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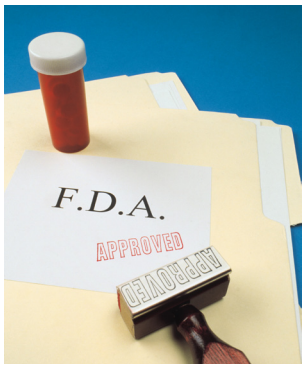


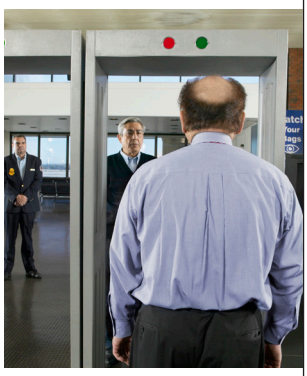

Strengthening risk management in the US public sector

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Strengthening risk management in the US public sector

Introduction

As the US government seeks to fulfill its purpose of safeguarding the freedom and well-being of its citizens, it operates in a world fraught with risk. Government departments and agencies face enormous risks every day, and the role of most government institutions is implicitly or explicitly rooted in managing risks that the private sector is either not equipped or not willing to take—everything from unsafe food and medicine that the Food and Drug Administration must police to the hundreds of billions of dollars in student loans that Federal Student Aid oversees and the threat of terrorism that the Department of Homeland Security (DHS) must constantly counter.

Yet, for a long time, risk management was an often-overlooked bit player on the grand stage of both business and government. Only recently—particularly within the last three years—has it come to the forefront of public debate, owing to risk-management failures that had shocking and widespread ripple effects, such as the Bernard Madoff fraud scandal, the Deepwater Horizon oil spill, and the housing crisis. Such failures often lead to costly government interventions and increased government risks. For example, the housing crisis has led to capital infusions of more than $150 billion for government-sponsored enterprises and to insurance exposures spiking to approximately $1 trillion at the Federal Housing Administration (FHA).

By its nature, risk management comes under scrutiny only when it fails. The catastrophic consequences of faulty risk management are newsworthy, but the daily successes of robust risk management are not—thus making it difficult for risk managers to get a permanent seat at the decision-making table. After all, who would have worried about the swine flu had it not threatened to become a pandemic? Would the National Aeronautic and Space Administration have the same risk-management controls in place today had it not lost two space shuttles? The crises of the past few years have served as a call to action, and some public-sector institutions have taken steps to strengthen their risk-management practices. For example, the Government National Mortgage Association formed a risk committee and appointed a chief risk officer (CRO) in 2008; the Securities and Exchange Commission established its Division of Risk, Strategy, and Financial Innovation in 2009; and the FHA created its Office of Risk Management and appointed a deputy assistant secretary for risk management in 2010.

While such efforts are important steps in the right direction, much work remains to ensure long-lasting and robust risk management in public-sector institutions. The task is arguably harder in the public sector than it is in the private sector, in large part due to challenges that are specific to government. The remainder of this paper describes these challenges and how to overcome them.

The direct benefits of strengthening public-sector risk management align with the government's goals of minimizing waste, fraud, abuse, and mismanagement. With a clearer understanding of the risks involved in agencies' missions and a greater ability to estimate the true subsidy costs of its programs, the US government will be able to make more prudent use of taxpayer money. More effective risk-related controls will also enable government institutions to better prevent, detect, and mitigate instances of waste, fraud, abuse, and mismanagement.

Barriers to robust risk management

Risk management is often more difficult for public-sector institutions than for companies. Seven risk-management challenges are particularly acute in the public sector.

1. *Mission goals that override other considerations.* Public-sector institutions have grown out of a need perceived by the public and articulated in each institution's mission. Not surprisingly, mission goals have tended to be the primary—and sometimes the only—consideration when it comes to decisions about taking on certain risks. For example, the

Small Business Administration (SBA) was created in 1953 to "aid, counsel, assist, and protect the interests of small-business concerns." The SBA may choose to take on a risky loan because doing so advances its mission of promoting small businesses, and because it believes the broader economic benefits outweigh the potential risks.

2. *Frequent leadership changes and vacant leadership positions.* Changes in leadership are common in the private sector, but they tend to be much more frequent among noncareer leaders in the public sector. During the Reagan administration, the average tenure in office for noncareer government executives was 1.7 years. Turnover is just as rapid in government today. For example, the government-owned Pension Benefit Guaranty Corporation has had seven different leaders—five executive directors and two interim executive directors—in the last 10 years. Public-sector institutions also suffer from leadership positions that remain vacant for a long time: the average time it takes to complete an appointment steadily increased from just over two months in the 1960s to more than eight months in recent years.[1] For the most senior appointees, the senate confirmation process contributes to the delay. Even a looming crisis does not necessarily speed up the appointment process. For example, despite an ongoing H1N1 threat, the Obama administration took about three months to confirm a secretary of health and human services. And in March 2009, in the throes of the financial crisis, media reports criticized Treasury Secretary Timothy Geithner for being "home alone," without top deputies to help handle major economic-policy issues.[2]

3. *Leaders who lack knowledge of risk management and business.* The appointed leaders of most public-sector institutions are outsiders to those institutions. As a result, an agency's most-senior leaders may not know the intricacies of the business and the institution, let alone the risk trade-offs involved in making critical decisions. One of the criticisms levied against Michael Brown, head of the Federal Emergency Management Agency when Hurricane Katrina struck, was that he had meager experience in disaster management.

4. *Separation of operating budgets from program budgets.* In the US government, "operating budgets" cover employee salaries and other costs of running the operation, while "program budgets" are used to pay benefits and reclaim funds from citizens and residents. In most public-sector institutions, the operating budget is separate from the program budget. For example, if the Social Security Administration (SSA) faces a spike in disability claims, it would pay those claims out of the program budget. Funding for the SSA's risk-management activities, however, would come out of the operating budget. This disconnect between the financing of risks that materialize and the financing of risk management leads to misaligned incentives. The SSA might not have incremental funding available for risk management in its operating budget even though it would lead to overall savings to the government through the program budget.

5. *Lack of clear risk metrics.* In the private sector, risk-oriented metrics (such as risk-adjusted return on capital) provide a quantitative basis for making risk trade-off decisions. Such return-related metrics are less clear in the public sector because most government institutions have both financial and mission objectives. Furthermore, risk-adjusted "mission impact" metrics are usually difficult to quantify, for two reasons. First, there are often time lags in mission impact—for example, it takes years to measure the long-term impact of housing grants. Second, there is a lack of evidence as to what the world would look like if the government did not carry out its mission. For example, it is difficult to estimate how many bank runs would occur if the Federal Deposit Insurance Corporation (FDIC) did not offer deposit insurance.

1 *Urgent business for America: Revitalizing the federal government for the 21st century*, National Commission on the Public Service, January 2003.
2 "Home alone at the Treasury," *Financial Times,* March 15, 2009.

6. *Complex procedural requirements.* Effecting change in the public sector requires complicated approval processes involving many internal and external stakeholders. Thus, public-sector institutions tend to be less nimble and flexible. For proof, one need look no further than government recruiting: in the words of John Berry, director of the Office of Personnel Management, "As [government workers] retire, it's tough to replace them when it takes five months on average to hire someone. Or when there are 40 steps to the process and 19 signatures."[3] Hiring for new risk-management positions is therefore not as simple as it would be in the private sector. Such complex procedures further underscore the importance of building robust risk-management practices sooner rather than later: once in place, changing these practices tends to be more difficult than in the private sector.

7. *Limited risk culture and risk mind-set.* Government workers are usually motivated primarily by the mission of their organization, and they often have the perception that the government could bail out their program should a risk event occur. As such, risk management has historically taken a back seat in decision making. In the rare occasions that risk analysis is conducted, it is usually after the fact and done by outsiders such as the Office of the Inspector General and the Government Accountability Office.

Five recommendations

In view of these challenges, it will take targeted and determined efforts to strengthen risk management in the public sector. This section lays out five recommendations, each of which tackles one or more of the challenges outlined above. Each recommendation is important, and all five work together and inform one another. Some agencies address risk strategy and processes but fail to create a risk organization and culture to sustain strong risk management. Conversely, some agencies form risk organizations but falter because they lack agreed-upon risk strategies and processes. Together, the recommendations address all the elements of an integrated approach to risk management (Exhibit 1).

1. Create transparency both internally and externally

A crucial step to strengthen risk management is to develop an understanding of the biggest risks the organization faces. Some public-sector entities have not yet identified which types of information they need to make such assessments, relying instead on what information happens to be easily available. Some agencies do collect data but produce reams of reports that merely present the raw data rather than synthesizing it and drawing out the implications for decision making.

What makes a handful of public-sector agencies excel at gathering risk insights and communicating them to stakeholders is the ability to synthesize large volumes of potentially incomplete information and provide clear, actionable recommendations to their stakeholders. For example, the National Institutes of Health conducts medical research and effectively synthesizes its findings into prioritized and action-oriented public-health advisories, rather than issuing nonprioritized research results from which the public will have to glean relevant information themselves. As an example of effective internal risk transparency, the FDIC uses CAMELS ratings[4] to assess a bank's condition. These ratings are not released to the public but are made known to a bank's top management. Since 2008 CAMELS ratings have helped the US government make decisions about which banks require special supervision.

For agency leaders to drive toward enhanced risk transparency, they must take the following steps: agree on what information is most relevant, gather it in one central location, take the time to synthesize it and draw actionable

3 Remarks made during the launch of the Obama administration's Hiring Reform Initiative in Washington, DC, May 11, 2010.
4 CAMELS: capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risk. This rating is based on a bank's financial statements and on-site examination by financial regulators. The scale is from 1 to 5 with 1 being strongest and 5 being weakest.

Exhibit 1

Public-sector organizations must take a comprehensive approach to risk management.

conclusions from it, disseminate the synthesized information in a digestible and usable form, and finally, discuss priority action steps with other stakeholders and agree on ownership for each step.

Clear risk reporting in the above manner increases risk awareness among both internal and external stakeholders. The latter is particularly important, as some external stakeholders—notably Congress and the Office of Management and Budget—participate in the clearance process for significant business changes, which may be required to address certain risk exposures that emerge. Thoughtful risk reporting can also enhance an agency's relationship with and reputation among the public, which expects transparency from the government.

2. Develop a "risk constitution"

A risk constitution codifies decisions made by an organization's entire leadership team. It therefore provides continuity even as an agency's leaders change and allows them to give guidance consistent with previous management principles—in particular on the difficult trade-off between mission and risk. A risk constitution can also bring to light any disagreement with previous principles; leadership can then deliberate such disagreements explicitly.

Leaders should ensure that the principles laid out in a risk constitution are clear, actionable, and well understood by the career staff. Risk-management staff should write the first draft of the document, but agency leadership should engage on the contents, making sure every line rings true.

The following list provides examples of what a good risk constitution should cover. Exhibit 2, showing excerpts of the Harvard Endowment Fund's risk constitution, illustrates how one organization chose to articulate its risk principles.

Exhibit 2

Excerpts from a risk constitution demonstrate one way of articulating risk principles.

	Example question	Example constitution text
Risk strategy	What is the risk tolerance for the portfolio?	▪ Less than a 5% chance of replicating Harvard's 1973–82 experience, when the real (adjusted for consumer-price-index inflation) value of the endowment declined by 31% and payout rose to 5.8%
Organization	Who should make tactical asset allocations?	▪ The staff, not the board, will make tactical allocation decisions ▪ Asset-class weights may not fall outside the range set by the board without prior board approval
Processes	Should assets be managed internally or externally?	▪ Harvard Management Company should be indifferent as to whether assets are managed internally or externally. The strategies pursued, either internal or external, should be those with the highest expectation of consistent value added

Source: Harvard University

a. *Risk strategy.* The risk constitution should include guidance on natural ownership (identification of the risks that the agency is best qualified to take on), quantified risk appetite (an articulation of the amount and types of risk that the institution is willing to take on in pursuit of its objectives), and the relative importance of fulfilling the mission versus managing risk (often a trade-off between money and other human interests, such as public health).

b. *Organization.* The constitution should lay out which risks will be managed in-house and which by third parties, how centralized the risk-management function will be, the role of the risk department relative to business or program areas, whether decisions will be made by individuals or committees, and how risk taking will be encouraged or discouraged in performance-management systems.

c. *Processes.* Leaders should determine whether the risk department will be more of an adviser or a source of control, whether risk processes will run concurrently with business processes or be distinct steps along the way, and the extent and nature of risk-related reports that the agency will prepare.

3. Initially focus on modifying a few core processes

Government agencies should roll out new risk-management approaches one process or area at a time. A gradual rollout has several advantages. First, early victories will convince the broader enterprise that risk management need not be a bottleneck and can be a source for positive improvement rather than casting blame. Second, early efforts to improve risk management will lead to lessons that can be applied in subsequent efforts. Finally, gradual rollout will allow the risk-management department to scale up efficiently over time.

The initial focus areas should target major risk exposures, but if changing core processes in three to six months would likely be unsuccessful due to their complexity, it may be worth choosing less-complex processes of medium importance to get started and create momentum for subsequent changes. Examples of core processes include loan underwriting at the SBA, grant-award processes at the Department of Housing and Urban Development, or the assessment of security threats at the DHS.

In the initial efforts to build risk-management capabilities, it is crucial to establish a constructive and collaborative tone. One way to do this is to involve a broad set of leaders in decisions about the agency's risk strategy, organization, and processes. Another way is to favor risk-management approaches that work in parallel to business processes, rather than as checks or controls after the fact. This contemporaneous risk-management approach tends to build relationships and trust across organizational boundaries and fosters a risk-management culture that focuses on helping colleagues do high-quality work, rather than inhibiting them from carrying out their responsibilities.

4. Establish a dedicated risk-management organization

Public-sector institutions should push for legislation that requires the appointment of a CRO and the formation of a risk-management department, with specific details about the roles, responsibilities, and qualifications of risk-management staff. Enshrining the risk department in law ensures continuity of risk management across administrations and independent of the specific individuals who are appointed to lead each agency.

The risk department should reside in a prominent place in the organization: the CRO should either be at the same level as the COO or CFO, or at most one level below, reporting to the CFO. Because the CRO will almost certainly be a political appointee, there should be a deputy CRO who is a career civil servant. That way, the agency will have a qualified lead risk manager to provide continuity in risk-management practices as well as risk-management support and guidance to new appointees.

The risk organization's structure should mirror the agency's structure, with dedicated risk personnel for each focus area. The exact size of the risk organization will vary by agency, but it must at least be large enough so that it can dedicate one or two people to each high-priority area. If an agency is a financial institution, its risk department should include a highly skilled quantitative function—a risk-modeling group with deep expertise in calculating credit risk, for example. Nonfinancial institutions have less need for specialized quantitative skills, but other centralized support services, such as risk reporting and risk training, could potentially be beneficial.

Risk personnel should have deep knowledge of both risk management and the institution's business. For public-sector entities that interact heavily with the private sector, recruiting talent from the private sector might prove useful, particularly since risk-management skills—and the requisite mind-sets—are a scarce resource in the public sector. Bringing in outsiders helps change mind-sets and behaviors. That said, there may be agency employees who could be a good fit for the risk organization. Management staff with risk-related duties in their current positions—for example, managers within underwriting functions—could be credible internal candidates.

Even if a public-sector agency is not ready to establish a formal risk organization and appoint a CRO, there are steps the agency can take to begin the journey toward stronger risk management. For example, it can start by adding risk management to the responsibilities of existing executive positions, incorporating risk management as an explicit agenda item in strategic-planning sessions, and using a risk lens when allocating resources and evaluating initiatives.

5. Build a risk culture

The final building block of comprehensive risk management is a risk-aware corporate culture. Such a culture is rare in the public sector, but some agencies have taken significant steps in the right direction.

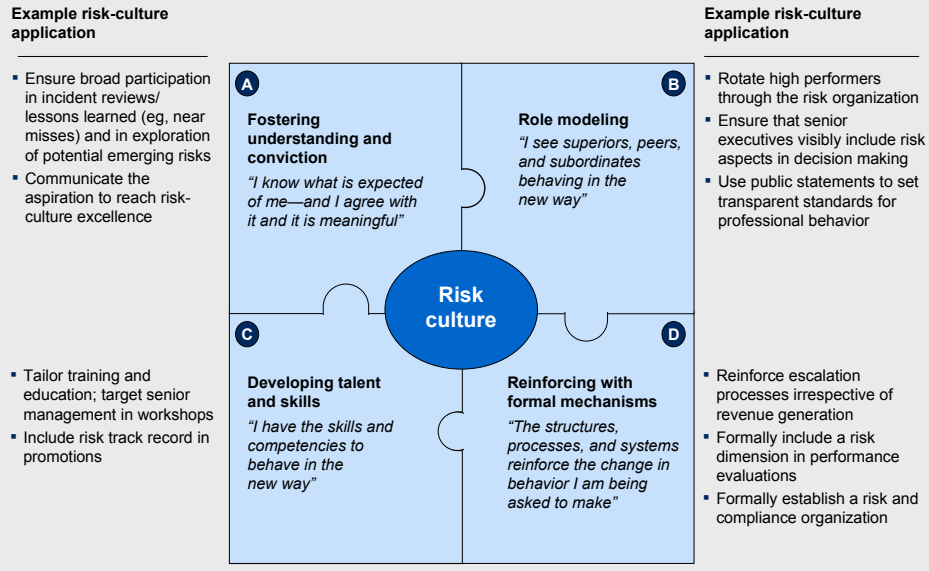
An initial step to building a risk culture is the creation of a risk-training curriculum and the launch of training programs that address the organization's needs. Typically, risk-management personnel work closely with internal program-specific experts to develop appropriate training curricula. The primary training audience is frontline employees whose jobs require them to take risks—for instance, individuals tasked with underwriting or with translating quality-control findings into action plans. The risk organization should also develop tailored training materials and workshops for senior management.

Agencies should offer training that addresses tactical needs—for example, courses on the proper use of risk-related tools and methodologies. Training should also foster an understanding of risk management's role in the agency's sustained operations. To achieve the latter, one effective approach entails having trainees review decisions they have made, helping them understand the risk trade-offs involved in those decisions, and linking the decisions to business outcomes. Such an exercise gives trainees a clear picture of the impact of their decisions on the organization's financial health.

Developing skills, although crucial, is only one component of creating a risk culture. A conscious effort by the leadership and the risk department in three additional dimensions is required: fostering understanding and conviction across the organization, role modeling, and establishing formal mechanisms for reinforcement. Exhibit 3 gives examples of potential actions to strengthen risk culture in all these areas.

Exhibit 3

Several actions can strengthen risk culture.



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Risk management has been growing in all sectors of the economy. In the 1980s, banks began to appoint CROs in earnest, and in the 1990s, insurance companies followed suit. Today, public-sector agencies are beginning to formalize risk-management departments and appoint CROs. These actions stem from the realization that the discipline of risk management can help the government make better use of taxpayer funds and more thoroughly evaluate the risks and rewards of government policies, to the benefit of us all.

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