PRIVATE REINSURANCE FEASIBILITY STUDY

REPORT TO THE CONGRESS

Federal Deposit Insurance Corporation

Washington, D.C.

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Private Reinsurance Feasibility Study

Report to the Congress

I. Introduction and Summary

This report is submitted to the Congress by the Board of Directors (Board) of the Federal Deposit Insurance Corporation (FDIC) to fulfill the requirements of section 322(b) of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), Pub. L. No. 102-242. The FDIC has studied the feasibility of establishing a private reinsurance system including a demonstration project as required by section 322(a) of FDICIA.

In order to ascertain whether establishing a private reinsurance system is feasible, the FDIC has initiated a Pilot Reinsurance Program (Pilot Program) as part of the demonstration project required under section 322(a). The goal of the Pilot Program is to determine whether private reinsurance may be a useful supplement to federal deposit insurance through the development and use of market-based deposit reinsurance prices without compromising the public-policy objectives of deposit insurance. The Pilot Program is in its formative stage, and it may eventually include actual reinsurance transactions.

In the course of this study, the FDIC has consulted with the Secretary of the Treasury, private consultants, and representatives from the insurance and banking industries. While

the demonstration project has not been concluded, the preliminary results are as follows:

1) While conceptually private reinsurance is attractive, the public-policy and practical issues surrounding its implementation are complex;

2) Combining private reinsurance with federal deposit insurance requires introducing and establishing a financial market that currently does not exist;

3) Potential reinsurers have shown limited interest in engaging in reinsurance contracts on terms acceptable to the FDIC thus far; and

4) For these reasons, further discussions are necessary to develop a consensus among bank regulators, potential reinsurers, and banks regarding the goals, limitations, and feasibility of such a program.

This report will: 1) summarize the background and authority for a private reinsurance feasibility study; 2) explain how the FDIC has conducted the study; 3) analyze the comment letters received as the result of a published Request for Comment; and 4) offer preliminary conclusions as to the feasibility of a private reinsurance system.

II. Background and Authority

Section 322 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), Pub. L. No. 102-242, requires the Board of Directors of the FDIC, in consultation with the Secretary of the Treasury and individuals from the private sector with expertise in private insurance, private reinsurance, depository institutions, or economics, to conduct a study of the feasibility of establishing a private reinsurance system. The

study must include a demonstration project consisting of a simulation, by a sample of private reinsurers and insured depository institutions, of the activities required for a private reinsurance system. These activities include:

(1) establishing a pricing structure for risk-based premiums;
(2) formulating insurance or reinsurance contracts; and
(3) identifying and collecting information necessary for evaluating and monitoring risks in insured depository institutions.

Section 322(a)(3) of FDICIA authorizes the FDIC to engage in actual reinsurance transactions as part of the demonstration project. As part of the new risk-related assessment system required by section 302(a) of FDICIA, the FDIC is authorized to obtain private reinsurance covering not more than 10 percent of any loss the FDIC incurs with respect to an insured depository institution and to base that institution's semiannual assessment, wholly or partially, on the cost of the reinsurance. Pursuant to section 302(g) of FDICIA, the new risk-related assessment system will become effective no later than January 1, 1994.

Before June 19, 1993, the FDIC must submit to the Congress a report on the study, to include the following:

(1) an analysis and review of the demonstration project;
(2) conclusions regarding the feasibility of a private reinsurance system;
(3) recommendations regarding whether:
(A) a private reinsurance system should be restricted to depository institutions over a certain asset size;
(B) similar reinsurance systems are feasible for depository institutions or groups of such institutions with total assets below any recommended asset size restriction; and
(C) public-policy goals can be satisfied by such reinsurance systems; and

(4) recommendations for administrative and legislative action as may be necessary to establish such reinsurance systems.

III. Legislative History

A. Treasury Report

In February 1991, the Department of the Treasury submitted a report to Congress on its 18-month study of the federal deposit insurance system, as required by section 1001 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) (Pub. L. No. 101-73, 103 Stat. 183). The report, entitled Modernizing the Financial System: Recommendations for Safer, More Competitive Banks, formed the foundation of the Administration's legislative proposal, introduced in Congress in March 1991.

Section 1001(b) of FIRREA required the Treasury Department to study the feasibility of establishing a deposit insurance premium rate structure which would take into account an institution's asset quality, interest-rate risk, management quality, profitability, and capital. In addition, section 1001(b) of FIRREA required the Treasury Department to study various incentives for market discipline including combining Federal with private insurance for the purpose of bringing market discipline to bear on the management of depository institutions.

In its report to Congress, the Treasury Department recommended that the FDIC establish a one-year demonstration

project to determine the feasibility of using the private sector to assist in pricing risk-related premiums. The report suggested an integration of FDIC deposit insurance with "just enough private reinsurance to serve as an overall price-indicator for the FDIC."[1] The report proposed that the demonstration project consist of a sampling of private reinsurers and banks to simulate a reinsurance arrangement and incorporate actual reinsurance transactions, if possible. The report also recommended that the study participants report the results of the project to Congress following the end of the one-year demonstration period.

The Administration's Bill

On March 20, 1991, the Administration's bill was introduced in the House of Representatives as H.R. 1505 and in the Senate as S.713. Section 116 of the bill required the FDIC, in consultation with the Secretary of the Treasury, to establish a reinsurance demonstration project to determine the feasibility of developing a private reinsurance system to assist in pricing risk-related premiums. The demonstration project would have consisted of a sample of private reinsurers and insured depository institutions that would simulate actual reinsurance transactions. Section 116 of the bill also authorized actual reinsurance transactions, if deemed appropriate by the FDIC.

[1] Modernizing the Financial System: Recommendations for Safer, More Competitive Banks, Department of the Treasury, February 1991, p. 34.

The bill would have established a Reinsurance Demonstration Project Committee comprised of the Chairperson of the FDIC and a representative of each private reinsurer and insured depository institution participating in the demonstration project. The Committee would have been responsible for reviewing and evaluating the results of the demonstration project and for reporting its findings to Congress within one year after the date of enactment. The FDIC would have submitted an additional report to Congress on the feasibility of a private reinsurance system. The FDIC's report would have included a separate statement of the views of the private participants regarding reinsurers' interest and capacity to participate in a reinsurance system.

House and Senate Legislation

During the House Financial Institutions Subcommittee's markup of the Administration's bill, no amendments were offered relating to private reinsurance. H.R. 2094, as introduced by House Banking Committee Chairman Gonzalez and Financial Institutions Subcommittee Chairman Annunzio, did not contain any provision relating to private reinsurance.

However, Subcommittee Chairman Annunzio's Committee Print of June 10, 1991 contained a slightly modified version of the Administration's private reinsurance study. Section 123 required the FDIC, in consultation with other federal banking agencies, the Securities and Exchange Commission, and private organizations

with expertise in reinsurance, to conduct a study of the feasibility of establishing a reinsurance program on an industry-wide basis.

Section 123 did not authorize the FDIC to conduct a demonstration project or to engage in actual reinsurance transactions. In conducting the study, the FDIC was directed to consider criteria for establishing a pricing mechanism for a reinsurance program which adequately protects the interests of insured depository institutions, the Bank Insurance Fund (BIF), and the Savings Association Insurance Fund (SAIF). The FDIC was also directed to consider the effect on the BIF and the SAIF of establishing a nationwide reinsurance program. The FDIC would have been required to submit a report to Congress, within 18-months of enactment, on the findings and conclusions of the study, as well as any recommendations for legislative or administrative action.

The House Banking Committee Print of June 12, 1991 retained section 123 intact, but moved it to Title V of the bill as section 523. The Print included a separate section (522) which required the FDIC to establish a reinsurance demonstration project to determine the feasibility of developing a private reinsurance system and authorized the FDIC to engage in actual reinsurance transactions, if deemed appropriate.

In H.R. 6,[2] sections 522 and 523 were combined. The text of section 522 of H.R. 6 is identical to that enacted as section 322

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[2] H.R. Rep. No. 157, 102nd Cong., 1st Sess. (1991).

in FDICIA. H.R. 6 required the FDIC to engage in a demonstration project consisting of a simulation of the activities required for a private reinsurance system and authorized the FDIC to engage in actual reinsurance transactions as part of the demonstration project.

Although H.R. 6 was defeated on November 4, 1991, the private reinsurance provision, renumbered as section 322, was included in House Banking Committee Chairman Gonzalez's <u>en bloc</u> Amendment as part of the House Committee on Rules Report of November 12, 1991 (H.R. 2094).[3] This provision was continued as section 322 in H.R. 3768, introduced by Chairman Gonzalez on November 14, 1991. H.R. 3768 was subsequently approved by the full House on November 21, 1991.

S. 543, as introduced by Senator Riegle, did not contain any provision relating to private reinsurance. In the Senate Banking Committee, Senator D'Amato offered Amendment No. 240 proposing a private reinsurance study identical to that contained in the final House bill. Although Senator D'Amato's amendment failed to pass, the efforts of Senator Dixon produced section 213 of S.543 concerning private reinsurance.

Section 213 required the FDIC to establish a three-year pilot program to assess the feasibility of the use of private reinsurance for the purpose of assisting the FDIC in establishing risk-related assessment rates. Under the program, the FDIC would have been required to obtain reinsurance for a percentage of

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[3] H.R. Rep. No. 309, 102nd Cong., 1st Sess. (1991).

insured risks posed by participating banks, not to exceed 10 percent. On termination of the pilot program, the FDIC was authorized to implement a nationwide reinsurance program.

As part of the risk-related assessment system, insured depository institutions with total assets in excess of $1 billion would have been required to obtain reinsurance for a percentage of their insured risk, not to exceed 10 percent. These large insured depository institutions would have negotiated directly with reinsurers to establish prices and the rights of the reinsurer to review documents in order to assess risk. Negotiated reinsurance agreements would have been subject to approval by the FDIC. Higher assessment rates would have been imposed for failure to obtain or renew reinsurance.

On November 26, 1991, the Conference Committee adopted the House provision requiring a private reinsurance study. Thus, section 322 as drafted by the House appears in FDICIA.

IV. Background and Issues

From the establishment of the FDIC in 1933 until the passage of FDICIA, the FDIC was required to charge the same assessment rate to all banks insured by the FDIC. This constraint was viewed by many as a major flaw in the design of the deposit insurance system. The objections were twofold: improper incentives and lack of fairness. First, uniform assessment rates do not provide a deterrent to excessive risk-taking by banks;

this contrasts with most insurance arrangements which use pricing to provide incentives for behavior desired by the insurer. Second, safe banks paid the price for the exposure created by risky banks; in many cases, safe banks were subsidizing their risky competitors.

The obvious solution to these problems is a system that ties assessment rates to risk. However, because the task of designing and implementing a risk-related system raises a host of troublesome issues, the original flat-rate system remained in place for nearly sixty years. FDICIA changed this by requiring the FDIC to establish a risk-related assessment system by January 1, 1994. The Act also provided the FDIC with the option of setting up a transitional system before that date. The FDIC exercised this option, and introduced a risk-related assessment system effective January 1, 1993.

While this risk-based system addresses the shortcomings of a flat-rate system, the lack of market elements may limit the extent to which the system accurately gauges risk. The FDIC-administered assessment rates result from the judgments of regulators, not market participants. While the regulators' judgments may be as keen as that of any market participant, they are not subject to the discipline of the market. This freedom from market forces calls into question the ability of the FDIC to price deposit insurance to create the proper incentives and fairness. This concern has led to suggestions for ways to introduce market elements into the deposit insurance system.

One proposal is to completely remove the federal government from deposit insurance and rely instead on private providers. While this would provide market prices instead of administered prices, there are two serious concerns about this approach. The first is that there are public-policy goals associated with the provision of deposit insurance that a fully private system may not achieve. The second concern is whether any entity other than the federal government has the financial resources to provide credible deposit insurance, particularly in times of severe economic distress.

If one accepts these objections and concludes that the federal government must provide deposit insurance, the question remains of whether market elements can be incorporated into a federal system. One basic approach is to use information from the prices of bank securities and obligations that deposit insurance does not cover. For example, differences in rates on uninsured deposits can reflect differences in bank riskiness. Similarly, the market value of bank equity may reflect the condition of the bank more accurately than book value does. Finally, subordinated debt is the final buffer against depositor losses and yields on this debt may reflect the exposure of the deposit insurer. One drawback to this approach is that the interests of the holders of these securities and obligations may differ significantly from the interests of the FDIC. For example, equity prices reflect the value of potential upside not available to the FDIC. A second impediment to using this

approach is that the vast majority of banks do not have publicly traded securities.

A second way to incorporate market elements into federal deposit insurance is to arrange for private capital to face the same risk that the FDIC does. The reinsurance arrangements that exist today in the insurance industry provide a model for such an approach. Primary insurers, those that provide insurance to firms and households, often want to transfer risk to another party to free up capacity or maintain a desired risk profile. To accomplish this, primary insurers contract with firms known as reinsurers who accept part of the risk in return for a fee.

This model can be applied to deposit insurance. The FDIC, acting as the primary insurer, would transfer some of its exposure to private firms playing the role of reinsurers. The reinsurers would face the same risk as does the FDIC. Therefore, the prices the reinsurers charge should reflect the market's assessment of the cost of providing deposit insurance to banks.

A Simple Example of an FDIC Reinsurance Transaction

When a bank fails, the FDIC pays the insured depositors in full and realizes value from the assets of the failed bank. The FDIC typically will incur a loss that arises because the subsequent proceeds from assets are insufficient to fully compensate the FDIC. The shortfall is made up from the FDIC

insurance fund which is derived from the assessments charged to banks.

Suppose the FDIC seeks reinsurance for its exposure to a bank. The FDIC enters into a contract that calls for the reinsurer to bear a set percentage, say 10 percent, of the FDIC's loss should the bank fail. In return, the FDIC pays a premium to the reinsurer for bearing this risk. The premium charged by the reinsurer could then be scaled up, in this case ten times, to obtain the market price of providing deposit insurance to the bank. This market price could be translated into an assessment rate by dividing by the assessment base. The FDIC could then pass this market-based assessment rate directly through to the bank.

In this ideal example, the combination of federal deposit insurance and private reinsurance accomplishes the goals of deposit insurance. The financial capacity of the federal government ensures that deposit insurance is credible, while the private market pricing of FDIC risk ensures that the system provides the proper incentives and is equitable to all banks.

Departures from the Simple Example

In practice, a private reinsurance system would likely depart from the simple example given above. The public-policy goals of the government may conflict with the desire by reinsurers to maximize profits. For example, the government has

an interest in ensuring that the banking system provides for flows of credit to certain segments of the economy. Private reinsurers, lacking a similar interest, may price reinsurance in a way that induces banks to provide less credit than the government desires.

Another departure may be that reinsurers may seek to limit their risk in ways that are infeasible or undesirable from the FDIC's perspective. Reinsurers may want contracts that are short-term or easily cancelled, whereas the FDIC provides long-term deposit insurance with cancellation only in extreme circumstances. Reinsurers may also seek to limit their risk through deductibles or stop-loss provisions. These features would mean that the exposure of the reinsurers would generally be less than that of the FDIC. This would call into question the advisability of directly passing on the reinsurance prices to the insured banks.

The FDIC is concerned with risk to the insurance fund, which is determined primarily by the probability of a bank failing. However, the loss also depends on the actions of the FDIC after the bank has failed, such as finding another bank to acquire the failed bank and successfully realizing value from the assets of the failed bank. Private reinsurers would face risk from these actions of the FDIC. The reinsurer would charge the FDIC for these risks, and this could drive a wedge between the ideal pricing of deposit insurance and the actual pricing of reinsurers.

These considerations suggest that in practice the prices charged by reinsurers will not replicate the desired prices in the ideal example given above. For example, if reinsurers can easily cancel, their prices will be lower than what the FDIC should charge given its sustained commitment to insured banks. Alternatively, if reinsurers perceive substantial risks from the actions of the FDIC, then reinsurance prices will exceed levels that would be fair to banks.

Does this mean that in practice reinsurance prices are not likely to be useful to the FDIC? The answer is no, at least to the extent that reinsurance prices reflect relative risk among banks. This information can be useful to the FDIC in assigning risk ratings to banks. Even though the FDIC might not choose to charge banks the same rate as the reinsurers charge the FDIC, the FDIC may want to charge lower rates to banks that the reinsurance market views as safer than other banks.

One way to obtain reinsurers' views of relative risks among banks is to use the following type of bidding process. Each potential reinsurer would submit a list of rates at which it was willing to reinsure individual banks. Reinsurers could submit bids for all eligible banks or any subset of eligible banks. The FDIC would compare the bids for each bank and select the lowest bidder to reinsure that bank. This bidding process would provide market-determined rates for individual banks, that is, it would reveal the amount that profit-seeking firms with capital at risk would charge to share the FDIC's exposure to a given bank.

Under this bidding process, a given reinsurer would be responsible for all banks for which it had been the lowest bidder. This means that when submitting its bids, a reinsurer would not know which banks it would reinsure. This creates two concerns. The first relates to the capacity of individual reinsurers. Under this system, some reinsurers could end up with more exposure than they are able to bear. This could be remedied by asking reinsurers to state an upper limit on exposure. Once this limit was reached for a given reinsurer, subsequent bids from that reinsurer would not be considered.

The second concern relates to diversification. Because a reinsurer would not know in advance the pool of banks it would reinsure, the reinsurer could not factor the benefits of diversification into its bid. As a result, reinsurance rates may be greater than rates that would arise if reinsurers could control the diversification of their exposure. This may be viewed as simply another example of the idea that reinsurance could provide useful relative prices but not useful levels of prices. However, the lack of control over exposure may be enough to make reinsurers reluctant to participate.

One way to address this problem is to form pools of banks and to seek bids on reinsurance for each pool. By letting reinsurers know in advance what their exposure would be, this would allow the benefits of diversification to be factored into the reinsurance prices. The drawback to seeking bids on pools is that it does not provide relative prices among banks. A pool

will contain banks that pose varying degrees of risk, and a pooled bidding approach will not reveal to the FDIC the reinsurance market's view of these risks.

One final issue is the information that the FDIC and banks would provide to reinsurers. The FDIC and other federal regulators spend a great deal of time and effort examining banks for safety and soundness. Reinsurers presumably would be interested in the results of banks examinations, but the results currently are not public information. If the FDIC does not give reinsurers access to examination reports, the reinsurance prices will likely reflect the fact that they are not based on the best available information.

Instead of gaining access to examination reports, reinsurers might deal directly with banks. This could include on-site visits, access to loan files, and interviews with management. Banks that issue marketable securities may already be subject to similar scrutiny and would not find it to be an additional burden. However, depending on the number of participating reinsurers and their requirements, many banks may find this to be a burden that outweighs the potential benefits of a reinsurance program.

V. Chronology of the Study

The FDIC began its private reinsurance study early in 1992. The first step undertaken was to decide what constituted an appropriate demonstration project, as required by FDICIA. Because the FDIC has the option of engaging in actual reinsurance transactions, a key issue was whether to exercise this authority or to formulate reinsurance simulations.

The FDIC believes that the best determination of the feasibility of private reinsurance is a concrete test of the market, and therefore it was decided to develop an approach for engaging in actual transactions. A simulation would not necessarily produce the same results as an actual transaction, and it is not clear that the private sector would be motivated to participate in a simulation. While development of an approach for engaging in actual transactions would require more time than performing a simulation, the additional time required is considered worthwhile for the additional benefit of obtaining more realistic information about the feasibility of private reinsurance. Thus, FDIC staff initiated development of a Pilot Reinsurance Program.

Also early in 1992, several groups contacted the FDIC about the private reinsurance study. Primarily, these groups established contact for the purpose of keeping informed about the study as it progressed, and to provide feedback about the study to the FDIC by means of an ongoing dialog. These early contacts

have resulted in beneficial discussions and led to additional contacts.

One group submitted a detailed proposal and contract to engage in reinsurance transactions with the FDIC. The FDIC considered the proposal, but believed that it was the intent of the Congress that private reinsurance be competitive. To expose the concept of private reinsurance transactions to a wider range of potential reinsurers and thus test the market, FDIC staff were given authority by the FDIC Policy Advisory Committee in July 1992 to proceed with a Pilot Program and develop a Request for Proposal (RFP) for private reinsurance transactions.

In the course of designing the Pilot Program, the FDIC held discussions with various groups that previously had expressed an interest in private reinsurance. In addition, the FDIC met with representatives from other federal bank regulatory agencies, from the Department of the Treasury, and from the insurance and banking industries. An interdivisional working group within the FDIC was formed to develop a proposed reinsurance process.

The discussions raised a number of complex issues, some of which presented potential impediments to proceeding with a Pilot Program. For example, it was not certain how a private reinsurance product would be viewed by the insurance industry regulators or the rating agencies, both of whom have a strong influence over the activities of insurance companies. Furthermore, private firms were reluctant to commit more than

minimal time or resources to a new venture with a highly uncertain future.

In order to obtain additional perspectives on the possibility of private reinsurance, the FDIC staff sought authority to solicit comments on a proposed Pilot Program process as well as specific issues that had arisen in discussions. The FDIC Board agreed on January 26, 1993, to seek comment on the staff's proposal for a Pilot Program. On February 3, 1993, the FDIC published in the Federal Register (58 FR 6966) a notice requesting public comment on all aspects of the planned Pilot Program for a 60-day comment period which ended on April 5, 1993. A reprint of the Federal Register notice was mailed to all insured banks and savings associations on February 17, 1993 by means of a Financial Institutions Letter (FIL) (Attachment 1). Additionally, the FDIC mailed the FIL to all parties who had previously contacted the FDIC about the reinsurance study, and to a group of insurance industry trade groups, consultants, several state insurance commissioners, certain insurance companies, and insurance brokers.

The response was limited. As of April 5, 1993, 35 letters had been received. Letters were received from 20 insured depository institutions (both banks and thrifts, although collectively referred to as "banks"), 7 trade groups (including 2 insurance industry trade groups), 2 insurance companies, 2 insurance industry consulting firms, 1 insurance brokerage firm, 2 private individuals, and 1 state banking department.

In general, support for the Pilot Program was reserved. Only 11 respondents specifically favored private reinsurance or suggested that the idea had merit. Fourteen respondents either opposed or had serious reservations about attempting any form of private reinsurance. Two respondents specifically disagreed with the FDIC's decision to engage in actual reinsurance transactions. One of these respondents believed that it would be "premature to engage in actual transactions until private reinsurance has been carefully studied and considered." The other respondent suggested that a simulation could yield the same results without imposing any potential burden on the banking industry. Two respondents suggested that the FDIC could do an actuarially fair pricing analysis on its own. Another recommended that the FDIC hire actuarial or risk management experts to assist in a pricing analysis.

Most respondents expressed concern about various aspects of the proposal, and offered suggestions as to how to deal with process issues and issues related to terms and conditions of the program. A few recommended alternative means of deposit insurance reform, including a proposal for loan loss insurance. Overall, the feedback was limited and reflected the complexity of the issues. As will be summarized below, there was no consensus in the suggestions offered.

A number of respondents expressed the opinion that the FDIC should provide additional time for consideration of the issues involved in the Pilot Program. It was noted that the proposed

Pilot Program and deposit reinsurance in general are extremely complex, and raise a number of difficult questions. Consequently, these respondents requested that the FDIC pace the Pilot Program slowly and provide program participants and others with further opportunities to comment as the program unfolds. It was suggested that the FDIC should proceed cautiously in order to develop a carefully thought-out, workable program.

Additionally, it was noted that the proposed timeline offered by the FDIC for the Pilot was ambitious. In light of these concerns and in view of the variety and complexity of issues to be analyzed, on April 20, 1993, the FDIC Board agreed to provide an additional 30-day period for public comment on this proposal. The FDIC published the notice in a form identical to that published on February 3, 1993, with one exception: as a result of providing an additional 30-day period for public comment, the FDIC does not intend to begin actual reinsurance coverage pursuant to the Pilot Program until a later assessment period than originally planned. The additional Request for Comment appeared in the Federal Register on April 27, 1993 (58 FR 25644), and a FIL was mailed on April 30, 1993 (Attachment 2).

The additional comment period expired on May 27, 1993, and the FDIC received 16 letters, including 12 from banks, 2 from banking industry trade groups, 1 from a bank-rating firm, and 1 from a banking industry consultant. Two of the respondents had previously submitted a comment letter to the FDIC. Again, the

response was mixed. Five respondents specifically favored private reinsurance, while 6 opposed it.

The FDIC is reviewing the outstanding issues pursuant to the Pilot Program based on the comments received and discussions held. There was nothing in the comments received to warrant concluding at this stage that private reinsurance is infeasible. The response suggests that the appropriate course of action is to continue with our efforts, and to continue to seek dialog with a wide variety of parties. To prepare for the RFP, the staff is developing a term sheet with general terms and conditions of participation. If at some stage of the Pilot the FDIC determines that it would not be feasible to continue, an appropriate recommendation will be made.

VI. Proposed Pilot Reinsurance Program

The Pilot Program would be divided into three phases. The first phase would include the selection of participating reinsurers. To solicit participants, the FDIC would issue an RFP that would include a term sheet with general terms and conditions of the reinsurance transactions, as well as eligibility criteria and requirements for participation (such as the reimbursement of development costs). Those reinsurers interested in pursuing the project would agree to becoming involved in the development of a detailed contract establishing the terms and conditions of reinsurance. A uniform contract delineating the terms and

conditions of reinsurance will be drawn up if possible within 3 months after the RFP.

During the second phase, participating reinsurers would be provided with approximately six months during which to complete their analysis of insured depository institutions deemed eligible by the FDIC for reinsurance. This phase would culminate in submission of a reinsurance bid to the FDIC by each participating reinsurer. The FDIC would allocate reinsurance by awarding winning bids on the basis of price.

Finally, during the third phase, a separate reinsurance contract would be entered into between the FDIC and each reinsurer for every insured depository institution to be reinsured. Reinsurance would be provided for the duration of the term established. After completion of the transactions, the FDIC will evaluate the Pilot Program.

VII. The Proposed Pilot Reinsurance Program: Issues

The following is a summary of the issues relating to the proposed Pilot Program as described within the Request for Comment in the Federal Register, and an analysis of the comments received with respect to the above.

A: Program Participants

As proposed, all segments of the insurance industry and other financial firms would be eligible for participation as reinsurers. Interested reinsurers would be required to demonstrate that they meet the eligibility criteria established by the FDIC. One requirement for selection would be the approval of the reinsurer's primary regulator. This requirement would ensure that a participant has adequate financial capacity to participate and that the type of business is authorized by the participant's primary regulator.

Furthermore, the FDIC is concerned about the need for maintaining the integrity of a Pilot Program. The general public must not be led to believe that their deposit insurance is dependent on payment to the FDIC by a private party. If a reinsurer fails, the FDIC would provide coverage for all insured depositors and continue to resolve institutions at the least possible cost to the deposit insurance funds. Rather than become involved in regulating the actions of the participating reinsurers, the FDIC solicited comments on appropriate minimum financial criteria to minimize the risk of reinsurer insolvency and ensure the timely payment of reinsurance claims.

In general, all respondents commenting on this issue agreed on the need for eligibility criteria. Approval of the primary regulator was not debated, and several suggestions were offered for appropriate financial criteria. One banking industry trade

group recommended holding the reinsurers to "strong standards of soundness comparable to those for banks." Another banking trade group advised the FDIC to seek the input of experts in the insurance industry. One insurance company suggested using standards developed by the National Association of Insurance Commissioners (NAIC) Model Law on Credit for Reinsurance and the NAIC project risk-based capital standards.

Given the wide variation in financial criteria established by the individual state insurance regulators and inherent in the myriad sectors of the insurance industry, it may be difficult to establish appropriate, consistent, and meaningful criteria. For this reason, one potential reinsurer suggested as an alternative the use of private-sector rating agencies. In other words, the FDIC could defer to the judgment of the rating agencies and set a minimum rating as a benchmark for eligibility. This latter idea, and the NAIC standards, seem to be credible approaches, and they will be investigated further by the FDIC.

There were a few suggestions as to which types of financial-services institutions should participate in the Pilot Program. A banking industry trade group recommended that banks be allowed to establish participating subsidiaries, subject to conflict of interest restrictions (i.e., banks would not be allowed to reinsure themselves). The FDIC intends to prohibit such "captive" insurance companies from reinsuring affiliated insured depository institutions.

One financial guarantee trade group advised that only domestic financial guarantee, surety, and reinsurance firms be allowed to participate. The FDIC's main concern in setting eligibility criteria, as noted above, is to ensure that participants are permitted by their regulators to engage in this type of transaction, and to ensure the integrity of the Pilot Program. Therefore, the FDIC does not believe it is necessary to automatically exclude any class of financial-services institutions.

The FDIC intends to require interested reinsurers to disclose to the FDIC all potential conflicts of interest prior to entering into the participation contract. In this regard the FDIC recently adopted a new statement of policy regarding fitness and integrity of contractors which became effective on May 4, 1993 (58 FR 2886). The policy statement applies to the acquisition of all categories of professional services, technical services and materials for the FDIC, except for legal services.[4]

One further issue concerning participation by reinsurers is whether the FDIC should reimburse participants for their

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[4]The policy statement has particular significance to potential contractors in litigation with the FDIC, the Resolution Trust Corporation (RTC), the Federal Savings and Loan Insurance Corporation (FSLIC) or any successor to the FSLIC, and firms or any of their affiliates that are in default on financial obligations to the FDIC, RTC, FSLIC or any successor to FSLIC. Under the policy statement, "default" means a delinquency of ninety or more days on the payment of principal or interest on a loan or advance from an insured depository institution or a failure to comply with the terms and conditions of a contract with the FDIC, RTC, FSLIC or any successor to FSLIC, or an insured depository institution, other than a loan or advance.

development costs. To the extent that development costs are not reimbursed, reinsurance premiums will be higher. If costs are reimbursed, should reinsurers be reimbursed fully or should development costs be shared between the FDIC and reinsurers? How should any reimbursement for development costs factor into the FDIC's acceptance of bids?

Of the respondents addressing this issue, slightly more than half said that development costs should not be reimbursed. If the FDIC's goal is to obtain meaningful prices, then it is not in the FDIC's best interests for development costs to be imbedded in premiums. However, as one trade group pointed out, the FDIC could request that premiums quoted be separated into various components.

Several respondents believed that it might be necessary to cover some development costs. One consultant cautioned against reimbursement except as a last resort. He argued that "if any organization is unwilling to spend some of its money for its own self-interest, then something is wrong." However, it is understandable that the uncertainty inherent in this Pilot Program may cause some participants to seek reimbursement. The consultant further noted that it would be extremely difficult to determine a workable allocation strategy for development cost reimbursements. The FDIC agrees that developing an equitable system for reimbursing a number of participants would not be simple. Furthermore, some banks suggested that it may not be in the best interests of public policy to use funds from the BIF or

the SAIF to pay for a reinsurer's development costs at a time when both funds are far from being recapitalized.

However, respondents from the insurance industry favored reimbursement. One insurance firm noted that reimbursement would attract more competition initially. While this may be true, it is not clear that it would be wise to entice participation by guaranteeing reimbursement. The FDIC will continue to study this issue.

Several respondents commented that it was unlikely that the insurance industry would have an interest in such a private reinsurance program. One financial institution stated that insurers might be wary of participating due to recent large losses incurred by the federal deposit insurance system. Another bank remarked that due to limited capacity in the insurance industry, participation in a reinsurance program could vary as industry performance cycled. A bank trade group further predicted that reinsurers might exit the program when economic conditions deteriorated, in a similar fashion to the withdrawal of insurers from Directors' and Officers' (D&O) liability coverage in the 1980s.

From the limited comments received, particularly from insurance industry representatives, it seems likely that these comments may be valid. The FDIC believed that more insurers would be likely to participate in a Pilot Program if given an opportunity to comment on the structure of the program before the RFP was issued. Based on this reasoning, the FDIC published the

Request for Comment, and mailed the document to selected industry representatives. Because it was not clear which segments of the insurance industry would be interested, the FDIC mailed the Request for Comment to a representative sample. The FDIC recognizes that there is uncertainty concerning the outcome and future of a reinsurance program, and that insurers may not express an interest in a new product with such an uncertain future, particularly if significant development costs would be expended in the process. Furthermore, given the unprecedented nature of this endeavor and the difficulty of educating the potential participants about the Program, it has been hard to generate commitments.

Because the Pilot Program may be difficult to manage if the FDIC seeks reinsurance coverage for all insured depository institutions, it may be necessary to select a limited group of insured institutions for which the FDIC will seek coverage. A few institutions volunteered to be included in the Pilot. The FDIC sought comments on the options of limiting the Pilot Program to insured depository institutions with assets over a given asset size, perhaps $1 billion, or selecting a random sample of insured institutions. The FDIC believes that selecting institutions on the basis of financial condition or allowing institutions to opt out could severely bias the results of the Pilot Program.

A strong majority of those commenting on this issue favored a random sample of insured institutions. Overall, respondents believed that it would be best to test the feasibility of private

reinsurance with a representative sample -- that is, to include institutions of all sizes, capital levels, and geographical regions. One trade group suggested that it was important to use a random sample, because limiting the participants to institutions based on selected criteria could lead to the misperception that depositors at an excluded class of institution may no longer have any deposit insurance, and therefore could result in unanticipated disintermediation.

There were several respondents -- primarily potential reinsurers -- who made a case for limiting the sample of reinsured institutions on the basis of size. In particular, the threshold of $1 billion in assets was offered as an objective minimum. One reason for this preference may be that publicly available information tends to be more readily available for larger institutions. Additionally, manpower limitations will restrict the underwriting abilities of reinsurers, and therefore economies of scale tend to make it more advantageous to reinsure larger institutions. One trade group suggested that these potential problems may place smaller institutions at a competitive disadvantage when reinsurers allocate their resources in making reinsurance decisions.

Given these potential problems, it is possible that smaller banks would not be reinsured, even if they are included in the Pilot Program. One respondent suggested that this would not be a problem, because it is appropriate for the FDIC to be the sole insurer of smaller institutions. One trade group expressed

concern that the exclusion of small banks could lead the public to perceive that small banks are "unreinsurable" and unhealthy, and that larger banks may tout their reinsurance status as a competitive advantage. The FDIC recognizes this concern, and does not intend to permit institutions to use reinsurance status in advertising and marketing. These comments suggest that separate reinsurance systems may be desirable.

On the other end of the scale, one trade group suggested that the largest institutions, or "systemic risk banks," may also be unreinsurable due to their risk of catastrophic loss. The FDIC may resolve a "systemic risk bank" (with concurrence from the Federal Reserve and the Secretary of the Treasury) in a way that extends the safety net beyond insured deposits, even if this is not the least costly approach. The insurance fund loss is repaid by emergency special assessments on all members of the relevant fund. One consultant suggested that these institutions would not need to be reinsured because they tend to be self-policing.

Furthermore, a potential reinsurer noted that capacity could be a problem in attempting to reinsure such a large institution with a single reinsurer. The FDIC's goal of reinsurance remains to obtain market-based pricing information about insured depository institutions, and as such, it is believed that no institution should be excluded on the basis of size. If capacity is a problem, it may be possible to lower the reinsurer's exposure.

In terms of the financial health of an institution, it was suggested that the FDIC should not seek reinsurance on the healthiest institutions -- those ranked "1" or "2" on a composite CAMEL rating. It was noted that this would be a waste of money, and no new information would be gained. Similarly, it was suggested that no reinsurer would want to assume the risk of an institution rated "4" or "5" on a composite CAMEL rating. For these reasons, it was proposed by one respondent that the FDIC select a group of institutions rated "3" in order to garner additional information about these middle-rated institutions. The FDIC would prefer to include a sample of all institutions, regardless of CAMEL rating. It is possible, after all, that the market and the FDIC could differ in their relative assessment of an institution.

Given all of the comments received regarding ways to limit participation by depository institutions, the FDIC believes that it is important to include a representative sample of institutions. To this end, the FDIC will continue to search for an acceptable means of including institutions of all sizes.

B: Reinsurance Terms

In order to participate in the Pilot Program, a reinsurer must enter into a contractual agreement with the FDIC binding the reinsurer to a set of uniform terms and conditions of participation (Participation Contract). Because the goal of the

Pilot Program is to derive market-based reinsurance premiums for insured depository institutions, it is believed that all other reinsurance terms and conditions must be held constant -- thus, the need for uniform terms and conditions of participation. In signing such an agreement as a condition of participation, there will be minimal confusion as to the rules of the engagement, thereby leaving the reinsurers free to focus their attention on their risk and pricing analyses.

The FDIC requested comments on the principal terms and conditions of participation. The comments received presented mixed opinions on all issues, which suggests that further discussion will be necessary to derive a uniform set of terms and conditions.

The FDIC suggested two separate possibilities for determining the liability of the reinsurer in the event of a bank failure. The first approach, pro rata reinsurance, would entail the reinsurer's assuming a fixed percentage of the FDIC's loss. The FDIC suggested one percent, in an effort to minimize the reinsurer's exposure yet still require the reinsurer's capital to be at risk. Under the alternative proposal, the FDIC would set a fixed dollar amount of liability for a particular institution at the time of entering into the contract.

Once again, there was no agreement among the respondents as to the preferred approach. Respondents did agree that an open-ended liability creates a problem, because reinsurers are subject to single capacity limitations by their regulators. In other

words, exposure to a single risk cannot exceed a fixed percentage of an insurer's capital. Several respondents recommended a stop-loss provision to set a maximum limit on the reinsurer's liability and to decrease uncertainty. The pro rata percentage suggested also varied. One respondent noted that single capacity limitations may require the FDIC to vary the percentages of risk assumed based on the size of the institution. The fixed dollar approach was seen to minimize uncertainty. A reinsurer would know exactly what his liability would be should an institution fail. There would be no delays in loss determination because of the lag in recoveries associated with the liquidation process. This approach was criticized for not yielding reinsurance premiums representative of the risk posed by an institution. However, if the liability is tied to the size of the institution, the relative risks assumed will be similar.

The FDIC envisions an appropriate term for reinsurance contracts as a period of 1 to 2 years. There were a variety of responses to the question of reinsurance contract duration. Several respondents preferred a term of up to 1 year, although a few suggested 2 years. One bank believed that it was preferable to extend the term to between 5 and 10 years, in order to limit the ability of the reinsurer to withdraw from a contract when an institution begins to develop signs of trouble. It is easier to determine the riskiness of banks over a shorter time horizon. The FDIC would prefer a duration that is long enough to be meaningful, yet not too long to reduce participation by

reinsurers, or lower the number of institutions reinsured due to the increased cost of reinsurance or uncertainty involved.

The FDIC also solicited comments on the right to cancel a reinsurance contract. The FDIC stated in the Request for Comment that it intended to reserve the right to cancel a contract at any time, but did not intend to extend the same right to reinsurers. One insurance company questioned the FDIC for assuming a unilateral cancellation ability. A bank recommended that the FDIC reassure reinsurers that it will not use this provision except in an extreme case. An insurance trade group advocated the right for a reinsurer to cancel in the event of an adverse change in law.

Respondents' views were divided on whether to permit repricing during the term of the contract. Those opposed to repricing noted that it would, in effect, shorten the term of the contract, or that it simply was not necessary with a contract length of one year. Those who supported repricing suggested that it might be restricted to certain key events. An insurance trade group noted that repricing would provide the FDIC with additional information, but that it would not be necessary.

While opinions were mixed, it seems from the comments received that in order to avoid conflicts, the FDIC will need to clarify a number of terms, especially if reinsurers are restricted from participation in the supervision, resolution, and liquidation processes. For example, one consultant recommended that the FDIC should define the following:

1. specific actions precedent to any foreclosure;
2. the manner and time-frame by which the amount of any loss will be quantified;
3. the exact dates with which a reinsurer's liability will begin and end;
4. the impact of bank mergers; and
5. how assistance programs will work.

The FDIC will also need to be specific with respect to cross-guarantee provisions of subsidiary banks.

C: Analysis and Bid Process

During the second phase of the Pilot Program, participating reinsurers would complete their analyses of covered institutions, and submit reinsurance bids to the FDIC. The FDIC requested comment on a range of issues related to this process.

Most data necessary for determining reinsurance premiums would be generated based on the quarterly consolidated reports of condition and income and other publicly available information. The FDIC requested comments on the amount and type of information required by reinsurers, and whether access to reports of examination is essential to providing reinsurance. If access to examination reports were permitted for the purpose of formulating a reinsurance bid, such access would be subject to appropriate privacy safeguards, confidentiality agreements, and the receipt of express permission of the appropriate federal banking agency for reports prepared by these agencies. The FDIC also requested comments concerning the anticipated burden on insured depository institutions of possible contacts from reinsurers interested in

submitting a reinsurance bid for a particular insured depository institution.

Most bankers had an opinion as to whether examination reports should be used by reinsurers, but the opinion was split. The insurance respondents were also divided in their views. Some argued that access to examination reports would help minimize uncertainty about the riskiness of an organization. One trade group recommended providing access to examination reports in order to provide reinsurers with additional information in order to minimize the required contact between bank and reinsurer. On the other hand, another banking industry trade group suggested that access to examination reports would be in conflict with one of the goals of the Pilot Program -- to develop an independent, market-driven view of the risk posed by individual institutions. Furthermore, issues of confidentiality arise. If a reinsurer is assessing the likelihood of an institution's failure, however, it seems appropriate for all information that would help to estimate the probability and cost of failure, including confidential information, be provided to the reinsurer.

Another banking trade group recommended that the FDIC provide reinsurers with basic regulatory information about participating institutions -- information such as restrictions imposed because of Prompt Corrective Action requirements, and cease and desist orders. These regulatory measures are typically disclosable events by banks. Given the mixed response, and also

the potential difficulty of making examination reports available, the FDIC will continue to study the issue.

With respect to the issue of contact between the reinsurer and the insured institution, several respondents agreed that contact would be necessary to cover topics not generally found in publicly available documents. For example, reinsurers may wish to inquire about loan review policies and procedures, pending litigation, management information system capabilities, and management strength. Any discussions could be subject to confidentiality agreements. Depending on the thoroughness of the inquiry, such a "due diligence" process can take an examination team several days to accomplish. A process this long could require an inordinate amount of a bank's time. Additionally, some reinsurers may wish to have an ongoing dialog with senior management. Increased information helps the reinsurer determine a meaningful premium, and to the extent that information is withheld, prices will tend to be higher to compensate for the uncertainty.

However, a number of banks and banking trade groups were quite concerned about the resulting burden. There is a trade-off between obtaining information and imposing a burden. Typically, publicly traded institutions maintain a dialog with securities analysts and analysts from various rating agencies. Most institutions should be capable of handling an additional set of inquiries. Smaller institutions may be less prepared for handling on-site inquiries. Nevertheless, the FDIC is concerned

about burdening participating institutions with overly burdensome information requests, and will attempt to set parameters for reasonable levels of contact in order to strike a balance between the two.

The bid would include premiums for each insured depository institution the participating reinsurer is willing to reinsure and a statement of the total volume of reinsurance business desired. All other terms and conditions of reinsurance would have been established previously by the Participation Contract. The FDIC would assign reinsurance on the basis of price for each insured depository institution to be reinsured. Reinsurance would be allocated until the desired volume of business based on total exposure per reinsurer is reached. Each reinsurer would charge the FDIC directly for the reinsurance premium. The FDIC requested comments on the bidding process, and whether only one bid should be accepted per institution.

Few respondents commented on this issue. One insurance company recommended that the FDIC be more specific with respect to determination of the winning bid. The FDIC also recognizes that the process, as proposed, generates uncertainty with respect to the final reinsurance portfolio obtained by the reinsurer. In other words, while the reinsurer may have decided which institutions to reinsure, the reinsurer will lack control over determination of the final reinsurance portfolio. This uncertainty may result in higher reinsurance premiums.

One alternative would be to pool institutions and allow reinsurers to bid on such pools. The advantage to reinsurers would be that the method decreases the portfolio diversification risk. Additionally, pooling is viewed as an attractive alternative, particularly in cases where it could be too expensive to individually price institutions -- possibly in the case of smaller banks. Unfortunately, a pool does not assist in the derivation of prices for individual institutions -- a critical function of the program. However, prices of pooled institutions considered comparable by the FDIC may provide information as to the appropriate range of premiums to charge institutions. This possibility will be considered further prior to issuing an RFP. Furthermore, one insurance company has indicated that it is committed to studying this issue further independently.

The FDIC intends to set a maximum acceptable reinsurance premium for all insured depository institutions deemed eligible by the FDIC for reinsurance. The FDIC would not enter into reinsurance contracts in which the premium quoted exceeds the maximum acceptable reinsurance premium. All bids received with reinsurance prices in excess of this maximum amount would be rejected. The purpose of setting a maximum price would be to allow reinsurers to avoid devoting additional analytical resources to an institution once the reinsurance price is determined to be in the range above the maximum price. Several respondents disagreed with the FDIC's proposal, arguing that it

would defeat the purpose of going to the market for information. Another respondent was concerned that a maximum might hinder participation or bias the results of the program. The FDIC's intent would be to set a price high enough to affect bids in only a relatively few cases.

If the amount of reinsurance the FDIC seeks is related to an institution's size, reinsurance of large institutions may be beyond the capacity of any single reinsurer. To address this, the FDIC requested comment on whether the FDIC should arrange to have more than one reinsurer provide coverage for certain institutions. To do this, the FDIC would accept multiple bids up to the coverage desired per institution by the FDIC. This may complicate matters by introducing multiple prices for a given institution. An alternative would be to lower the coverage in cases where capacity is a concern.

D: Use of Results

Once the FDIC has awarded bids, reinsurance contracts will be signed between the FDIC and the reinsurer. An insured depository institution deemed eligible for reinsurance by the FDIC would not be a party to the contract. Reinsurance coverage would be provided for a specified period following the awarding of bids.

The FDIC requested comment as to how, if at all, pricing information obtained from the Pilot Program should affect an

institution's assessment rate. Similarly, the FDIC requested comment as to how to use the information that an institution is considered "unreinsurable" by the market. The current risk-related premium system allows the FDIC to include any available information in its determination of an institution's supervisory assignment. Ideally, the market would provide reinsurance prices for all insured institutions, and these prices could be weighed in the determination of supervisory subgroups.

The majority of respondents commenting on this issue urged the FDIC not to use the reinsurance prices to affect an institution's assessment rate during the course of the Pilot Program. For reasons discussed previously, there are concerns about passing through reinsurance premiums directly to insured depository institutions. In particular, commenters raised three areas of concern -- the uncertainty of market-based premiums, resulting incomparable premiums, and the existence of the FDIC's new risk-related premium system.

First, it was noted that the range of reinsurance premiums is unknown. Several respondents suggested that the FDIC wait until a stable reinsurance market exists before passing along rates -- in other words, make sure that the market works before affecting participating institutions. Several letters received commented on the ability of the private sector to assess risk to the insurance funds. One bank commented that reinsurers would lack the capability of determining the riskiness of insured depository institutions in-house. One banking trade group

suggested that the Pilot Program would be useful for determining whether the private sector could calculate premiums more accurately, and therefore reduce premiums overall for the banking industry. Other respondents suggested that the Pilot Program may not generate much new information, because the FDIC already has the capability of judging the riskiness of insured depository institutions.

It is not clear that private-sector premiums will be lower than the range of rates currently being assessed by the FDIC (23 to 31 basis points). In fact, one respondent suggested that the exercise may help the FDIC raise premiums to more realistic levels. As the Pilot Program progresses, the FDIC will be able to evaluate how successfully the reinsurance market determines a bank's riskiness and its reinsurance prices. The FDIC agrees that it is wise to pursue this subject cautiously. Until additional information is available, the FDIC does not intend to pass along the reinsurance premium directly.

Second, a number of respondents raised the concern that the goals of reinsurance participants would be in conflict with the FDIC's goals of the Pilot Program. As respondents pointed out, the FDIC, as a government agency, is non-profit by nature. The FDIC upholds public-policy goals. Insurance companies are profit-driven, and thus any reinsurance premiums assessed against banks would necessarily include a profit component. Insurance companies practice loss control, risk transfer and management.

While these assertions are correct, they do not obviate the test of the Pilot. As discussed previously, the premiums cannot be perfectly comparable. A contributing factor not mentioned previously is that FDIC premiums currently contain a recapitalization component -- that is, because each fund is required by statute to recapitalize to a level equal to 1.25 percent of insured deposits, current FDIC assessments contain a risk portion and a recapitalization portion.

Perhaps the key reason why premiums cannot be perfectly comparable is that the reinsurers would be reinsuring the FDIC, which could have a part in the determination of when an insured depository institution fails. In other words, the FDIC would have some control over the outcome of an insurable event. However, pursuant to section 38 of the Federal Deposit Insurance Act (Prompt Corrective Action), the appropriate federal banking agency generally must appoint a receiver, or with the concurrence of the FDIC, a conservator, not later than 90 days after an insured institution becomes critically undercapitalized. Nevertheless, this was a concern of several respondents. Several groups advised that the FDIC should delineate carefully in a contract what would constitute depository institution failure, loss to the insurance fund, and the cost of assistance.

During the Pilot Program, the FDIC does not intend to allow reinsurers to impose restrictions on banks, or, in other words, to act as regulators. In addition, after an institution fails, the FDIC would be responsible for all resolution and liquidation

activities. One respondent suggested that it would be appropriate to allow the market mechanism to set restrictions on banks. Another respondent, an insurance company, noted that reinsurance requires candid and frequent discussions between the parties involved.

While reinsurance in the private sector may offer greater flexibility for its participants, it is important to remember that the Pilot Program is using reinsurance to accomplish its goal of establishing market-derived prices, and not an exercise in allowing private-sector participation in other regulatory processes. To do otherwise could be to allow the private sector to intervene in carrying out the FDIC's statutory mandates and in issues of public policy. Additionally, the FDIC is not seeking a "partner" in deposit insurance.

Given these constraints over the general terms of the Pilot Program, one issue the reinsurer must therefore confront is "regulatory risk." The reinsurance premiums will contain an element of regulatory risk. Thus, reinsurance premiums cannot be directly comparable to those charged by the FDIC. Although it is not possible for the reinsurer and the FDIC to face the same risks, the Pilot Program can still yield worthwhile information.

Additionally, different reinsurers will employ various methodologies for assessing their risk and determining premiums. One respondent commented that different methodologies could invalidate the results of the Pilot Program, because the exposure of banks would not be calculated the same and the premiums would

be incomparable. Consequently, this could result in inequitable reinsurance terms for insured depository institutions. Given this conclusion, one respondent asked the FDIC to set methodology parameters in order to create a level playing field for reinsurance participants. However, the market uses different methodologies to assess risk for other purposes, and it is not clear that there are good reasons for requiring a single methodology.

Reinsurers will have different tolerance levels for risk, as well. This fact could lead to a range of reinsurance prices for a single insured depository institution. One trade group suggested that the success of the Pilot Program should be judged by its ability to generate comparable reinsurance prices per institution. As noted above, part of the appeal of the market is the fact that there is diversity of opinion, and the FDIC will be interested in determining if there is a difference of opinion as to how an institution is priced.

Furthermore, it seems plausible, as several respondents noted, that reinsurers will be highly risk averse. The net result may be that too many institutions may be considered "unreinsurable." A bank trade group warned that premiums would not be fair if capacity constraints limit reinsurance to only the healthiest institutions. However, the primary goal of the Pilot Program is to obtain information. Although it is possible that there will be an adverse selection problem, the information garnered will allow the FDIC to view how the market identifies

the healthiest institutions. Or, it might be possible to use private reinsurance results to help establish a minimal risk group of institutions for premium-setting purposes.

Certain institutions will not obtain reinsurance, because they will be considered too risky by the reinsurers, or for other reasons, including capacity constraints. In theory, this rating could be used to motivate an institution to improve its performance, particularly if it were associated with a mandatory increase in the institution's assessment rate, as was suggested by several respondents. In other words, the market's signal could be used to trigger some form of regulatory intervention. One respondent suggested that the appropriate intervention would be to close all "unreinsurable" institutions.

A number of respondents felt that an "unreinsurable" rating should not affect an institution during the Pilot Program. The rationale behind this was similar to arguments against using the reinsurance premium to affect assessment rates during the Pilot Program. First, the results are unknown. As was pointed out, an "unreinsurable" rating may not be due to an institution's risk. Instead, the rating might reflect a problem with the Pilot Program itself, or some process of the program. Furthermore, concern was expressed that disclosure of such a negative rating could undermine the public's confidence in an institution. However, as is true with the issue of how to use the reinsurance pricing information, the FDIC believes it is wise to approach the issue with caution. As the program progresses, it may be

possible to use the information generated when setting an institution's supervisory subgroup assignment.

Finally, it was suggested that reinsurance premiums could interfere with the FDIC's new risk-related premium system before the system has an opportunity to work. One trade group specifically requested that the Pilot Program be delayed in order to understand the results of the FDIC's risk-related premium system first. The group suggested that a reinsurance experiment might disrupt the results of the risk-related premiums.

Currently, an institution's risk-related premium depends on its capital rating and supervisory factors. Toward this end, as noted above, the FDIC has allowed some leeway in the risk-related premium structure to allow for the inclusion of other factors considered relevant to an institution's financial condition and the risk posed to the insurance funds. That is, the supervisory subgroup assignment depends on the supervisory evaluation provided to the FDIC by the institution's primary federal regulator, as well as other information deemed applicable by the FDIC. It would be possible to include the reinsurance premium as a factor in determining an institution's supervisory subgroup. In fact, this has been considered, and the FDIC has requested comment on this possibility.

One bank remarked that a reinsurance program would be unnecessary, because banks are already subject to two risk-based measurement systems: risk-based capital and risk-related deposit insurance premiums. While this is correct, in that banks are

already required to meet several risk-based tests, neither measure uses the market as its primary means of determining the categorization of a bank.

A number of respondents were concerned about the public's perception of the Pilot Program, and possible outcomes of disclosure. For example, high reinsurance premiums may decrease the public's confidence in a given institution, and create misunderstandings as to what the premiums mean. For this reason, it was suggested that reinsurance pricing information be held in confidence by the FDIC, and that the terms and conditions of participation by reinsurers include a strict confidentiality agreement. Currently, institutions are not permitted to disclose their risk-related assessment rates or their risk-related rating. Reinsurance premiums would most likely be treated similarly.

VIII. Conclusion

The purpose of introducing private reinsurance into the federal deposit insurance system is to allow the FDIC to use market forces to gauge risk more accurately. This, in turn, would allow the FDIC to set assessment rates that would create better incentives for banks and enhance the fairness of the system. Conceptually, this type of public-private partnership has considerable appeal. At Congress' request, the FDIC explored this issue at length through discussions with other regulators and with representatives from the banking and insurance

industries. These discussions helped the FDIC to identify the issues involved and to formulate an approach to carrying out a pilot reinsurance project. Both the issues and the approach were presented in a notice requesting public comment on all aspects of this effort.

The discussions and the public comments reflect the complexity of transforming private reinsurance from an appealing idea into a workable enterprise. This effort will require some consensus to develop among banks, potential reinsurers, and bank regulators regarding the goals, limitations, and feasibility of private reinsurance. This task presents a challenge because it requires each group to venture into unfamiliar territory. In light of this, the FDIC has sought, and will continue to seek, the counsel of a number of parties in order to arrive at a reasonable approach to a Pilot Reinsurance Program.

The FDIC envisions a pilot program with three phases. After completing each phase, the FDIC will decide whether to continue on this course in light of the findings up to that point. In the first phase, the FDIC will determine the general terms under which it is willing to obtain reinsurance and will solicit participation of parties willing to provide reinsurance. The FDIC will work with these parties to develop a detailed and final reinsurance contract. In the second phase, the reinsurers will conduct their analysis of banks and submit bids indicating the prices at which they are willing to reinsure banks. In the third phase, the FDIC and the reinsurers will enter into

reinsurance contracts. The third phase will end when the term of the reinsurance contracts terminates.