The primary advantage of this system is that it could be adopted easily. To implement it would require only slight modifications of the FDIC's existing powers. Ex post pricing schemes based on performance would allow the FDIC to identify and price, after the fact, previously unregulated forms of risk that insured banks may be exploiting. The most severe problem associated with ex post pricing stems from the loose relationship between ex post performance and expected (ex ante) risk. A bank that performed poorly in the past, for example, might be a conservatively run bank that poses little threat to the FDIC's insurance fund. The profitable bank, on the other hand, might be a risky institution that happened to be correctly on oil prices or interest-rate movements. Yet, under the ex post deposit-insurance pricing system, the safe bank would pay higher premiums than the risky bank. However, one would not expect this inconsistency to persist over the long run because the aggregate losses, and therefore the aggregate deposit-insurance premiums paid by the risky bank, should exceed those of the conservatively run bank.

Conclusion

There are at least six general methods for adjusting the cost of the FDIC's deposit insurance to insured banks. Each method has its advantages and disadvantages and, for simplicity, has been presented here as a competing method for pricing deposit guarantees. In practice, however, many of these methods could be combined to achieve a pricing system that would be superior to any of the separate pricing mechanisms by itself. Indeed, almost all of the current deposit-insurance reform proposals rely on some combination of these methods. The role that we want the federal deposit insurance to play in our financial system in the future will be the ultimate deciding factor in determining which combination of the generic methods is adopted.

11. There is evidence that uninsured depositors exert some discipline over bank risk-taking by charging riskier banks higher premiums for funds. This is evident in the market for large certificates of deposit (CDs) where there appears to be a terming of CD rates according to the risk of the bank. See, Herbert Baer and Eliahu Benveniste, "Uninsured Deposits as a Source of Market Discipline: Some New Evidence," Economic Perspectives, vol. 3, issue 5, September/October 1986, Federal Reserve Bank of Chicago, pp. 23-31.


14. There is nothing magical about $10,000. We could easily argue that the federally insured limits should be set at $5,000 or $25,000.


3. After deducting operating expenses and insurance losses from the gross insurance assessment, the FDIC rebates 60 percent of the remaining assessment income back to bank stockholders through increased capital requirements. Higher levels of capital increase the amount of money that stockholders have at risk in the bank, thus making risky loan and investment strategies pursued by bank managers more costly and less attractive to stockholders. Increased capital requirements thus encourage bank stockholders to discipline the bank-taking behavior of bank managers. In addition, increased capital requirements protect the FDIC's insurer.
Measuring Risk
Risk is the degree of uncertainty associated with the outcome of today's decisions. A financial text, risk refers to the degree of uncertainly. The more uncertain the outcome, the greater the risk. Measuring the risk of the bank's portfolio is an important ingredient in many of the risk-adjusted deposit-insurance proposals. Unfortunately, measuring the risk of insured banks is very difficult to do.


Risk-adjusted capital (deposit-insurance premiums) may have effects equivalent to assessing risk-adjusted pricing (either risk-based capital or deposit insurance). Although one can argue that risk-adjusted capital would be reassessed periodically, the bank's riskiness of its operations may be less effective and potentially less stable, than the current pricing system. Therefore, raising equity capital to pay for risk-based capital requirements may have effects equivalent to assessment of a risk-adjusted deposit-insurance premium. Risk-adjusted capital requirements, like uniform capital requirements, have the potential flaws in the idea of using stockholders to discipline the bank's riskiness. In the absence of clear risk-adjusted capital standards, this problem is exacerbated by the necessity that the subordinated debt holders do not receive profits from risk-adjusted capital. Unlike regular depositors, the subordinated debtholder can cut off capital. Unlike regular depositors, the subordinated debtholder does not have a claim on the bank's capital. If the debtholder perceives that the bank is undercapitalized, he or she may decide to refuse to extend new capital. Under this system, the riskiness of the bank would be reassessed periodically on the basis of the perceived riskiness of the bank. Another advantage of the risk-adjusted system is that the ratio of capital to risk is directly price the deposit guarantees. An alternative method of setting the deposit insurance premium would be to compensate the FDIC for the riskiness of the bank's operations. The FDIC then would assume direct responsibility for all first $10,000 or so of any deposit and private companies would assume direct responsibility for each additional $10,000 or tranche of any deposit. This procedure places private capital at risk for any portion of an insured deposit above the base FDIC insurance limit.

The bank's total deposit-insurance premium would be determined by the firm and its private depositors in the market. The premiums the bank pays to the private insurers for their guar- antees would be set in recognition of the risks to the private insurers arising from those guarantees. The FDIC guar- antees on the first $10,000 of every deposit would be tied to the premiums paid to private insurers for their guarantees.

For the private insurance system to work, the government must allow private de- positors to fail if they cannot meet their obligations to the insured banks. The FDIC would be responsible for guar- anteeing the deposits previously guaran- teed by the insured bank's private insurer. This approach also requires sharing information on the condition of banks with the private insurance industry and the FDIC. Finally, private insurers would have to be involved against the private insurers to fail when they cannot meet their obligations to the insured banks. In addition, if the model is not flexible and forward- looking, banks may seek to exploit new opportunities available for market- ing off-balance-sheet risks in an example of how banks can avoid regulations in lieu of an insurance premium.

Post-Ex Premiums. An alternative way of risk-adjusting deposit-insurance premiums is to base them on the bank's (ex-post) performance of the bank. This would increase the costs of risk-taking and lead to higher premiums for banks that are riskier. The promise of off-balance-sheet risks is an example of how banks can avoid regulations in lieu of a deposit insurance premium.
ace fund from losses on bank asset portfolios because bank capital is the first line of defense against losses on their assets. As a result, bank regulators want to the risk of any loss that is absorbed by bank capital, the smaller the loss the FDIC is willing to absorb.

A major drawback of a uniform increase in bank capital requirements is that it does not discriminate among banks. On the bank that aggressively expends risk, aggressively expotes risk the policy will be effective in reducing the risk of insurability.

4. Buser, Chen and Kane refer to this type of implicit premium adjustment as a regulatory tax. The tax is calculated as the difference between the FDIC's expected cost of its guarantees to the bank and the losses that the bank's capital could bear.


6. The subsidized creditors of the bank are in- vested in the bank and would have an incentive to make loan repayments. The interest that is secondary to the claims of depositors, the FDIC, and general creditors. In other words, if the bank were to liquidate a bank, it would not be worthwhile for the bank to take the risk of not repaying its depositors. The FDIC would be responsible for guaranteeing the deposits previously guaranteed by the bank. The FDIC would then assume responsibility for the bank's remaining assets.


8. It is possible that increases in capital requirements may have perverse effects on the risk-taking of banks. In such cases, bank regulators may want to consider the potential effects of their capital requirements on the risk-taking of banks.


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A bank that performed poorly in the past, for example, might be a conservatively run bank that poses little threat to the FDIC’s insurance fund. The profitable bank, on the other hand, might have been presented here as a competing method for pricing deposit guarantees. However, in practice, many of these methods could be combined to achieve a pricing system that would be superior to any of the separate pricing mechanisms by itself. Indeed, almost all of the current deposit-insurance reform proposals rely on some combination of these methods. The role that we want federal deposit insurance to play in our financial system in the future will be the ultimate deciding factor in determining which combination of the generic methods is adopted.

**Conclusion**

There are at least six general methods for adjusting the cost of the FDIC’s deposit insurance to insured banks. Each method has its advantages and disadvantages and, for simplicity, has been presented here as a competing method for pricing deposit guarantees. However, in practice, many of these methods could be combined to achieve a pricing system that would be superior to any of the separate pricing mechanisms by itself. Indeed, almost all of the current deposit-insurance reform proposals rely on some combination of these methods. The role that we want federal deposit insurance to play in our financial system in the future will be the ultimate deciding factor in determining which combination of the generic methods is adopted.

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