service, and it may be undesirable for a federal agency to make exceedingly fine subjective distinctions that have the effect of allocating credit to favored activities or institutions. Within those limits, however, risk differentiation is important, and the technical issues of how best to achieve it are significant.

If a significant adverse change in the banking and economic cycle occurs in the next few years, historical experience suggests that many of the resulting bank failures will come from institutions that did not pay insurance premiums at year-end 1999. The question will then be how many of those premium misclassifications were the result of what one might call random errors — the price we willingly accepted for not having an overly burdensome regulatory and supervisory structure — and how many were the result of systematically subsidizing certain types of riskier institutions at the expense of other members of the system.

When we consider the more than 9,500 insured institutions that all paid no premium at year-end 1999, there clearly were some systematic factors that distinguished their risk profiles. The distinction between banks with composite examination ratings of 1 and 2 is one example, but there may be others. For example, should new banks or fast growing banks pay additional premiums, both for reasons of risk differentiation and to force them to pay for the external cost they impose on other members in a mutual structure? Are there indicators that would identify those banks within the best risk-related premium category that have high concentrations of risky assets, significant interest-rate risk or market risk, or weak risk-management practices?

The best risk indicators may not be the same for large institutions as for small institutions, and indeed, both onsite and offsite examination procedures vary depending on the size, complexity and risk profile of a bank. FDICIA provided the FDIC with authority to establish separate premium systems for large versus small institutions. Because of their size, scope and complexity, large institutions and their supervisors necessarily measure and manage risk differently than is the case for a typical small bank. By the end of the nineties it was clear that some thought needed to be given to the implications of the developments in large-bank risk measurement for the way the FDIC measures risk for insurance purposes, so that the FDIC might benefit from the results of risk measurement undertaken by industry practitioners, as well as by their supervisors and publicly available sources. Likewise, risks taken by large banks are priced in a variety of markets, conceivably resulting in useful information that may be valuable in pricing deposit insurance. And the proliferation of financial instruments by which risks are transferred and priced is at least suggestive of the possibility that new instruments could be developed that could enhance risk-based pricing at the individual institution level, or provide market signals about the direction of the FDIC’s aggregate exposure.

Given the potential for a bank’s risk profile to change quickly, changes in risk profiles in the interval between examinations may take on added significance in the years ahead. The FDIC already has a number of offsite tools for evaluating these inter-examination trends, and the importance of continuing to refine such tools and develop new ones is likely to increase.

Finally, if risks are indeed becoming more opaque and complex to monitor as we have argued, there is room for discussion of the implications for deposit insurance pricing. An interesting public policy question is what role, if any, deposit insurance premiums should