**Remarks
By
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Before
The
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Today, I want to talk to you about the future -- the future of the federal deposit insurance program.

The FDIC is in a unique position among regulatory agencies. In our role as insurer, we are a financial institution. As a result, we believe we can improve the way we manage the deposit insurance funds by drawing on private-sector risk-management practices.

We believe that the market can help us better manage risk by helping us to better price risk. In particular, we are looking at ways that the FDIC may enter into risk-sharing arrangements with market participants.

This wouldn't take an act of Congress -- there has already been one. The Federal Deposit Insurance Corporation Improvement Act authorized the FDIC to transfer up to 10 percent of its risk exposure to market participants. Total insured deposits currently are about $3 trillion, so the FDIC could conceivably transfer the exposure on $300 billion of insured deposits. Of course, if we proceed, we would start on a smaller scale with pilot projects to test different risk-sharing arrangements.

Why are we considering this? To lay off risk?

No.

Rather, we recognize that the market is much better at pricing a product than we are because it incorporates the judgments of many individuals about events that will affect the dollars that they themselves have at risk.

Of course, market information alone is not perfect. But, combined with our supervisory information, it can be a valuable tool. Markets are capable of processing far more information and acting far more quickly than any one government agency can ever hope to do.

Incorporating market information also helps address the concerns of bankers about the subjectivity of examination ratings for purposes of pricing deposit insurance. For these reasons, we plan to publish a Request For Proposal (RFP) next week to contract with a

private-sector firm to investigate the potential for the FDIC to draw upon the reinsurance markets for information on deposit insurance pricing. In the near future, we also will explore the potential for the FDIC to draw upon large commercial and investment banks for their expertise in designing instruments to transfer and price risk.

For any arrangements that appear promising, we would then need to determine whether the market is likely to be sufficiently liquid to obtain reliable pricing signals.

We will use the information we gain from these efforts in formulating our recommendations to Congress for comprehensive deposit insurance reform early next year.

As many of you know, our comprehensive reform effort is described in the Options Paper we released eight weeks ago. It discusses many ways to reform our system to make it better. All of the options we are studying are premised on the importance of getting the pricing right for deposit insurance. If we get the pricing right, reflecting the true risk of individual institutions, the funds are better protected against loss.

Correctly charging each institution for the risk it poses also helps us tackle the well-known "moral hazard" problem created by a federal guarantee. And, better risk-based pricing brings needed fairness. In the long run, safer institutions will pay less and riskier institutions will pay more for the exposures they create.

In our Options Paper on deposit insurance reform, we explore the ways in which the FDIC can achieve risk-based pricing. We are particularly interested in how these tools can assist us in evaluating the exposures from the largest and most complex banks - where our potential liability is most highly concentrated. We must be mindful that with the deposit bases of the largest institutions now dwarfing the deposit insurance funds, the system is only as strong as its weakest link.

For more than a decade, financial experts outside government -- and some in government, too -- have called for greater use of private-sector discipline to improve our insurance system. FDICIA, in 1991, took a step in this direction of risk-based insurance, but the system today falls short of market-based pricing. This would not be the first time that the FDIC has explored the use of market information. Following FDICIA, the FDIC completed a study on ways in which reinsurance contracts might be employed to provide market opinions of risk. At that time, however, just after a protracted banking crisis, the terms under which coverage could be obtained were not favorable.

Past proposals to bring market discipline into the system have included lowering coverage levels, using "coinsurance" to increase depositor discipline, or privatizing deposit insurance. These approaches raised significant concerns because they either changed the products banks offer their customers or jeopardized the stability of the system by eliminating the federal backstop. But much has happened since FDICIA. Financial innovation has greatly expanded the range of possibilities for pricing risk in the marketplace. Now we believe that the time is right for another look at the markets.

We are already looking at markets to enhance bank supervision. Since the passage of the Gramm-Leach-Bliley Act, bank regulators are evaluating the possibility of using subordinated debt as a tool to help assess risk in large banking organizations.

We believe that a similar approach, using more market-oriented risk-sharing techniques, may benefit the insurance system.

We are exploring tools used today in the marketplace. Commercial and investments banks, insurance firms, and large commercial firms use a variety of instruments to transfer risks, including swaps, structured securities, and reinsurance arrangements. These may serve as a starting point for thinking about instruments the FDIC could use to help us evaluate our risk exposure.

For example: We could enter into risk-management contracts that allow the FDIC to transfer a portion of the risk held by the insurance funds. The price we pay to transfer the risk gives us valuable information about the price we should charge the banks that we insure.

Perhaps the most straightforward example would be a contract in which the company to which we shift the risk agrees to pay some percentage of the FDIC's loss if a particular institution were to fail within a specified period. In return, the company would receive either an upfront payment or periodic payments from the FDIC.

There might be many variations on this approach. Contracts could cover pools of insured institutions rather than individual institutions. This might give us market judgments about emerging trends or the riskiness of banks with certain characteristics, such as a concentration in consumer credit.

The contracts also might call for a specified payment if a bank fails, rather than an amount contingent on the ultimate resolution and liquidation costs. This would allow the risk-sharer to bear only the risk of bank insolvency and not any further risk related to the manner in which the FDIC resolves a failed bank.

They could also be structured to tell us about the different layers of risk in our portfolio of insured institutions. Of particular importance to us would be understanding how to price catastrophic exposures - by this we mean individual or systemic events that could exhaust the fund.

Contracts of this sort, often referred to as catastrophe bonds, could provide us with not only information on how to price this exposure, but also on the appropriateness of our funding arrangements to deal with it.

Again, we could come up with many variations. There are market participants with expertise to devise and evaluate different approaches. We've used risk-sharing arrangements over the years in the liquidation and resolution area. Our experience has

taught us that well-designed and well-executed public-private partnerships can enhance the FDIC's ability to perform key functions -- particularly when the functions are similar, if not identical, to tasks performed by the private sector. Assessing risk is one such function.

In the 80s and 90s, the FDIC and RTC worked with private firms to use existing liquidation methods as well as to create new ones. Together with our colleagues in the private sector, we pioneered the use of mortgage-backed securities for commercial real estate and created private-sector participation structures for everything from raw land to judgments and charge-offs.

By 1995, our use of such market-inspired arrangements totaled more than $63 billion. And, in so doing, we helped to create liquid markets that did not previously exist and sold assets that were previously not marketable on anywhere near the scale that we eventually sold them.

And, with some of the bigger failures, we developed risk-sharing arrangements at the time of failure that allowed the bulk of assets to stay in the private sector.

There's one more important point worth mentioning. Using market risk-management and risk-sharing techniques also has the potential to reduce regulatory burden on banks. By its nature, the process would rationalize and challenge the measures used by regulators to monitor and respond to bank risk-taking.

For example, the reporting burden on insured institutions might be reduced if information currently reported by banks was judged to be unnecessary by market participants.

It is safe to say that most of our work is ahead of us. We believe that these reforms will help make the insurance system safer and stronger for all banks and bank depositors.

Thank you.

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