RISK MANAGEMENT LESSONS FROM 13 OCTOBER DAYS

by Steve Brown

Back in late 1960, newly-elected President Kennedy was briefed on the Bay of Pigs operation that had been in the planning stages under the Eisenhower Administration. Not having enough experience or political footing to stand up to the likes of Allen Dulles (CIA Director) and others, President Kennedy reluctantly approved the plan with little rigorous review and without challenging key assumptions. Unfortunately, as we all know, the results were disastrous. A year later and 50Ys ago from today, the Kennedy administration verified that Russia was installing nuclear missiles in Cuba, capable of striking the US. Being in an untenable situation, Kennedy gathered his best and brightest minds in the Administration and set to work on a resolution. To his credit, Kennedy learned from his Bay of Pigs mistakes and put a different decision-making process in place. The fact that Kennedy proactively decided how to decide before hand has gone down in the Hall of Fame annals of leadership and critical decision making. Understanding his team's shortcomings with the Bay of Pigs, Kennedy provided for the rigorous challenging of assumptions, open conflict and constructive problem resolution. The result was the successful handling of the Cuban Missile Crisis.

One technique that Kennedy employed was the "potential failure analysis." While many bankers are familiar with a post-mortem analysis (also called "Lessons Learned," a "hot wash" or "after action report"), a potential failure analysis occurs before the event or strategy is implemented. In order to stimulate divergent views and bring risk factors out on the table, Kennedy gathered a list of all options available to America. He then had his working group brainstorm each option, laying out the pros and cons of different alternatives such as working through diplomatic channels, putting a naval blockade around Cuba or conducting a preemptive bombing raid. He then asked the group to imagine failure in each case and the reasons that might have caused such a failure. Then, working backwards, he had the group highlight those factors that materially contributed to each failure and then asked how to mitigate each risk. After vigorous debates and analysis over all options and assumptions, Kennedy's team then ranked the alternatives lowest to highest risk and decided to try each in quick succession (starting with diplomatic channels, then instituting a naval blockade and then conducting an aerial assault). The result, of course, was the successful execution of the naval option and the removal of missiles from Cuba.

Bankers looking to enhance their risk management processes should consider utilizing the potential failure analysis technique. Strategies such as expanding into an adjacent geographical region, launching mobile retail capture, bringing on a new C&I lending team, or starting a wealth management division can all be better explored when more than just the upside is reviewed. The technique allows team members to move away from their focus of winning an argument, by forcing them into an alternative view through the lens of failure - almost as a stress test before an investment is made. This change in perspective is huge and has proven to provide a deeper analysis of a problem. The methodology better explores a position's downside instead of just merely listing the cons or negatives. Here, key assumptions are tested such as whether the timetable is appropriate, there is enough investment, whether marketing should play a larger role, whether the problem the accuracy of credit losses.

If after mitigation, the bank can live with the most probable failure scenario given the potential upside, then it may be worth proceeding. In addition, this methodology reinforces proactive strategic risk management instead of reactive. It gets team members looking forward (albeit by looking backwards) instead of at the current state of affairs.

If you are looking to pick up some critical decision-making skills on this 50th anniversary of the Cuban Missile Crisis, consider utilizing potential failure analysis to further expand your risk management process. If you do, you might find that some of the old Camelot magic can be had by your administration.

BANK NEWS

M&A

M&T Bank Corp ($79.5B, NY) will buy Hudson City Bancorp ($44.1B, NJ) for about $3.7B. The move adds 135 branches (about an 18% increase) to M&T's existing footprint of 773 and expands its operations in NY, NJ and CT.

M&A

TD Bank will sell the U.S. operations of its TD Insurance Inc. subsidiary to USI Insurance Services (NY) for an undisclosed sum. TD Insurance offers auto, home, life, employee benefit, property and casualty insurance. USI has 100 offices in 26 states and is a portfolio company of Goldman Sachs Capital Partners.

Security Enhancement

Visa announced a new service to protect card data. The service is called Visa Merchant Data Secure with Point-to-Point Encryption and it will be offered to merchants by early 2013.

Auto Lending

TransUnion reports the number of car owners behind 60 days or more in 2Q declined to 0.33%, the lowest level since the credit reporting agency began tracking such data and down 25% YOY. This could be one reason why Wells Fargo and other major banks have announced plans to expand auto lending.

High Debt Level

CNNMoney is reporting the percentage of U.S. national debt to GDP has risen from about 54% in 2009 to nearly 73% as of 2Q 2012.

Gas Prices

CNNMoney reports gas prices have soared from an average of $1.62 in Jan. 2009 to $3.67 in Aug. 2012. That is a whopping 127% increase over that period.