‘No Creditor Worse Off’: Resolution Mechanisms Update

Also in this issue
- Black Swans Mean Business (Part II)
- OTC Clearing Evaluation (Part II)
- Your Internal Audit: Is it Delivering For You?
- Understanding Model Validation
- Islamic Finance: Unique Risk Management Challenges and the Impact of Basel III
Black Swans Mean Business (Part II)

A Commercial Approach to Managing Civil and National Security Risks

In this second part of a 2-part article series on Black and White Swans, risk expert Atula Abeysekera seeks to ensure principles of financial risk management are taken up by the UK Government as it reviews current civil and national security risk management. Originally published as a White Paper the Editors agreed that the nature and in our view strong, good risk policy recommendations herein warranted making this available to GRU subscribers as articles. We hope you agree.

White Swans

The key objective for managing risks in an uncertain world is to reduce the risk of the ‘unknown’ risks in a cost effective way so that the ‘unknown’ tail becomes a more manageable phenomenon, as shown in Fig. 1 below.

An holistic governance structure and an enterprise-led risk management culture are urgently required by government to proactively manage ‘unknown-unknown’ risks. This can, occasionally, create an opportunity from knowledge gained. Government made a start by formulating their thinking in the Corporate Governance Good Practices Code for central Government Departments in July 2011. Unfortunately, much more needs to be done and the world of business is not a bad place to look for inspiration. We propose that the Government implement the following changes to (i) the way risk management systems are overseen and (ii) the quantitative capabilities of the UK Government in managing risk.

Fig. 1 - High-level illustration of Bow Group proposals
1. Independent Oversight

The Office for Risk Management

To more proactively manage civil and national security Black Swan risks, the Government’s risk assessment process needs to be challenged and overseen to a far greater extent than it is currently. Such an ambition could be fulfilled by the creation of an independent office, which we will call the ‘Office for Risk Management’ (ORM) with external expertise. This should be adjoined to the Cabinet Office. The ORM should be chaired by a senior independent person with skills in risk management and corporate governance and experience in Government and Business. It should consist of subject matter experts representing key disciplines. The ORM’s fundamental roles would be to challenge the risk management at the heart of the Government and provide an advisory role to the Prime Minister and the Cabinet. The model for the ORM should be similar to the new Office of Budget Responsibility (OBR) created by the Coalition Government. The oversight of ORM can be by the Public Accounts Committee and the budget would be similar to that of OBR – by our estimations, a grant aided flat cash funding allocation of £2 million per annum should be sufficient.

Within the ORM, in accordance with best practice, specialist subgroups should be created. Each subgroup should be responsible for challenging Governments’ risk assessments and providing independent feedback to the Prime Minister and the Cabinet. The ORM should produce an annual report on risk management performance of the Government. The sub groups can be created to broadly mirror the NSC’s own sub committees such as cyber security, counter terrorism, hazards, resilience and contingencies; nuclear, emerging powers, economic and current hot spots (Syria, Afghanistan etc.). Following the model used in Business, the ORM should be able to instruct the Cabinet Office to perform specific stress tests on predefined Black Swan events and independently assess their resilience. The ORM should also perform independent incident reviews on the activities of COBR(A).

Group think

The ORM would help to avoid ‘group think’ by bringing in multidisciplinary external expertise from outside of Government, a useful catalyst for encouraging outside-the-box thinking and for generating new ideas. The point was highlighted by the Science and Technology Select Committee in 2011, when they expressed concern over the exclusion of Government’s Chief Scientific Adviser (GCSA) in the National Risk Assessment (NRA) strategy, stating: “we consider that science should be at the heart of the NRA process and have recommended that the GSCA have greater involvement. We urge the Government to do better at embedding scientific advice and an evidence-based approach in risk assessment and policy processes before emergencies occur”.

Risk Culture

One of the mandates of the ORM would be to promote and issue guidance on a new risk culture among civil servants. The culture should encourage the capture and escalation of emerging risks at grass root level from departments, their agencies and other public bodies, to better identify potential and emerging Black Swans. This could be achieved by the ‘right’ policies, procedures, training, remuneration and incentives to promote best practice risk behaviour and at the same time encouraging creative and entrepreneurial risk decision-making by civil servants.

2. Quantitative Process Changes

Three Lines of Defence

We propose that the Government adapts best practice used in multinational companies where a sound risk framework should have three lines of defence, as described above and represented in Fig. 2. From a UK Government perspective, this would look like the following. The 1st level of defence (illustrated as the red ring in the fig. 2, above) is the Government department where the risk originated and is responsible for managing that risk. The 2nd level of defence (the white ring) is the Civil Contingencies and National Security Secretariat’s efforts on risk mitigation, which would likely operate out of the Cabinet Office. The 3rd level of defence (the blue ring) is the responsibility of the Prime Minister and his Cabinet, supported by the newly formed independent ORM. As with the Business approach, the risk crystallises if all three levels are breached.

Cause

Horizon scanning is a methodical way of identifying opportunities and threats that are starting to emerge. The UK’s Foresight Horizon Scanning Centre, currently based at the Department of Business Innovation and Skills, is a good starting point to gather information on and quantitatively analyse emerging Black Swans. We believe
that the Foresight Horizon Scanning Centre should be expanded, given its strategic importance, and moved permanently to the newly-formed ORM. This will ensure that the study of emerging risks is joined-up and coordinated centrally.

**Effect**

We recommend that the UK Government could do more to improve quantitative methodologies for aggregating risks across the country. Expertise needs to be gained to understand correlations between risks, stress test modelling and scenario testing. Modelling techniques used by Business, such as ‘value at risk’ and ‘GARCH with dynamic conditional correlation’ could contribute to a better understanding of risk interactions quantitatively.

In addition, a robust stress-testing program is needed to simulate extreme events involving UK’s civil and national security risks. The point of this exercise would be to design, using simulated scenarios of events that could significantly impact the country, effective contingency plans to mitigate the effect of these risks. Such a programme could help the Government to prepare better for risks and create an opportunity to allocate resources in a more effective way.

**Conclusions and Recommendations**

Managing its civil and national security risk is one of the greater challenges facing any government. Since, 2010 the UK Government has made some strides to firm up the way it predicts and manages these risks. However, there is a great deal more it can be doing.

The world of Business, and in particular, the financial world, has seen considerably more progress than the public sector in this respect. But rather than lament this point, the Government should actively seek to replicate best practice techniques in risk management, which could have an enormous value impact on both the UK’s finances and the life of the nation. As a starting point for this process of reform, we make the following policy recommendations:

1. Setting up of an Office for Risk Management (ORM). This would be structured as an enlarged base for the UK’s Foresight Horizon Scanning Centre.
2. Bringing in external experts to advise the ORM, which should have the effect of reducing ‘group think’ within the Government’s risk management processes.
3. Encouraging a ‘risk culture’ across Government Departments by introducing training in risk management from outside practitioners.
4. Introducing ‘best practice’ risk management structures from Business, including the ‘three lines of defence’ approach.
5. Introducing quantitative risk modelling strategies to both the ORM and Government Departments. These techniques are currently widely used by banks, with startling results, and should be replicated by Government in managing Black Swan risk. It is essential that the Government acts to reform its risk management framework. The policy proposals put forward in this paper and summarised above are a pragmatic and cost effective way of achieving meaningful results for the country. The Government must act swiftly, as what is at stake is nothing short of the life of the nation and the security of our citizens.

**Essential Reading**


US Department of Defense Briefing, 22 February 2002: transcript of then Secretary of State, Donald Rumsfeld.


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