The primary advantage of this system 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, any 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 benefit 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 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.

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 tapering of CD rates according to the risk of the bank. See, Herbert Baer and Eliahu Benaroch, “Uninsured Deposits as a Source of Market Discipline: Some New Evidence.”

12. See, Paul M. Horvitz, “The Case Against Risk-Based Deposit Insurnace.”


14. There is nothing magical about $10,000. We could easily argue that the federally insured limits should be set at $50,000 or $25,000.

15. See, for example, Robert B. Avery, Gerald A. Harwicz, and Myron L. Kwast, “An Analysis of Risk-Based Deposit Insurance for Commercial Banks.”


19. See the Federal Deposit Insurance Corporation’s “The First Fifty Years. The Federal Deposit Insurance Corporation: 1933-1985.”


21. See the Federal Deposit Insurance Corporation’s “The First Fifty Years. The Federal Deposit Insurance Corporation: 1933-1985.”

22. See the Federal Deposit Insurance Corporation’s “The First Fifty Years. The Federal Deposit Insurance Corporation: 1933-1985.”
Measuring Risk
Risk is the degree of uncertainty associated with the achievement of today's financial decisions. In a context, text, risk refers to the degree of uncertainty associated with the achievement of today's financial decisions. In the context of any loss that is absorbed by bank capital, the smaller the loss the FDIC insures, the smaller the capital requirement is for any riskier asset. A major drawback of a uniform increase in bank capital requirements is that it does not discriminate among banks on the basis of their riskiness. As banks become more aggressively risk-oriented, profit opportunities will face the same capital requirements as banks. Although one can argue that increased capital requirements change the risk incentives facing banks more than for conservatively managed banks, it is doubtful that such requirements can be relied upon to remove all significant differences in the risk of their asset portfolios. Further, if the rights required are binding on the conservatively managed banks, the use of the right to the size of the FDIC guarantees is the size of the banking industry has the undesired effect of punishing safe banks.

Risk-based capital regulators are considering risk-based capital requirements as a means of leveling the playing field among banks. A flat-rate deposit-insurance premium, for example, combined with uniform risk-adjusted capital requirements, may have effects equivalent to assessment of a risk-adjusted deposit-insurance premium. However, a risk-adjusted capital requirement, the level of capital a bank is required to hold is directly related to the size of the bank (bank) and the size of the bank's deposits. Under this method, the riskiness of the bank would be reassessed periodically on the basis of the size of its deposits, and the riskier increases over the last reassessment of its capital. Risk-adjusted capital requirements are intended to increase its level of capital.

Risk-adjusted capital increases, in contrast to a uniform price-deciding capital increases, go in the best interest of the banks, and may avoid, or at least reduce, the sharp movements in the market for deposit insurance. The GAO argues for a 3 percent subordinated debt capital requirement in addition to primary bank capital. The additional debt that subordinated debt affords the FDIC's insurance fund. The FDIC is protected because subordinated debt holds last claim against the assets of the bank until the FDIC, uninsured depositors, and general creditors of the bank are repaid. The advantage of this risk-adjusted debt proposal is the feasibility of its use for medium-size to large banks. Small bank capital market would have trouble placing subordinated debt issues. Large and medium-size banks that are too large to sell debt are less effective even small capital markets could have trouble issuing small amounts of subordinated debt to meet mandated standards. This problem is exacerbated by the necessity that the subordinated debt be short-term debt that requires frequent refinancing.

Explicit Risk-Adjusted Premiums
The task of this major category of pricing is to set the premium (deposit insurance) the bank will pay to the FDIC. Unlike implicit premium, risk-adjusted premiums can profit if the risk strategy pays off. Therefore, raising equity capital to reduce bank risk is the same as reducing the riskiness of the bank. The risk-adjusted capital premium can be varied. Risk-adjusted premiums may be determined in one of three fundamental ways. Risk-adjusted premiums use one of the following three types of explicit premiums.

1. Risk-Adjusted Capital
2. Risk-Adjusted Deposit Guarantees
3. Ex Post Premiums

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Risk-Adjusted Deposit Guarantees
Private reinsurance of the federal deposit insurance program is the extension of the deposit insurance in a form of either a surcharge or a rebate to the insured banks.

Ex Post Premiums
An alternative method of assessing risk-adjusted premiums is to base them on the historical performance of the bank over the rating period. That is, set the premium at the expected return on the asset portfolio of the bank over the period during which the premium is assessed. The ex post risk adjustment of the insurance premium comes in the form of either a surcharge or a rebate to the insured banks, depending upon the historical performance of the bank over the rating period.