



A large, faded watermark of the FDIC seal is centered on the page. The seal is circular and contains the text "FEDERAL DEPOSIT INSURANCE CORPORATION" around the perimeter and "1933" in the center. The central emblem features a shield with a key and stars.

Risk-based Premiums

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The Deposit Insurance Conference in the MENA Region
November 18, 2009



Risk-based Premiums

- Public policy goal:
 - Promote economic growth & financial stability
- Methods - some combination of:
 - Bank access to lender of last resort
 - Riskless settlement of payment system transactions
 - Prudential supervision
 - Deposit insurance





Risk-based Premiums

- Prudential Supervision:
 - Ensure that condition and practices do not introduce excessive risk into the banking system.
 - No amount of prudential supervision can provide protection against runs like deposit insurance
- Deposit insurance attributes
 - Promotes public assurance/confidence
 - Removes incentive to participate in deposit runs





Risk-based Premiums

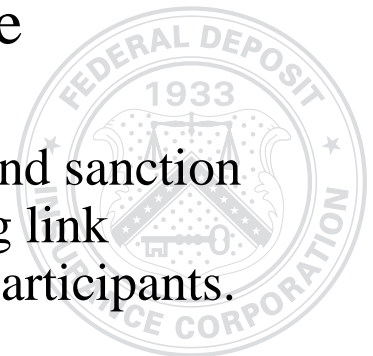
- Moral Hazard: The risk of creating incentives for excessive risk taking
 - Insured depositors/creditors may have less incentive to monitor the bank's condition
 - Deposit insurance can alter the normal risk/reward balance (i.e. capital markets)
 - Can contribute to higher cost of resolutions
- Even the best structural designs cannot eliminate moral hazard
 - Therefore, supervision and market oversight are essential





Risk-based Premiums

- Structural issues:
 - When the insurer does not have direct supervision duties
 - Supervisor should provide the insurer with necessary information on condition and practices
 - When the deposit insurer IS also the supervisor
 - Structure should provide balance between functions
 - When the chartering institution is neither the supervisor or insurer
 - Need for coordination of who has enforcement and sanction authority/responsibility. There should be a strong link between bank risks and actions from safety net participants.





Risk-based Premiums

- Design issues
 - Scope of deposit insurance
 - Scope on non-banking activities covered?
 - Coverage amounts and methods
 - Should be sufficient to prevent destabilizing bank runs
 - Should not be so extensive as to eliminate market discipline
 - Design considerations
 - Types of deposits
 - Amount of insurance (i.e. IMF model)
 - Limits or co-insurance
 - Implicit or explicit
 - Pricing





Risk-based Premiums

- The Too Big to Fail model
 - When troubled institutions introduce systemic risk, governments may intervene with guaranties beyond deposit insurance limits.
 - Undermines capital market discipline

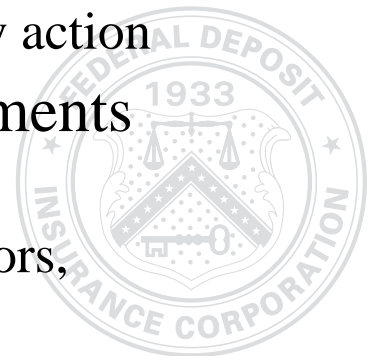




Risk-based Premiums

Potential solutions:

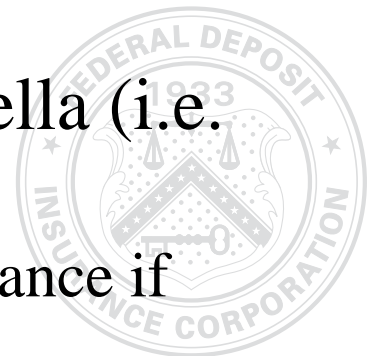
- Third party solution
 - Create a class of creditors with incentives to monitor bank risk taking and adjust their pricing/yields – direct market discipline
 - Related to proposals for large depositor haircuts or requirements for banks to issue subordinated debt.
 - Indirect use: use third party information to
 - adjust insurance premiums or trigger supervisory action
 - Concern: reliance on third party risk assessments may not always be reliable
 - Other third party sources: rating agencies, creditors,



Risk-based Premiums

Potential solutions:

- Reinsurance
 - Direct market pricing
 - Tradeable risk sharing contracts issued by deposit insurer
- Concern: Risk sharing contracts may not work in large scale system failure (i.e. credit default swaps). Introduces new systemic risk participant not under prudential umbrella (i.e. AIG)
 - The problem will transcend deposit insurance if systemic





Risk-based Premiums

Potential solutions

- Require large banks to pay extra costs associated with resolutions that are not “least cost”
- Creates incentive to find market solutions





Risk-based Premiums

- Potential solutions
 - Require large banks to have an exit plan
 - Ability to unwind (disentangle) complex structure
 - Identify least costs solutions





Risk-based Premiums

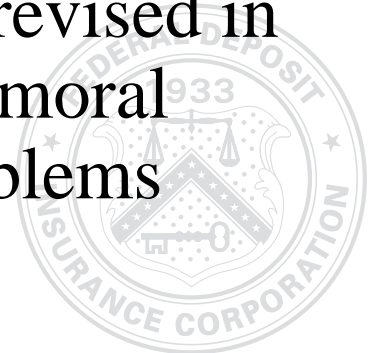
- Premiums
 - Related to insurance funding
 - A stand-alone fund supported by the banks creates a stakeholder incentive over the health of the system
 - Purpose of premium: Pricing to maintain adequate financial capacity of the insurer
 - Methods
 - Flat rate
 - Risk-related rate





Risk-based Premiums

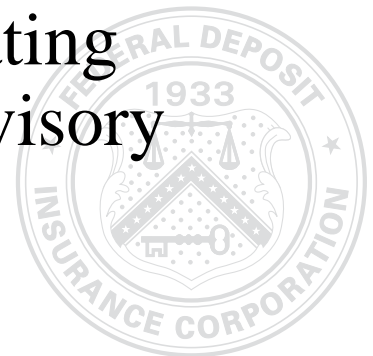
- Premiums
 - Flat rate: A simple and easy method to maintain a deposit insurance fund.
 - Risk: Moral hazard is left to prudential supervision and market
 - FDIC used flat rate for 60 years until revised in 89/91 under PCA reforms to mitigate moral hazard. PCA designed to address problems early and supplement with risk-based premiums.





Risk-based Premiums

- Premiums
 - Risk-related premiums may provide additional control over moral hazard
 - Financial incentives for risk avoidance
 - Should influence risk decisions well ahead of potential sanctions (ex ante)
 - Problem: higher premiums can exacerbate problems when triggered by deteriorating financial condition – similar to supervisory sanctions





Risk-based Premiums

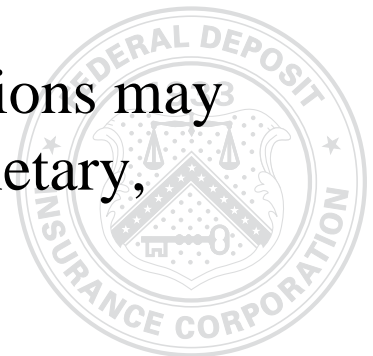
- Drivers for risk-related premiums
 - Supervision risk ratings
 - Supervisory ratings (i.e. CAMELS) and capital ratios determine premium category
 - Supervisory examinations: yes or no.
 - Asset/Deposit size
 - ROCA ratings (for branches of foreign banks)
 - Pledged assets
 - Third party ratings (i.e. bond ratings)
 - Market data (creditor pricing)
 - Financial performance measures
 - Stress tests





Risk-based Premiums

- Risk-based Supervision issues
 - Moral hazard is already addressed in risk-based supervision
 - Higher risk already require higher capital
 - When deteriorated financial condition triggers supervisory action, higher premiums may be too late to serve as an incentive (ex post)
 - Prudential supervision of individual institutions may not fully address large scale economic, monetary, systemic, or political drivers for risk





Risk-based Premiums

Thank you

