BP OIL SPILL AND BANKING

by Steve Brown

As BP and the US Gov't struggle to get the biggest oil disaster in US history under control, it got us thinking about risk management. As with certain recent financial disasters such as the failure of Lehman, Bear Stearns, FNMA and FHLMC; the BP oil spill was massive in size and its impact will be felt far and wide for some time to come. There are many other parallels to banking and overall risk management, as well, but we believe some are especially worthy of highlighting for our readers because of their eerie similarities.

Research done by Dr. Robert Bea on the BP disaster could be applied directly to the financial markets. Bea is an engineer with 57Ys experience investigating past disasters and a professor at the University of California at Berkeley. His preliminary findings, as reported by NBC news indicate the disaster occurred as a result of a series of mistakes, flawed decisions, improper design, not detecting early warning signs and flawed maintenance processes. He indicates that based on the analysis, the disaster was preventable had existing guidelines and practices been followed properly. He indicated operations did not meet industry standards and bad decisions by employees were designed to save time and money at the expense of safety. In short, he summed the whole thing up by saying the risk was "horribly underestimated" and the federal government failed to properly oversee the project.

While only time will tell what actually happened with the oil disaster and how it could have been avoided, we were shocked at how easily these comments could also be applied to most of the companies at the center of the financial crisis.

For instance, consider that both the oil disaster and the financial disaster highlight improper risk management. Operators either thought they had things under control or they underestimated the possibility of a small event occurring that would create a large impact. Both were wrong and both led to catastrophic consequences.

Another major item that was missing from both situations was a failure of fail safe security controls. When oil drillers don't have adequate safety controls, as we have seen, things can get very ugly very quickly. As we saw with the oil spill, there were no ready made plans in the event a primary fail-safe device failed. Welders were building domes, top kills and other devices on the spot to try and solve the problem. The same can occur in banking, when there is a lack of effective credit, liquidity, capital or business continuity/contingency planning and a massive event happens to disrupt normal business operations.

A further issue in the oil spill was a lack of ongoing testing of back up devices. Things don't always work as planned and without testing in real life environments, when things bad things happen it can go downhill fast. Banks that actively test and retest their business continuity plans may not get it exactly right if and when a disaster occurs, but they are probably more prepared than others to weather things.

The oil spill also shows that people can be overconfident in safety measures that may not work when needed. In banking, there was overconfidence in capital sources, such as trust preferreds, bank holding company loans and liquidity lines that disappeared when the crisis hit in force.

It is obvious as well that oil is hard to control once it gets out in the open ocean and we have little choice but to let it run its course. In a similar way, industry leverage got out of control and we all know from first hand experience that it is hard to control credit when all things go bad at once. In addition, liquidity, while abundant now, should not be expected to continue as such forever either.

Whether one is dealing with an oil spill or a massive financial crisis, better risk management processes, contingency testing, analysis and stress testing are all needed now more than ever to deal with the ever-changing environment.

BANK NEWS

CU M&A

Franklin Mint Federal CU ($600mm, PA) has entered a deal to purchase Main Line Health Employees Federal CU ($52mm) for an undisclosed sum.

Bank Tax

Analysts predict there will be no agreement on a global bank tax at this weekend's G20 Meeting

Bank Ratings

Both Moody's and Fitch released their bank update and they were cautiously optimistic. In short, asset quality has hit bottom, as banks have recognized 60% of their asset problems. Core earnings should slowly improve with credit quality returning to "normal" levels in the next 18 months.

Bank Insurance

According to the ABA, insurance revenue at bank holding companies hit a record $15B, up 39%. Approximately, 67% of bank holding companies over $1B have an insurance operation.