short-term incentives. From senior management levels through to operational staff, incentives should be clearly articulated, communicated and distributed in a consistent and transparent way. Disincentives can be difficult to implement without being punitive but can be useful to demonstrate unacceptable behavior. Misconduct, including cutting corners and cover-ups, needs to be addressed in a timely manner with consequences visible to all staff.

- Metrics – both quantitative and qualitative measures are important and are expected by boards and regulators. Measuring compliance with risk management obligations, such as completing training on time, is straightforward and this is often captured in balanced scorecards. Surveys and engagement results are also useful quantitative contributors. Qualitative measures are more subjective but still relevant. Positive engagement with the risk function versus continual pushback is hard to measure but provides an indication of culture. Financial loss due to poor conduct, including fraud, provides a very tangible and repeatable measure.

Establishing a strong risk-aware culture is possible by mixing these ingredients in a way that aligns with company size, mix and complexity.

Where the perfect cake might provide great taste, texture and presentation, demonstrated behaviors of a strong risk culture include:

- Accountability/ownership – at all levels of management
- Clear escalation channels – visible reminders of who to go to when an issue is identified
- Committed leadership – the tone at the top is where it all begins
- Opportunity to challenge – encouraging all staff to ask questions
- Reward and consequence – supports the desired message

Individual performance reviews are a taste test for risk culture. They can be very good indicators of risk culture if emphasis is placed on the right behavioral objectives. Problems arise when performance measurement is not aligned to the desired risk culture. If performance assessments don't consider and recognize risk related achievements and behaviors, this will conflict with what a company is trying to achieve. For example, boards and senior managers may encourage challenge & escalation, but performance templates may not incorporate and reward these behaviors adequately.

Every company must strive to instill a strong risk-aware culture that delivers the performance to reach defined organizational objectives. By considering the four elements mentioned above, that is, company values, clear and ongoing communication, appropriate incentives and metrics, then with time and attention, the desired risk culture is achievable. Like a tried and tested cake recipe, once it is perfected the benefits are both reliable and enjoyable.

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## authors

### Helen Carmody

#### Senior Risk Manager



Helen Carmody is a Senior Risk Manager for QSuper, a superannuation (pension) fund in Brisbane, Australia. With qualifications in applied mathematics and finance, Helen has over 14 years' experience in financial services in both regulator and institutional settings. Specializing in stakeholder engagement and strategic communication, Helen has worked with Executive Officers to develop and implement risk management frameworks. She is currently playing a key role in the establishment of an insurance company within the QSuper Group. Helen is passionate about risk culture and believes we all have a role to play in defining the desired risk culture of the company for which we work. Helen is a Sustaining member of PRMIA.



## 📊 influencing your organization's risk culture

by **Mark D. Trembacki**

In a data-driven business and risk environment that increasingly demands predictive measures and sophisticated models, the term “risk culture” can be seen as abstract and difficult to assess and measure. In my view, risk culture is the glue that binds all aspects of risk-taking

and risk management together through shared organizational values, beliefs, and attitudes. Through awareness and deliberate planning, risk culture can be proactively influenced to enhance an organization's risk and business management environments.

Without a strong risk culture, even the best Enterprise Risk Management framework would be vulnerable to weaknesses and failures. In its July 2008 report, the Institute of International Finance stated: “Effective development of a risk culture throughout the firm is perhaps the most fundamental tool for effective risk management.”<sup>1</sup> Risk culture provides an essential element to a successful and sustainable risk management framework with key benefits such as:

### Enhancing desired flexibility

Strong risk organizations understand that risk management frameworks are designed to be flexible in order to accommodate the complexities and vagaries of real world scenarios. By serving as an enduring guiding light, risk culture supports better decisions and actions without overly rigid or complex rules.

### Bridging framework gaps

Even the best risk framework has gaps in coverage or direction. Risk culture can guide actions when a gap exists. A strong risk culture can also counterbalance exposures resulting from complex organizational structures or operational practices.

### Supporting growth, change, and continuous improvement

As new business activities are explored, operating environments evolve, or enhancement opportunities are identified, risk culture supports more proactive, timely, and seamless transitions; it also heightens the effectiveness of change management disciplines.

To achieve these important benefits, risk culture requires assessment and planning. Like many aspects of risk management, basic awareness of your environment and risk drivers is the first step. Based on my experience, I propose six primary ways to proactively shape your risk culture:

#### 1. Discuss it by making risk culture a deliberate part of your leadership agenda.

If you manage what you measure, then apply that practice to talking about qualitative concepts like risk culture. As Christine Lagarde stated, leaders must take “values as seriously as valuation, culture as seriously as capital.”<sup>2</sup>

#### 2. “Walk the talk” and ensure that the stories your organization tells reinforce culture.

The message delivered by the leadership is important and should be consistently communicated throughout the organization leveraging as many channels as possible. Can you increase clarity and consistency on what is valued? Consider the “urban legends” in your organization and make sure that those powerful stories support the risk culture you desire.

#### 3. Be on the lookout for ways to enhance transparency.

Timely, relevant, and complete information flow is critical for decision makers. Problems and challenges are inevitable: transparency translates into an improved ability to deal with challenges (and seize opportunities) more openly, effectively, and proactively.

#### 4. Examine decision-making, and other approval and governance processes.

Risk considerations should be formally embedded in decision-making processes, including strategy. Strong and effective processes convey the organization's key decision standards. Lastly, strive to achieve a balance of collaboration and consensus with effective challenge to ensure the organization is able to fully identify current or emerging risks.

#### 5. Think about incentives and consequences, both visible and informal.

Financial and other incentives need to support the desired risk culture. Outcomes achieved through inappropriate or countercultural behaviors should not be rewarded.

#### 6. Foster a safe environment for employees to bring forward risks or issues.

Employees need to know they are supported if they identify an unmitigated risk or emerging threat.

<sup>1</sup> / “Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations,” Institute of International Finance, July 2008, 33.

<sup>2</sup> / Christine Lagarde, “Economic Inclusion and Financial Integrity,” Address to the Conference on Inclusive Capitalism, London, England, May 27, 2014.

The organization’s leadership can first consider these topics; however, it also is beneficial to cast the net more broadly to obtain a deeper composite view to see what employees really think. This fact-finding objective can be accomplished through surveys, focus group discussions, virtual water coolers, or other methods with employees and potentially external stakeholders with a view into the organization. Crafting a set of survey questions appropriate for your organization is not only a great way to collect information, but it serves a reinforcing role in and of itself as the outreach shapes your risk culture by showing leadership is paying attention to it.

A strong risk culture provides broad benefits to any organization, and its shape and evolution should not be left to chance. Risk culture is a powerful influence within your organization, guiding actions and behaviors. Through thoughtful planning, risk culture can be proactively molded to support the strategic goals of your organization.

author

Mark D. Trembacki



Mark Trembacki founded Risk Management Levers, Inc., a consulting firm focused on risk management strategies and change management. He teaches Enterprise Risk Management in the Masters of Finance program at the University of Illinois, Urbana-Champaign. Mark previously enjoyed a diverse career at BMO Financial Group, holding a variety of senior risk management and business leadership roles.

Mark graduated from the University of Illinois, earned an MBA in Finance from The University of Chicago Booth School of Business, and is a CPA. Mark serves as the Treasurer of the DuPage Children’s Museum and Chair of the Chicago Metro History Education Center. Mark is a Sustaining member of PRMIA.

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## 🚧 risk culture - what is it and how to cultivate it

by **Matthew Dive**, PRM

Like Justice Stewart's famous obscenity test, we know bad risk culture when we see it. Traders in London manipulated the LIBOR fix, all the while describing themselves as the 'Cartel'. Credit ratings agencies competed to stamp AAA ratings on structured credit products of dubious quality. And executives at Enron shuttered power plants for false maintenance in order to profit from spikes in energy prices.

Despite our ease in recognizing bad examples of it, defining risk culture is more difficult. In sociology, culture sits between human nature and individual personality as a set of behaviors and beliefs that guides – if not binds – acceptable behavior. In the financial services industry, a useful way to think about risk culture is what we do in the 'gaps', or in the absence of limits or controls. For most of us, what we do in the gaps dominates our working day.

There are several approaches for managing risk culture, although many suffer from a lack of clarity and provide too little practical guidance. The following are five indicators of risk culture along with some practical considerations of what can be done to improve it.

**Tone-from-the-top meets the message-in-the-middle.** Every discussion of risk culture notes the importance of 'tone-from-the-top'. Clear and repeated messages from the top set cultural expectations. Having structural governance pieces in place like a Chief Risk Officer, clear reporting lines, and a separate risk committee also matters. Furthermore, a thorough and practical risk appetite statement that cascades effectively from the Board down helps to ensure that risk is accounted for in business decisions.

Despite this, the steer provided from middle management to their direct employees bears significant influence on risk culture. Research<sup>1</sup> indicates that managers' risk perspectives play a more significant role in shaping their employees' attitudes than any message from the executive management. Given this phenomenon, it is easy to see how sub-cultures can develop between teams led by managers with different perspectives on risk. This also means that programs, training, and interventions should be tailored to take account of these sub-cultures rather than to take a one-size-fits-all approach.

<sup>1</sup> / "Risk Governance, Structures, Culture and Behaviour: A View from the Inside", Elizabeth Sheedy and Barbara Griffen, 2014.

**Measure it.** Like anything in risk, you should measure what you want to manage. Formal surveys on a standalone basis or as part of staff surveys can provide valuable insights, although attention to format needs to be given, as busy staff will set aside surveys that are too long. Furthermore, a perceived lack of anonymity may reduce response rates or cause distorted responses by staff worried about recriminations. Sampling small populations or where staff turnover is high can be problematic, as the statistical hurdles for significance can be too high to be able to gain meaningful results.

**Incentives matter.** Perhaps the key lesson to be learned from looking into examples of poor risk culture is that incentives matter. Many of the implications are obvious: performance targets and incentives must be defined, measured, and aligned to strategy. However, incentives should not be curtailed or eliminated. The absence of incentives designed to elicit appropriate risk behaviors can be just as dangerous as it can lead an organization to take too little risk, or to take risk in ways that don't help to meet objectives.

**Personal risk-taking.** Anyone who has worked on – or dealt with – a trading desk knows that personal attitudes to risk can spill over into the workplace. Managing this across existing staff is challenging and a matter of sensitivity. But the recruitment process provides an opportunity to assess how applicants think and apply risk in their decision-making. Preventing unhealthy cultures from entering an organization in the first place is far more effective than dealing with the aftermath.

**Manage consequences and celebrate success.** What happens when something goes wrong? Is it swept under the carpet, or ignored altogether? On the other hand, how is success celebrated? Consistent consequence management reinforces desirable behaviors and establishes precedents. Demonstrations of a healthy risk culture should be celebrated within the organization, whether through the formal performance review process or informally and openly via team meetings, events and communications. Ultimately a risk culture that focuses on what is done right will be much more successful than one that concentrates on risk failures.

Risk culture is ultimately a human phenomenon and as such can be nebulous and tricky to pin down. Nevertheless, research and experience point to some practical considerations of relevance across financial services. The indicators set out above provide some guiding principles within which culture can be better understood and managed towards the betterment of the organisation and its stakeholders.



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*All opinions expressed are those of the author and do not reflect those of his employer.*

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**Matthew Dive**, PRM



Matthew Dive is the Manager for Investment Risk at AustralianSuper, a pension fund with AUD\$95bn in assets under management. Prior to this role Matthew worked in central banking and reserves management at the Reserve Bank of Australia and Bank of England, where he held various roles with responsibility for market and counterparty risk, financial market infrastructure policy, and financial stability. Matthew is a Sustaining member of PRMIA and holds a PRM certification.

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Risk culture is a relatively new topic for some but also very much a hot topic for most risk professionals. There are a number of different definitions for risk culture but they all share an emphasis on behaviors, values and ethics. Risk culture is also dynamic and can change at a macro and micro level as attitudes of the individuals in the organization change.

It is intuitively appealing that this area should be getting more attention as it could be argued that we have a disproportional focus on quantitative analyses to the detriment of a focus on the individuals who are responsible for those analyses, their behavior and values and the environment in which they work. One important aspect of risk culture is agency risk - the political and behavioral risks that arise from misalignments of interests between agents and those who hire them.

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## the next big step in risk management

by dr. **Jonathan** Allenby, **Colm** Fitzgerald  
and dr. **Monika** Smatralova

Risk managers live in an age of advanced and complex risk management frameworks. We've seen significant evolution and big steps forward in these frameworks, notably from a quantitative perspective. But we still have big opportunities for progress ahead.

Most of the risk management frameworks implemented in financial institutions are designed to address the outward manifestations of problems that have already become apparent. However, they give less attention to risks that are less clearly defined and that have not fully taken shape. This is where we find our greatest opportunities to make progress. Arguably the biggest opportunity here relates to better managing the risks related to human behavior.

Let's explore one aspect of this risk - agency risk. This is the risk arising from an agent acting more in their own interest rather than in the interest of the principal who is hiring them. Our risk management textbooks discuss this risk but limit the discussion to issues around information asymmetry. It is obvious to most people that the risk is much more complex.

Why are our educational materials and indeed our research efforts lacking here? The fact that we are all mostly agents is one possible reason. You could say there is a misalignment of interests to do something about misalignments of interests. Practically speaking, we have no models, no frameworks or no structures in which to assess and manage agency risk. Most risk managers would agree that agency risk is a significant risk but usually end up at a loss for how to deal with it better.

The purpose of this article is to set out a broader framework to consider agency risk. We begin by stepping back from our risk management frameworks and taking a, hopefully obvious, higher-level perspective. That perspective is that the overall aim of our organizations is to make progress - genuine progress - to do things better and to get appropriately rewarded for doing so. Such progress is the main aid to profit maximization in organizations, their more explicit objective, especially in the long run.

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## progress

What are the main principles that support and enable this progress? What impedes progress? What are the biggest risks and constraints to achieving progress? How can they be overcome? Why might they not be overcome?

Thought, reason and persuasion could be argued to be the main principles of progress. Action needs to follow them. Courage is typically essential in this regard - the courage to do the right thing, rather than the easy thing, to listen to our inner voice and when necessary to engage and influence others. Courage is the overcoming of fear, not the absence of it. We all behave courageously everyday, to a greater or lesser extent, and we know that these actions, however small, contribute towards making progress.

Take the example of a trader or an investment manager. The more preparation that they put into a trade, in terms of taking thought, applying reason and being open to persuasion, and the more courage they have in enacting it, the more likely it is to be successful. Similarly, take the example of a risk manager, the more thought, reason and persuasion that are put into how to manage a risk, and the more courage which they show putting this into action, the more likely they are to see a progressive outcome in terms of the risk become better managed.

As a corollary, the main enemies of progress are minds that are closed to thought, reason and persuasion, and worst still, those who take action while being closed to them. Those unwilling or afraid to act can also be included. A caveat here is that we need to distinguish between unconstrained openness and being open but able to filter rhetoric.

At a high level, the above discussion probably makes sense to most people. But we can equally recognize that people can be constrained towards, or even closed to, these principles of progress for a variety of reasons. Below we look at two specific types of constraints - political constraints and constraints that arise from the different types of human behavior. Both constraints have significant relevance for agents.



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## political constraints

There are three aspects of political dynamics that can constrain progress and that need to be negotiated in order to achieve progress: attachment to the status quo, existing power structures based on self-interest and rigid hierarchies.

Stability without disrupting the status quo and the relative predictability that this creates is considered valuable by many people. It facilitates people to make plans and apply various kinds of reason to their lives, careers and businesses. In the midst of life's ups and downs, many aim to follow the mantra 'keep calm and carry on'. But when major changes or shocks cause significant disruption, however ultimately progressive, and especially when they are unexpected, they can take the heart out of people. Many live about a few paychecks away from disaster. Major changes and shocks can lead them to vent their fury, blame or scapegoat somebody – and this is usually the agent initiating or implementing the major change.

Power structures exist within groups. Those with power generally use it when something comes along to threaten their power or self-interest. They are usually supported by those loyal to them, to some extent or another. It costs little for agents well established in their careers, with some power, to voice their opinions and exercise their influence, whereas those agents still to establish themselves, with little power, even if their ideas are better, can find themselves having to weigh up the cost of talking up. As Keynes observed:

” *“Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally.”*

Most groups have a more or less rigid hierarchy. Those higher up in the hierarchy generally try to protect their place, wealth and relative power within the hierarchy and resist attempts to exogenously move those lower in the hierarchy above them. Any agent disrupting the hierarchy risks experiencing some fury from this power.

Making progress involves attending to, dealing with and overcoming all three of the above constraints (that is: don't shock the system, protect the establishment and don't upset the balance of power). These constraints exist to some degree or another in all groups.

This is not to say that people don't care beyond their self-interest. They do, and often care a lot. The point is mostly about how much they can or will do about it and the constraints impeding them. The difficulty with which these constraints can be overcome in an organization could be regarded as an indication of the political risk in that organization – an important element of agency risk.

In order for these constraints to be overcome, agents within the system need to be courageous and not yield to any instincts for servitude to the existing status quo. The agents most likely to do so are those who also behave with an element of strong benevolence and those who have a very high regard for doing the right thing and seeing justice done. These agents are most likely to be the ones who leave their egos at the door.

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## constraints arising from human behavior

The extent to which individuals' behaviors differ from the above ideal behavior produces a constraint to be negotiated to achieve progress. How does the typical behavior of agents compare against this ideal? Very roughly we might categorize the behavior of agents into four different spectrums of behavior:<sup>1</sup>.

### Type 1 - Citizens

Responsible individuals, who can look after themselves, rule themselves, who are willing to participate beyond their own self-interest for the greater good to do the right thing, and who have a general care for others.

### Type 2 - Egotists

Responsible individuals who can look after themselves, who can rule themselves, but whose efforts to participate beyond their self-interest and the interests of those close to themselves, in practice, is only marginal or non-existent. They have less care for others than *Citizens* and are more open to actions that are detrimental to others for their own ends.

### Type 3 - Conformists

Individuals who cannot or will not rule themselves, who instead are somewhat slavish, willing to sacrifice some of their freedom if it also means removing some of their responsibility, who effectively aim to gain an element of security by making themselves dependent on some master or ruler in order to have more of a quiet life.

### Type 4 - Brutes

Individuals who are willing to be brutal and mindless in their actions if they consider it in their interest, ultimately cowardly individuals who are typically enemies to anyone better than themselves, who often despise those who treat them well and look up to those who make no concessions, and who are mostly filled with nonsense. Their consideration for others is often quite limited.

In reality, individuals will usually demonstrate a combination of all four types of behavior to some extent or another. The relative balance of the behaviors in any particular individual is the important practical factor.

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<sup>1</sup> / This is based on the classical distinction between *polîtês*, *idiôtes*, *doulos* and *barbaros*. Eric Berne uses a similar distinction in his book, "The Mind in Action" (Grigson Press, 2011)

The *Citizen* type of behavior is a necessary pre-condition for progress. The *Egotist* behavior presents an agency risk when self-interest is not properly aligned to achieving progress. *Conformist* behavior is unlikely to initiate any significant progress, its aim is often to find a more ‘benevolent master’ – so it represents a more passive type of agency risk. The *Brute* behavior typically brings things down to its level – it represents the greatest agency risk in any organization.

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## managing agency risk

In summary, managing agency risk is not just about managing self-interest. It’s also about analyzing, assessing and managing political constraints and the behavioral characteristics of individuals. At present very few organizations are explicitly doing this, meaning that their capacity for progress is being constrained in a manner where reason cannot be adequately used to negotiate and overcome the constraints. As risk managers we value reason, indeed for many of us hell is the absence of reason.

In our next article we will outline methodologies, tools and techniques to manage agency risk in the context of the agency risk framework set out above.

Comments and feedback on this article are very welcome and we would like to encourage greater discussion of this topic.

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Dr Monika Smatralova is a senior risk practitioner currently leading the Supervisory Review and Evaluation Process in Group Risk, Permanent tsb. Her academic background is in Financial Management. She has been working in risk function of major high street and captive banks for a last decade focusing mainly on the credit and operational risk management and measurement and Enterprise risk management. During her experience she has developed a solid analytical and modelling skills and built a robust knowledge about risk methodologies and approaches.

Monika is also actively involved in senior leadership at PRMIA, successfully leading the Irish Chapter since 2013. In 2014 she was elected as the EMEA Regional Directors Committee Co-Chair and a member of PRMIA Global Council. In 2015 Monika joined the PRMIA Educational Committee.



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## the four pillars of risk culture

by **Adam Litke**

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### risk process vs. risk culture

Firms often speak of their risk management function in terms of how well organized it is, how well staffed it is, how much money they have invested in technology, and how prominent their risk officers are in the corporate hierarchy. Among the governance and process items often cited as evidence of good risk culture are:

- Attention to data quality
- Automation of reporting processes
- Extensive limit structures
- Clear statements of risk appetite at every level of the firm
- Good governance structures
- Independence of risk managers
- An appropriately crafted incentive structure for risk takers.

While all of these things are important, they are not risk culture. They are either risk governance or risk process. They are vital prerequisites to good risk management, but, without a good risk culture, they are little more than a Potemkin village.

Risk culture is not about what you do, it is about how you do it and what you are thinking when you do it. Time and again, we have seen firms with excellent risk governance but poor risk culture experience large losses. This doesn't mean that a firm with good risk culture and poor risk governance will do well. After all, if you don't know your positions you can't manage them no matter how smart or well-meaning you are. It does mean that, no matter how hard it is to quantify, the human aspect of risk management cannot be neglected.

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## the pillars

The key pillars of a good risk culture can be summed up in four words: transparency, challenge, humility, and curiosity. While these may sound like a set of virtues from a child's schooling in good citizenship, they stand for very specific behaviors that lead to good risk management.

We will start with transparency because it is the easiest of the virtues to foster, and lack of it is often the first sign that something is wrong with an institution's risk culture. In its simplest form, transparency means that anyone in the firm who could have a need to know about something or who could possibly contribute to the analysis of a problem has access to all relevant information. We often hear about lack of transparency in the aftermath of a large financial loss or "unforeseeable" crisis; famous examples of this include:

- AIG losses on complex credit transactions where members of the transaction approval committee who were critical of deals were removed from the committee in the name of streamlining process
- The J.P. Morgan London Whale scandal where both business managers and risk managers outside of the London CIO office were aware of the full nature of positions
- The water crisis in Flint, Michigan where officials dismissed the complaints of local residents despite being in possession of data showing that there might be a problem.

You may ask why we are discussing a water crisis in the middle of a piece on risk culture. First of all, we must remember that risk is not always financial risk. Second, the ways in which people avoid being transparent are universal. Examine the following quote from a report issued by the State of Michigan's Flint Water Advisory Task Force. "Throughout 2015, as the public raised concerns and as independent studies and testing were conducted and brought to the attention of MDEQ, the agency's response was often one of aggressive dismissal, belittlement, and attempts to discredit these efforts and the individuals involved"<sup>1</sup>. Compare this to the kind of thing that anyone who has ever been a junior market risk manager speaking to a senior trader has probably heard at one point or another. "I'm not really over my limit because your models are wrong", "I haven't got time to talk to you about my positions; I have to make money", or "Go back to your boss and tell him to send somebody who can understand what we are doing." All of these are ways of telling somebody that they don't need to know what is going on and are the very opposite of transparency. In a good risk culture you keep people informed, and bad risk cultures always find ways of limiting the flow of information.

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<sup>1</sup> / <http://flintwaterstudy.org/2016/03/flint-water-advisory-task-force-final-report/>

This brings us to the idea of challenge or the ability of people not directly involved in the decision making process to question what is going on. A risk manager who cannot challenge a trading decision is nothing more than a risk reporter. The most common places challenge breaks down are in great-man led organizations where an imperial CEO refuses to listen to his subordinates. This does not have to be a large firm. The most common examples in finance seem to come from the hedge fund community where many firms have been founded by a single powerful trader who is still the ultimate decision maker.

It is difficult to count the number of times I have spoken to hedge fund CROs who are looking for jobs because their firm has taken an outsized position that they are convinced will go badly. Invariably they have escalated this issue to the head of the firm and, almost always, they have been told that it is not their name on the door and, therefore, not their decision. Needless to say, most of the funds involved end up failing suddenly sometime in the next few months with both sides realizing that if they had managed to work things out they might have avoided destruction. It is reasonable to ask whether this is a culture issue or a governance issue. Of course, it is both. However, the cultural issues are more important than those of governance. In order for challenge to be effective, powerful people need to be willing to listen to dissenting voices and, if necessary, reverse their positions.

In the world of risk management humility is not being humble in the conventional sense. Rather, it is being able to admit that one doesn't understand things. A wonderful example of humility in action comes from a portfolio manager of my acquaintance who runs a market neutral macro hedge fund. Each strategy in the fund was designed to be uncorrelated to the market and was extensively tested out of sample to ensure that this lack of correlation was stable. When he observed his performance, he realized that it exhibited a surprising correlation to the stock market. This man has powerful incentives to convince himself that this effect is a mere coincidence. He has marketed his investment strategy as a diversifying component of a portfolio. He has hired some of the best minds on Wall Street to help him construct his portfolio. At least in the short run, admitting that he doesn't understand something is likely to lower his compensation. Nonetheless, he admits he doesn't understand what is happening and is investigating the causes. This is true even though his performance has not begun to suffer.

Contrast this behavior with the behavior of many portfolio managers who experience severe market underperformance. The standard phrasing in their investment letters will be along the lines of "Our portfolios have underperformed in the last year but we have confidence in our strategies." A bit of this is necessary marketing as investors are not likely to keep their fund with a manager who says he doesn't understand what is going on. All too often it is also the truth. They continue to stick to their positions as they lose more and more money, blowing through any stop loss limits they have set for themselves and doubling down on bad positions in the hopes that when things go back their way they will make up their losses.

What is the key difference between these two types of manager? The first is willing to admit that the market is telling him he is wrong despite all prior experience. The second can't conceive the idea that he could be wrong and will continue to come up with reasons why he is right despite the fact that the market has gone against him.

The humility of the first manager in admitting he doesn't know something extends to the culture of the firm. Successful people and firms got where they are by being right most of the time. They have every right to be proud of this. If they have built a good risk culture, then they are willing to show humility and admit that they do not understand everything. A sure sign of a poor risk culture is the opposite statement.

Curiosity is the partner of humility in many ways. While the humble risk manager admits that he doesn't always know what is going on, the curious risk manager is always trying to figure out why. Two examples will illustrate this point.

**Example 1:** It is 2006 and our curious risk manager sees that the market for CDOs of ABS is exploding. She asks why so many of these assets are being snapped up and is told that they have a high coupon for a bond rated AAA. Since she is curious, she asks about the rating methodology and about the spreads for comparable assets. As soon as she looks into the rating methodology, she sees that there is no data behind it and immediately moves to keep her firm out of the market. Now contrast her with the incurious risk manager who simply accepts the rating agency's word that the assets really are AAA. Following their ratings based guidelines, his firm purchases large numbers of these ABS CDOs and, in 2007 and 2008, suffers large losses. Both of these risk managers followed the governance processes of their respective firms, but only one of them was curious and tried to find what was happening.

**Example 2:** It is 2015 and traders, who have already taken credit valuation adjustments (CVA), debt valuation adjustments (DVA) and funding valuation adjustments (FVA) into account when valuing their portfolios of derivatives start complaining that they must also account for the lifetime cost of capital (KVA) when valuing their investments. Our incurious risk manager simply acquiesces. After all, capital is something the firm charges for and it seems reasonable that any charges must be passed on to customers. The fact that these charges mean that all new deals are entered with a large up-front loss is troubling, but, if those are the rules, the traders will just have to price conservatively. The curious risk manager goes further. He takes the trouble to learn how the accounting for derivatives works. He learns that cost of capital isn't really a cost but (to oversimplify a bit) is another word for return on equity or profit. This allows him to ask why firms don't account for lifetime cost of capital when purchasing assets like bonds or equity. He is able to work with the traders to ensure that the firm implements policies that do not favor one asset class over another if they have the same risk return profile. In this case curiosity hasn't helped prevent a loss, but it has helped the firm to structure its business in an optimal way.

Curiosity is important because it keeps us from being intellectually lazy. It is all too easy to accept conventional assumptions that work well in normal times. Good risk management is not about what works well in normal times. It is about knowing when and why things fail to work and planning around them. Only a firm that fosters curiosity in its risk managers can expect them to provide useful insights.

Our four pillars are not independent. Transparency is a necessary condition for challenge; you can't challenge what you don't know about. Curiosity and humility are two sides of the same coin. All of these pillars are vital to a good risk cultures. Without them, risk becomes a compliance and reporting function but can't add value to the firm.



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Adam Litke is the Head of Risk Solutions for Bloomberg. He is responsible for developing Bloomberg’s strategy around risk models and software. Prior to this Adam was the head of Market Risk for the Securities and Investment Group of Wells Fargo and head of Market Risk for Wachovia where he managed market risk activities including quantitative risk management, counterparty risk modeling and direct management of market risk. Before that Adam worked for Barclays Bank, PLC as the head of Market Risk in the Americas and head of Market Risk for Global Financing. Adam also served as the Global Head of Market Risk for Swiss Re Financial Products, and spent several years in various management roles with BNP Paribas.

Adam is a trustee of the Georgia State University Risk Management Foundation and is a former advisory board member for the GSU masters program in mathematical risk management. He is also a past chairman of the Market Risk Program Committee for the New York Chapter of PRMIA.

chapter profile - PRMIA Russia

a bit of history

The Russian community of risk managers originally started as a local chapter of GARP in February 1999. The co-founder and the first director of the GARP branch in Russia was Alexander Shipilov. In the fall of 2000 Sergey Smirnov succeeded him in the role of the GARP Russia director. The change of GARP status as a non-profit organization to a commercial one in 2001 resulted in the emergence of PRMIA Russia in early 2002 as one of the first local

chapters of PRMIA. Alexander Shipilov and Sergey Smirnov were among 25 founders of the new organization. At that time the PRMIA Russia Steering Committee was formed. It included Leonid Erokhin, Richard Hainsworth, Nikolay Kulikov, Alexey Lobanov, Evgeniy Logovinskiy, Andrey Porokh, Oleg Samokhvalov, Sergey Smirnov, Andrey Shishakov, Natalya Sitnikova, Mikhail Rogov, Sergei Zavyalov, and Tatiana Melnikova (PRMIA Russia RD in 2005-2015).

chapter at a glance

Some facts about PRMIA Russia nowadays:

12

steering committee members

59

PRM Holders in Russia

825

Participants of PRMIA Russia events in 2015

3076

Chapter followers

Russia Risk Conference and Perm Winter School

From its inception, PRMIA Russia has promoted the best industry standards, holding 5-10 events per year. This includes the annually conducted Russia Risk Conference and Perm Winter School, as well as seminars, roundtables and master classes held ‘ad hoc’ throughout the year.

Russia Risk Conference ([www.riskconference.ru](http://www.riskconference.ru)) was started by Sergey Smirnov in 2004 as the “Global Risk Management Practices and Emerging Markets” conference in Moscow. This was set to become a flagship of PRMIA Russia events. The Risk Conference program includes a variety of formats: panel discussions, round tables, do-it-yourself workshops (such as data mining or machine learning, for example). The latest XI Russia Risk Conference was held in November 2015 with the core focus on innovations: in risk management (in the era of global instability), in banking regulation (with a flavor of upcoming Basel IV) and in financial technologies (in the light of disruptive trends like blockchain). The 2015 conference set a record in the number of participants for all time of its existence – more than 200 – and featured a Art installation presentation reflecting on new (crypto-)currency markets.

Perm Winter School ([www.permwinterschool.ru](http://www.permwinterschool.ru)) – called by its participants “the coolest risk event” – is another good tradition of PRMIA Russia. Since 2011 it gathers 150-180 participants in a creative 2-3-day environment near the Ural Mountains. The main beneficiaries of the school are students who have a chance to interact with world-class academicians such as Didier Sornette, Ramo Gençay, Rosario Mantegna, Fabrizio Lillo, Richard Olsen and Alan Laubsch as well as leading Russian regulators and risk industry professionals.

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## setting the professional standard

Since the fall of 2015 the Russian Chapter of PRMIA has been involved in the national initiative to set the financial risk manager professional qualification standard. This activity is a part of a national effort to describe new professions.

National professional standard is based on the international regulation and best practices. At the same time it has to consider specificities of the local risk regulation, e.g. the credit risk IRB framework in Russia has comprehensive modeling data quality requirements that are not so detailed in Basel II. Four professions - risk-analyst, risk manager, integrated risk manager (ERM), and chief risk officer (CRO) – are described considering various roles (reporting, methodology, evaluation, management, control, validation and audit) and risk areas (such as credit, market, operational, liquidity, aggregated, model risks and risks of industrial enterprises).

In total, 30+ experts were involved in the standard development with PRMIA Russia members taking the lead in the effort. Currently the standard is under discussion with the Russian risk management community. The date of the standard approval by the Ministry of Labor is targeted to be September 7, 2016, the date of PRMIA code of ethics adoption in 2009. September 7 thus truly claims to be the Day of Risk Manager in Russia.

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## a look into the future

Financial markets are now in complete transition. The regulatory landscape drastically changes the way we do business; technology transforms the operations and introduces new emerging kinds of risks. As expressed by Alan Laubsch, Director at Financial Networks Analytics and key-note speaker of XI Russia Risk Conference: “We live in an increasingly complex and rapidly changing world. Prediction and control are no longer working. What really matters is to perceive and react to changing road conditions.”

We do hope that PRMIA Russia will continue playing the role of a GPS navigator for the Russian risk community on this road ahead.

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## steering committee

- Sergey Ivliev (Regional Director), Co-founder & COO, Lykke
- Tatiana Melnikova, Deputy Chief Risk Officer, Bank of Moscow, RD in 2005–2015
- Sergey Smirnov, Open Joint-Stock Company “Insurance Company AHML”, RD in 2001–2005
- Leonid Erokhin, Deputy Head of Risk Management Department, VEB
- Olga Kotina, Head of Credit Risk, NLMK
- Alexey Lobanov, Deputy Director, Banking Regulation Department, Bank of Russia
- Ruslan Morozov, Head of Cross-sale and CRM Department, OTKRITIE Bank (JSC)
- Andrey Shishakov, Independent Consultant
- Alexey Skvortsov, Head of Division for Financial Instruments Value Control, Gazprombank
- Henry Penikas, Assistant Professor, National Research University Higher School of Economics
- Oleg Pleshivtsev, CRO, Agency For Housing Mortgage Lending
- Mikhail Rogov, Ass. Proff. (Docent) , International University of Dubna



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## PRMIA highlighted chapter event

### 2016 FINTECH RISK MANAGEMENT AND COMPLIANCE ROUND TABLE #1

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#### PRMIA San Francisco Steering Committee

The PRMIA San Francisco Chapter held a FinTech risk and compliance conference in April as part of our new strategy that includes expanding the scope of industries covered by our vast global network.

Bob Mark, Managing Partner of Black Diamond Risk and Chapter Regional Director, opened the meeting with an insightful overview of the challenges facing risk managers in FinTech businesses. Dr. Mark then introduced and thanked Kraig Conrad, PRMIA Executive Director, for supporting the local San Francisco Chapter and their FinTech initiatives. Steering Committee member Harriet Britt, senior consultant at Oyster Consulting, next introduced and thanked Ildiko Ducker of Pillsbury for sponsoring the meeting in their offices. Conrad and Ducker both emphasized that FinTech is a game changer that has the potential to further contribute to a more diverse and stronger financial system.

Mark, Britt, and fellow Steering Committee member Laxmi Ramanath, president of La Meer Inc., respectively next spoke about the challenges that FinTech firms face in upgrading and integrating risk, compliance, and technology. Financial risk, operational risk, and overall ERM capabilities within a FinTech firm—along with policies, methodologies and infrastructure (data, systems, and controls)—need to evolve and rapidly adapt to external market conditions and opportunities.

Each speaker mentioned that regulators and legislators are looking at FinTech firms with an eye toward developing new regulations. Securities regulators, such as the US Securities and Exchange Commission and FINRA, currently apply the same standards for traditional investment and brokerage firms, as well as for up and coming FinTech firms. For example, robo advisors, securities firms and other types of investment firms in the digital space are currently required to comply with existing rules and requirements. Management teams unfamiliar with necessary regulation standards need to make sure they are in compliance with the rules.

Gene Yoshida, senior director of enterprise risk at Prosper Marketplace; Evan Meagher, director of finance and operations and chief compliance officer at SigFig; and Michael Weiss, information security manager at Funding Circle, spoke about the business challenges that FinTech firms face. They provided their perspective on the challenges the industry faces to achieve best practices in the risk, compliance and security management and technology areas.

Each speaker emphasized that a key takeaway was that risk and compliance management should not be taken lightly. Regulatory scrutiny is growing, and penalties associated with a regulatory fine can negatively affect a company's reputation. FinTech companies are part of a burgeoning, nascent industry and the creation of unnecessary risk can establish a loss that may potentially lead to an erosion of credibility. The speakers pointed out that FinTech firms need to pay a great deal of attention to risk and compliance as they build up their businesses.

Each speaker also emphasized the importance of having clearly articulated standards to benchmark the quality of their risk and compliance management programs. Several industry-led initiatives to publish operating standards were discussed. For example, The Marketplace Lending Association initiative to publish operating standards includes standards related to investor disclosure, responsible lending, safety & soundness, governance & controls, and risk management. It was also pointed out that FinTech firms are disrupting and reshaping the financial space from outside in, and ultimately contributing to a stronger financial system.

Jim Lipkis, software business development and product strategy lead at Vivo Security, spoke about the current state of the art in measuring cybersecurity risk. He provided examples of analytics that can be used to quantify cybersecurity risk and showed that historical incident data often reveals consistent patterns over time that can be used to forecast cybersecurity risk.

The event culminated in a vigorous round table discussion among participants on several of the areas discussed during the conference. Participants welcomed the opportunity to continue the round table discussion at the next FinTech conference. Look for more information on the next PRMIA San Francisco event.



# INTELLIGENT RISK

knowledge for the PRMIA community

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