

# Banking is not insurance

Banking and insurance are sometimes lumped together as financial services but, in fact, the two industries take entirely separate approaches to risk management. The distinction helps us to understand the financial crisis and offers important guidance for financial reform efforts.

Risk managers have two key tools for mitigating the odds of negative consequences: direct knowledge of individual cases and diversification. For banks, direct knowledge is primary, diversification secondary; for insurance companies, diversification is primary and direct knowledge is secondary.

Bankers manage credit risk by carefully selecting customers. They study potential customers before lending to them. A banker will interview a business owner, comb his financials, review historical information, and even visit the business site before lending him money. With this direct

knowledge, the banker can make a good decision about whether to make the loan and about how to price it. This is what the banker does on a daily basis. In addition, the banker's secondary strategy is to find loans from a variety of arenas; diversification for some banks is easier than it is for others, but all seek at least some measure of variety in their loan portfolio.

Insurance companies, on the other hand, start with diversification. They know that the bigger the customer pool, the smaller impact an individual customer will have if he collects. The format for selling insurance on homes or autos is pretty standard. As a secondary protection, an insurance agent attempts to obtain at least some direct knowledge. He might ask an auto policy customer about his driving history, for example. But the primary way the company prices the policy is related to the total number of policies written. The bigger the pool, the smaller the risk.

For the last 20 years, secondary market advocates have been trying to move banking away from the direct knowledge model of risk management to the diversification model. The securitization and structured finance apparatus that emerged for mortgages during the 1990s and 2000s effectively turned banking into insurance. And what a disaster it was! It takes a lot more than diversification to make a fruitful relationship between a lender and borrower.

I hope that lawmakers working on reform legislation don't miss this point. The strength of the banking industry is its direct knowledge approach to risk mitigation. That's just a fancy way of saying that bankers take the time to get to know their borrowers. Reform legislation should respect the need lenders have for direct knowledge. Banking is not insurance. Reform legislation should not attempt to further apply to banking inappropriate models from other industries. ❖



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