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Statement of the Shadow Financial Regulatory Committee on

The FDIC's Proposed Risk-Based Assessment System

September 18, 2006

Pursuant to the Federal Deposit Insurance Reform Act of 2005 the FDIC has proposed a revised system of risk-based deposit insurance assessments. The proposed system reflects the efforts of the agency to meet a tight statutory deadline and to overcome important statistical difficulties. The major difficulty is a sampling issue. Recent years have witnessed relatively few bank failures, at least partly because of the favorable economic environment, but also because tougher rules on bank capital and closure under the "prompt corrective action" provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) have reduced the risks to the bank insurance fund. Most of the data used to calculate bank failure probabilities come from failures that occurred before the prompt correction act tripwires were put in place, and hence have limited predictive power. Given this limitation, it is surprising that the FDIC chose to propose an elaborate system of risk categories and associated premium charges.

The Shadow Financial Regulatory Committee believes that the FDIC should use the same principles—actuarial fairness—by which the private insurance industry operates. The proposed system does not meet this test. The relevant risk that an FDIC assessment system should address is the risk of loss to the insurance fund, not losses suffered by such other stakeholders. Such stakeholders include depositors at foreign branches, uninsured depositors, other uninsured creditors, bondholders or stockholders. The FDIC proposal focuses almost exclusively on the probability of failure of individual banks, without also considering the likely magnitude of loss given failure. The FDICIA defines a risk-based system as one that takes both these factors into account.

Background

Economists favor risk-based insurance premiums. When all insureds pay the same rate, risk-taking is subsidized and conservative operation penalized. Our current bank regulatory system combines capital requirements with provisions for prompt corrective action by the regulatory authorities. Under such a framework, risk-based premiums are not strictly necessary (since troubled banks that are closed in a timely manner should impose no losses on the insurance fund). However, because capital requirements may erode in the future, and because regulators may come under political pressure not to close troubled institutions promptly, a risk-based system of actuarially fair insurance charges can provide a useful backstop for limiting risk to the insurance fund.

Among other things, the elaborate proposed FDIC system:

- divides banks into four risk classes, based on capital adequacy levels and the agency's traditional supervisory grading system (CAMELS).
- assigns a premium level to each category, defined in terms of basis points multiplied by total domestic bank deposits (insured and uninsured).

- within the top (least risky) category, assigns banks to one of six sub-categories, depending on factors that differ with bank size—
    - the banks in the top category will pay a premium between 2 and 4 basis points.
    - banks within the top category that have been chartered within the past seven years would all pay 4 basis points, regardless of other factors.
- charges higher premiums to banks in the higher risk categories.

Shortcomings of the Proposal

In several ways this system fails to meet the test of actuarial fairness.

First, the proposal continues the past practice of assessing premiums on all domestic deposits, rather than just insured deposits. This ignores the fact that in absorbing bank losses, uninsured deposits share co-equally in absorbing bank losses with the insurance fund. As a result, it actuarially unfair because institutions are assessed on deposits that are not insured. Losses suffered by uninsured depositors impose no burden on the insurance fund. As a corollary, holding all else constant, assessing all deposits results in institutions with larger-than-average uninsured deposits (as a fraction of total deposits) subsidizing other institutions.

Second, the proposal focuses almost exclusively on the probability of failure, and virtually ignores differences in the magnitude of losses once failure occurs. The magnitude of the loss suffered by the FDIC is lessened to the extent that losses are absorbed by depositors in foreign branches, other uninsured depositors, general creditors, and holders of subordinated debt. Actuarially, these factors should be taken into account in setting the premium structure. Loss absorption by the nondeposit creditors results from the national "depositor preference" statute enacted in 1993, which essentially converts depositors at foreign branches and nondeposit liabilities into a cushion that protects the insurance fund.

Third, in analyzing data to determine premium assessment rates, the FDIC excluded all failures in which fraud was a primary contributing factor. This is inappropriate because fraud is a principal source of loss under a prompt corrective action system, which looks to reliable financial signals to trigger regulatory action. That is, when fraud is present, and financial data do not present an accurate picture of the condition of an insured bank, supervisory officials may not be able to implement prompt correction action principles. In recent years, virtually all failures imposing substantial losses on the insurance fund have involved fraud.

Fourth, there is no justification for establishing six subcategories of institutions in the least risky category. Complex calculations using arbitrarily selected financial ratios cannot rationalize very small differences in premiums. Such calculations overreach the empirical support existing data can provide. For example, the proposal provides no evidence to support the use of a new "weighted" CAMELS rating in place of the traditional composite CAMELS rating.

Fifth, the proposed premium schedule does not correspond with reported differences in failure rates of banks in the four risk categories. For example, banks in the riskiest category purportedly fail about 30 times more frequently than banks in the least risky category, yet the proposed premium level for the banks in the riskiest category ranges only between 10 and 20 times the proposed premium for the banks in the least risky category.

Shadow Committee Recommendations

To address these shortcomings, the Committee recommends that the proposal be modified as follows:

- Only insured domestic deposits should be subject to assessment (the FDIC is currently considering a proposal to obtain the data needed to implement such a change).
- Until adequate empirical evidence is available and analyzed, the proposed six sub-categories in the top or least risky category should be combined into fewer categories (perhaps just one).
- The construction of the risk categories and the associated premiums should include data on bank failures where fraud was a contributing factor and data on the magnitude of losses imposed on the insurance fund (as well as the probability of loss).
- Premiums also should be structured to provide incentives to banks to issue subordinated debt or other nondeposit liabilities, by recognizing the cushion they provide to the insurance fund.
- The premium structure should fairly reflect the losses in the different risk categories (that is, the ratio of premiums in the different categories should reflect the ratio of historical losses suffered by the insurance fund in those categories).
- The FDIC should assess new or recently chartered institutions at a somewhat higher rate than would otherwise apply, both because these institutions benefit from the accumulation of premiums contributed by competitors in the past, and because of the limited information on which to base such assessments. As information accumulates, some of the higher

assessments could be rebated for institutions that demonstrate sufficient safety and soundness in their operation.

Over the longer run, the FDIC should continually analyze and refine its enforcement and premium systems to maintain actuarial fairness and to minimize its losses. The touchstone of any refinements is that they should be based on sound and transparent research principles.