

An Update on Emerging Issues in Banking

FDIC Looks to Research Used in Private Sector for Pricing and Managing Risk

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The FDIC continued to follow up on its April 2001 [Recommendations for Deposit Insurance Reform](#) by tackling perhaps the most complex question -- how to price deposit insurance. At a recent Conference sponsored jointly by the FDIC and Journal of Financial Services Research (JFSR), leading scholars and researchers examined the implications of the latest developments in credit risk modeling and related risk measurement methods for pricing federal deposit insurance.

In order to address fundamental flaws in our system of providing deposit insurance, the FDIC recommended a comprehensive set of reforms. Among these recommendations was a request for new authority to charge premiums that are more closely tied to banks' actual risk profiles. While this is sound theory -- consistent with policies implemented by private-sector insurance companies -- there are nonetheless legitimate questions about how specifically the FDIC would determine and price the risk in banks. Another recommendation in last year's package was a request to move beyond the static fund target in current law toward a more dynamic target that reflects the aggregate risk on the FDIC's balance sheet. This also poses a challenge for the FDIC as it seeks to determine how best to adjust the size of the insurance fund in response to changes in the economy and other risk factors.

In an effort to seek solutions to these challenging questions, the FDIC is increasingly looking to pricing techniques that have been successful in the private sector. The recent Conference was in keeping with this effort, as the FDIC joined with the JFSR to invite academics, fellow bank regulators, and other industry experts to submit advanced research focused on the specific pricing and risk measurement issues posed by federal deposit insurance.

Research presented at the Conference centered around three basic issues: the FDIC's loss exposure, the probability of default for individual banks, and "severity," or the loss rate given default. The research offered new approaches for the Corporation's risk measurement and deposit insurance pricing. Participants discussed the feasibility of using private-sector models to gauge the risks to the insurance fund, as well as the potential sensitivity of these models to changes in underlying economic conditions and other factors that influence risk exposure. They also explored a wide range of practical policy considerations concerning cost burden, the limitations of risk measurement methods, and incentives relating to pricing deposit insurance.

Three papers presented at the Conference broke new ground in applying the latest generation of credit risk models to the problem of pricing federal deposit insurance. These models are similar to those used by the most sophisticated banking and financial institutions, and this class of models is currently under review by the Basel Committee on Bank Supervision for use in measuring capital

adequacy.

In addition, two papers investigated the use of yield spreads on the publicly traded subordinated debt of insured institutions as a possible indicator of default risk. The final two papers explored new ways of using supervisory information and bank financial data to price deposit insurance. One of these papers presented a novel proposal to use the interest rates that banks charge their commercial borrowers to gauge the default risk posed to the insurance fund.

The Conference proved most useful in identifying promising approaches for enhancing the measurement of FDIC risk exposure and laying the groundwork for future research in this area. According to the Director of the FDIC's Division of Insurance and Research, Art Murton, "From the FDIC's perspective, the Conference was a major success. The research presented represents the state of the art in risk measurement and pricing, and the authors were successful in adapting those techniques to the FDIC's business problems. We plan to pursue an aggressive research agenda in partnership with these and other experts in this field, building on the foundation of the work presented at this Conference."

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