

Banks should take model lessons from insurers

The banking industry has something to learn from the insurance industry on the subject of models, says Alistair Wood, head of research at Hampden Agencies, the largest of the three members' agencies serving members of Lloyd's.

He thinks banks had an "over-reliance" on models, whereas the catastrophe models used in the insurance industry are used with a greater "circumspection". "Models are inherently unreliable because they are always based on the past," he says.

"We invest in the Lloyds markets and we see how various syndicates use catastrophe models," he continues. "They are used as information and then the underwriter would normally bring his own inside judgement and not just be purely driven by what the models say."

The insurance industry has learnt through events such as Hurricane Katrina which devastated New Orleans in 2005 that underwriting based purely on catastrophe models results in an unhealthy convergence because there are limited numbers of models. "Everyone would end up writing the same thing with the same narrative, so if one gets it wrong, they all get it wrong."

The vital ingredient that has been neglected in the current crisis, Wood believes, is "human judgement". He says, "I think in underwriting the gut feeling is very important, so if you just go on the basis of what the model says, you're taking away the human element. It's not an easy business, so that's the skill of the underwriter - to have the right judgement."

Wood is also critical of the banking industry's models. "Depending on who you talk to, the current financial crisis seems to have been unforeseen by these models. The value at risk model makes an assumption of liquidity and clearly we don't have liquidity in the current credit crisis so the model doesn't work."

He says risk committees within banks need to constantly challenge the assumptions of their models and their degree of reliance on them: "If they haven't worked, then they'll need to do what the insurance industry has done, which is to go through this iterative process of rebuilding the models and testing their validity."

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