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Statement of the Shadow Financial Regulatory Committee

on

FDIC Pilot Reinsurance Program

May 24, 1993

The Federal Deposit Insurance Corporation (FDIC) is planning a pilot reinsurance program, as required under FDICIA. While FDICIA did not contain specifics for this program, the Congressional objective seems to have been replication in the private sector of functions historically performed by the FDIC itself.

The pricing and underwriting of risk assumed by deposit sureties are central attributes of the deposit insurance function. If done correctly, a pilot program could highlight ways to enhance the efficiency of regulatory processes.

As a first step FDIC has sought response to a pilot project to ascertain whether premiums that would be charged by private reinsurers should be taken into account in establishing insurance premium classifications. In early 1993, FDIC announced a pilot reinsurance program that would be a component of a broader examination of the feasibility of private deposit reinsurance. A number of important parameters of the pilot program are left at least partially unspecified.

The reinsurer would assume liability for specific institutions. Pilot reinsurance is to cover

"not more than 10 per cent of any loss incurred by FDIC" with respect to an insured depository institution. That institution's semi-annual deposit insurance assessment would be based on the cost of the private reinsurance. Private reinsurers would be invited to participate for the purpose of deriving market-based deposit reinsurance prices for those institutions the FDIC designates as eligible. Reinsurers would be required to enter into contracts with the FDIC containing terms and conditions of participation. Interested reinsurers would be required to demonstrate that they meet eligibility criteria to be established by the FDIC.

The FDIC intends to place a maximum on the acceptable reinsurance prices for institutions it designates as eligible for the reinsurance pilot program. According to FDIC, most data necessary for determining reinsurance premiums would be generated based on the quarterly consolidated reports of condition and income and other publicly available information.

The FDIC also raised the possibility of access to examination reports. To the extent that information is withheld by FDIC or the discovery process (e.g., due diligence) is impeded, the structure of the pilot may make premiums higher than necessary.

The FDIC proposal is deficient in at least four respects.

First, there is no indication of accountability by FDIC itself for the prompt resolution of bank problems. That is, despite the stipulations of FDICIA, FDIC has sufficient latitude that it could compromise the interests of a reinsurer by not undertaking prompt remedial action. A reinsurer would have little basis for assessing its exposure to this risk.

Second, the proposal denies to reinsurers any right to reprice or cancel coverage prior to the expiration of the reinsurance contract for reasons of adverse disclosure, adverse developments, or (perhaps especially) actions or delays of actions by regulatory authorities contrary to the interests of sureties. Such rights constitute an important form of discipline on FDIC. Cancellation of reinsurance contracts by either party should follow private market

practices such as consideration and notice. Repricing of reinsurance during the proposed two-year term of the contract would be a reasonable option, given the information asymmetries and uncertainty as to prompt regulatory intervention.

Third, while FDICIA does not require regulatory authorities to utilize market valuations in analyzing capital sufficiency, it is unlikely private insurers would fail to do so. Current reports of condition and examination reports are highly deficient in providing these evaluation data. For the market pricing to operate effectively, reinsurers should be permitted to undertake reasonable due diligence reviews.

Fourth, FDIC requires consent from a surety's primary supervisory agency as to the surety's fitness to participate in the pilot. Since FDIC is a party to the reinsurance process, however, <u>its</u> financial standards rather than those of the primary supervisor of the reinsurer, should govern the acceptability of a reinsurance company. Such responsibility requires the development of condition measurement criteria beyond those which may be imposed on many prospective reinsurers by their own supervisors.

In summary, privatization of deposit insurance should seek to provide financial market replication of values attaching to a performance guarantee. Successful privatization requires resolution of major problems now afflicting the conduct of federal deposit insurance. Foremost of needed reforms are the valuation in economic terms of entities offering insured deposits, predictable discipline for resolution action, and accountability for results. Without these reforms, the pilot program would be an exercise in futility.