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Statement No. 83

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Statement of the Shadow Financial Regulatory Committee

on

The FDIC's Proposed Schedule of Risk-Sensitive Premiums

June 1, 1992

The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) in Section 302 requires the FDIC to establish by January 1, 1994 a schedule of risk-rated premiums for the deposit insurance it provides banks and thrifts. In mid-May, the FDIC outlined a proposed four-level schedule of premiums to take effect in January 1993. Proposed premiums range from a low of 25 cents per $100 of assessable deposits at the healthiest banks to a high of 31 cents at the weakest ones. An institution's health is to be cross-classified on two summary dimensions: (1) the extent of its accounting capitalization and (2) the degree of "supervisory concern" that emerges from agency assessments of safety and soundness.

In principle, moving to a system of risk-sensitive pricing for FDIC insurance is a salutary development and the sooner it is put in place, the better. However, the benefits of this move depend critically on the accurate measurement and appropriate pricing of the relevant risk. The Shadow Financial Regulatory Committee believes that the FDIC's proposed premium schedule misconceives, mismeasures and misprices risk. It neglects important dimensions of FDIC risk exposure and sets too high a price for very low-risk institutions and too low a price for very high-risk firms.

The risk that is relevant to the FDIC and to federal taxpayers is the loss exposure that insured institutions impose on FDIC insurance reserves. Premiums represent prices paid for insurance services rendered. From a public-policy point of view, the ideal situation would be for the premium each institution pays to equal the value of the services it receives. Over time, the FDIC must learn to measure its loss exposures accurately and endeavor to set prices that correspond closely to economic costs.

The appropriate price for any FDIC risk exposure is the economic cost of efficiently monitoring and financing that exposure. To assess the burden of FDIC premiums for any class of institutions, premiums must be weighed against the benefits members of the class receive from having their deposits federally guaranteed. The depth of the FDIC's current negative reserve position supports financial analysis indicating that, on average, past FDIC premiums have been too low on an ex ante basis. By underpricing its loss exposures, the FDIC encouraged strong and weak institutions alike to take on additional risk.

The Committee is skeptical of the argument that high minimum premiums are an effective way for the FDIC to repair its negative reserve position in the long run without taxpayer assistance. This could happen only if the 25-cent premiums targeted for the nation's strongest institutions would in future years produce more than enough net revenue to offset the losses that continue to reside in the riskiest end of FDIC's business. The problem is that setting premiums above cost for low-risk institutions generates pressure for such entities to take on additional risk, to shift a greater proportion of their funding activities into liabilities against which FDIC premiums are not assessed, or even to relinquish their U.S. banking charters. Whether managers who seek additional risk do so by overtly moving their institution into a recognized higher-risk category or by covertly exploiting weaknesses in the FDIC's premium and risk assessment procedures, future inflows of net revenue under the proposed schedule cannot realistically be expected to materialize in the amounts required to replenish FDIC reserves.

Industry criticism of the FDIC proposal has focused, not on the rationality of the FDIC's pricing strategy, but on feared disruptive consequences. Some observers claim that making premiums conditional on agency risk-ratings may poison an institution's relations with its regulators and its standing with customers. They assert that making a bank's premium expense rise in a predictable way as its supervisory rating declines would give too much weight to the "arbitrary" opinions of examiners and their supervisors.

The economic force of this objection turns on the alleged unfairness and inaccuracy of the rating process, not on the discipline that arises from a poor rating. Unfairness and inaccuracy should be eliminated in any case.

Ratings could become public knowledge because an institution's supervisory rating might be roughly inferred from its accounting statements. Exposing controversial rating issues to public scrutiny should enhance incentives for examiners and supervisors to improve their rating skills and to work harder at eliminating unfairness in the examination process. Customer reaction to adverse changes in ratings could be expected to spur healthy shifts of business from weaker to stronger institutions. These visible effects would generate desirable pressure on chartering authorities to impose effective sanctions on low-rated institutions more promptly.