HARNESSING THE FREE MARKET: REINSURANCE MODELS FOR FDIC DEPOSIT INSURANCE PRICING

ANNA KUZMIK WALKER*

* Associate, Sullivan & Cromwell, Washington, DC. Thanks to Professors Hal Scott and Howell Jackson of Harvard Law School, Arthur Merton of the Federal Deposit Insurance Company, and Andrew Walker of Steptoe & Johnson.

I. INTRODUCTION

Adam Smith's invisible hand analogy,[1] originally posed in 1776,[2] has guided much more than the allocation of resources. The way the Western world thinks about markets and their regulation has been altered irreversibly by this philosophy that advocates little or no government regulation. As recent attempts at deregulation have demonstrated, however, once government regulation exists, a quick return to an unregulated marketplace may not present the most practical method of achieving the benefits of a free market.[3] In response to the examples of economic failure and disastrous political repercussions encountered in rapid market reform, students of regulation have tried to find other directions in which the invisible hand may point. Gradual market reform through limited privatization stands as a primary alternative direction.

Since the savings and loan crisis,[4] proponents of market efficiency and limited government intervention have predicted disaster in bank deposit insurance and have devised private insurance schemes to correct the situation. Such market proponents had little reason to cheer when Congress enacted the Fed-

1. The invisible hand was Smith's depiction of market forces controlling the amount and the methods of production in an economy. It now symbolizes the efficiency of the free market.

2. ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS (1776).

3. For example, airlines and passengers blame many of the problems suffered by the airline industry, including price wars, frequent bankruptcy of air carriers, and reduced safety, on the deregulation of the airline industry instigated by the Reagan Administration.

4. For information about the savings and loan scandal, see LAWRENCE J. WHITE, THE S&L DEBACLE: PUBLIC LESSONS FOR BANK AND THRIFT REGULATION (1991). There have been many bank insurance reform proposals based on privatization. *See generally* PETER J. WALLISON, BACK FROM THE BRINK: A PRACTICAL PLAN FOR PRIVATIZING DEPOSIT INSURANCE AND STRENGTHENING OUR BANKS AND THRIFTS (1990); Bert Ely, *Deposit Insurance Reform: 100% Cross-Guarantees are the Only Answer*, 45 CONSUMER FIN. L.Q. REP. 148 (1991); Daniel R. Fischel et al., *The Regulation of Banks and Bank Holding Companies*, 73 VA. L. REV. 301 (1987); John H. Kareken, *Deposit Insurance Reform*, FED. RESERVE BANK OF MINNEAPOLIS Q. REV., Spring, 1983. Although these reform proposals advocate varying degrees of privatization in deposit insurance, none urges complete deregulation of the banking industry.

eral Deposit Insurance Corporation Improvement Act of 1991 (FDICIA),[5] its latest attempt at mitigating the problems of moral hazard[6] caused by deposit insurance. Rather than concentrating on fundamental reform, such as the liberalization of interstate banking restrictions,[7] the FDICIA increased regulation and decreased regulator discretion, thereby regulating the regulators.[8]

The FDICIA does not, however, overlook entirely market discipline. Two provisions of the FDICIA address potential market reform within the deposit insurance scheme. Section 311(d)(1) of the FDICIA instructs the Federal Deposit Insurance Corporation (FDIC) to study the feasibility of deposit tracking across banks to place meaningful limits on FDIC insurance,[9] while section 322(a) allows the FDIC to experiment with private reinsurance of deposit insurance. Because section 311(d)(1) only authorizes the FDIC to conduct a feasibility study, this article concentrates on the possibility of market reform through a section 322 reinsurance program.

Congress established the FDIC after the Great Depression as a protective measure against two types of risk considered important factors in the collapse of banking early in the Depression era. Irrational runs on banks constitute the first risk. As a matter of business practice, banks retain only a small portion of all deposits on hand for immediate withdrawal. The largest share of deposits is used to fund bank loans. Because banks normally can-

5. Pub. L. No. 102-242, 105 Stat. 2236 (codified at 12 U.S.C. §§ 1811-34 (1994)) [hereinafter FDICIA].

6. Moral hazard is the decreased incentive to take precautionary measures that results when one person or entity is allowed to transfer to another the risk associated with his behavior.

7. The Treasury Department has urged liberalization of interstate banking regulations in an effort to increase competition and to promote safety in the banking industry. *See* U.S. TREASURY DEP'T., MODERNIZING THE FINANCIAL SYSTEM: RECOMMENDATIONS FOR SAFER, MORE COMPETITIVE BANKS (1991).

8. For example, the "prompt corrective action" standard created in § 131 of the FDICIA addresses the problem of regulatory hesitation to close a troubled bank by erecting a complex scheme of regulatory standards that reduces the regulator's ability to select the most appropriate resolution to a specific situation. For a discussion of the merits of the "prompt corrective action" standard, see ASSESSING BANK REFORM: FDICIA ONE YEAR LATER (George G. Kaufman & Robert E. Litan eds., Brookings Institution 1993) [hereinafter FDICIA ONE YEAR LATER].

9. Currently, the FDIC's $100,000 limit on deposit insurance is side-stepped readily by acquiring bank accounts with several different banks and spreading funds among them. In theory, a depositor could have $100,000 on deposit with every bank in the nation and be fully insured. Preventing depositors from doubling-up on insurance decreases both the effective deposit insurance limit and the degree of depositor protection. This also would decrease the total exposure of the Bank Insurance Fund, thereby shifting more of the burden of monitoring banks to the depositors.

not collect outstanding loans immediately, they generally do not have the capacity to meet a large demand for deposit withdrawals. If banks turn away depositors without their requested withdrawals, the depositors may panic and attempt to close accounts even with healthy banks. Deposit insurance and Federal Reserve loans exist to quell potential panics by reassuring depositors of the security of their funds irrespective of the bank's financial status.

The second risk directly addressed by the FDIC is systemic risk. Systemic risk considers the possibility that one bank failure will lead to other bank failures, thus disturbing large segments of the banking system.[10] The FDIC regulates the general safety and soundness of banks. Its regulatory role encompasses functions such as the monitoring of bank balance sheets, lending practices, and investment strategies for signs of financial distress that lead to bank failure.

The FDIC generally has fulfilled its mission of inhibiting bank runs and decreasing systemic risk. The widespread failures of savings and loans in the 1980s followed by the threat of similar failures in banking, however, have led many to question the secondary results of permitting the federal government to absorb the costs of risky banking activities. While risk may lead to greater instability in banking, it also checks market behavior. Because the Bank Insurance Fund (BIF) absorbs risks that depositors otherwise would consider when calculating return, bank managers have an incentive to seek high returns on investments with little regard for risk. This moral hazard in the banking industry becomes most acute when a bank already faces significant losses.[11]

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10. The risk of systemic failure is based on the inevitable transactions and relationships between banks that arise from the payment of checks, interbank loans, and the dependence of small banks on larger banks for consumer services.

11. Shareholders exert some influence over bank managers. Their ability to discourage or prevent excessive risk-taking limits the effect of moral hazard among depositors. When a bank experiences financial difficulty, however, shareholders are the first to lose value. The more value that shareholders lose, the more willing they are to "bet the bank" and encourage high-risk, high-return strategies in an attempt to recoup their initial investment. As shareholder value approaches zero, depositors should move their deposits to safer institutions, thereby discouraging weak institutions from "betting the bank." Deposit insurance eliminates depositors' incentive to move their funds, restoring the managers' ability to pursue high-risk investments.

The potential for excessive risk-taking exists even if a bank does not face financial stress. By definition, shareholders tend to be less risk averse than depositors because they are willing to risk loss in exchange for the possibility of obtaining returns greater than those offered by banks. Therefore, shareholders will be more willing than depositors to

Reinsurance, one potential solution for correcting moral hazard, centers on the premise that charging banks a market rate for deposit insurance will induce them to take risks commensurate with their return. If banks are charged rates that reflect the risk accepted by insurers, they have an incentive to limit risk-taking. Moreover, risk-based pricing promotes equality within the deposit insurance system. Without a direct relationship between risk and insurance premiums, sound banks following careful investment policies subsidize the less prudent practices of competitors.[12]

Although the FDIC assigns its own risk ratings to banks,[13] regulatory agencies are not subject to market discipline when calculating bank insurance premiums. Additionally, the FDIC does not have the pricing experience of the private market[14] and is vulnerable to political pressure and industry lobbying.[15] Private

accept riskier investments. *See* CONGRESSIONAL BUDGET OFFICE, REFORMING FEDERAL DEPOSIT INSURANCE 7 (1990) [hereinafter CBO REPORT]; Jonathan R. Macey & Geoffrey P. Miller, *Bank Failures, Risk Monitoring and the Market for Bank Control*, 88 COLUM. L. REV. 1153, 1162 (1988). Risk-based pricing forces banks to internalize the costs of their risky behavior.

12. This presents the classic "tragedy of the commons" scenario. When each bank in a group of banks pays the same insurance premium, the price of insuring the risk of the entire group is divided among them equally. However, if one or more of those banks engages in riskier behavior than the others, the increased risk taken by the subset of the group is funded by all the banks, even though any benefits of the risky behavior devolve only upon the subset. Each bank, therefore, has incentive to engage in risky behavior; only self-restraint by each bank prevents a scramble to engage in risky behavior at the expense of the other banks.

13. The FDIC already implements internal risk evaluation under § 302 of the FDICIA. *See* Final Rule on Risk-Based Premiums, 57 Fed. Reg. 45263, 45278-83 (to be codified at 12 C.F.R. pt. 327) (1992). Although the new pricing system has caused banks to shore up capital, reducing bank risk and demonstrating bank responsiveness to premium rates, the FDIC is unlikely to reach the full range of premiums available through the private market, *see infra* note 15. Now more than ever, the FDIC is less likely to implement a wide range of premiums without market mechanisms because the banking market has improved, *see* William M. Issac, *What a Difference One Year Has Made to the Nation's Banks*, AM. BANKER, Oct. 1, 1993, at 18, and also because the Clinton Administration has shifted the focus from bank safety to the "credit crunch," *see* Barbara A. Rehm, *If Clinton Can Tame GAO, Banks Will Cheer*, AM. BANKER, May 4, 1993, at 1. At this point, notice the fallacy in the argument that risk-based premiums increase the risk of failure in weak banks through the higher premium price. The argument rings false because a bank should be able to borrow money to pay its premium if the bank has reasonable prospects for recovery. If recovery is unlikely, however, the size of the premium becomes irrelevant in the face of pending failure. Moreover, in the long-run, risk-based premiums will provide banks with greater incentives to follow safe investment practices so that insurance premiums do not become prohibitively large.

14. Before enactment of the FDICIA, premiums were set at the same rate for all banks and were based upon the level of deposit insurance fund reserves. *See* 12 U.S.C. § 1817(b) (1988).

15. Jerry Jordan, the president of the Cleveland Federal Reserve Bank, recently was quoted as saying that political considerations always would prevent a rate range wide enough to reflect properly differences in risk when rates are set by a public agency. David

insurers and reinsurers, therefore, should be better at pricing deposit insurance. Even if private reinsurers set prices that do not reflect fully the costs to the FDIC, they can provide a market evaluation of relative risk among banks that the FDIC could employ in setting its own prices.

It is difficult to determine the significance to the FDIC of the prices set by the free market because no reliable empirical information exists to indicate how reinsurers will price deposit reinsurance. For example, until reinsurers develop sufficient "loss" data to set premiums based on actuarial risk, premiums are unlikely to reflect enough information about such risk to warrant specific uses for that information by the FDIC. Furthermore, even as reinsurers develop information and expertise, bids set by the market may not reflect all of the costs to the FDIC; market prices will not account for the public costs associated with insuring the entire banking system (rather than a single institution or subset of banking institutions) and implementing various social policies. More importantly, the prices set by the reinsurance market are themselves likely to reflect the risk of adverse (or beneficent) FDIC action.

These uncertainties, some of which may never be resolved satisfactorily, make it important to consider how the FDIC might use reinsurance premium information. First, the FDIC could pass reinsurance rates directly on to banks without any adjustment (direct pricing).[16] Second, the FDIC could create a formula that

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T. Johannesen & Sara C. Settembrini, *The Best of All Regulators: A Well Informed Marketplace*, AM. BANKER, June 3, 1993, at 4. Although the FDICIA required that the FDIC increase premiums for federal deposit insurance in 1992, the actual assessment implemented was only one-half the size originally proposed by the FDIC. *See* Stephen Labaton, *U.S. Regulators Scale Back Rise in Banking Fees*, N.Y. TIMES, Sept. 16, 1992, at A1. It is difficult, however, to determine exactly what proportion of the discrepancy resulted from political pressure and what proportion resulted from revised FDIC loss projections for the BIF. *See FDIC Upholds Current Deposit Insurance Premium for Healthiest Banks and Thrifts*, Banking Rep. (BNA) (Sept. 21, 1992), *available in* LEXIS, Banking Library, Curnws File. The range of premium rates between the best and worst banks (with FDIC insured deposits) has been set artificially at only eight percent. This figure is smaller than the prevailing market-rate spread among CD rates paid by banks at the time the public rate spread was set. In addition, the prompt corrective action standards in the FDICIA have been defined so that ninety percent of all banks holding nearly two-thirds of all bank assets were classified as well capitalized in June 1992. George G. Kaufman & George J. Benston, *Intellectual History of the Federal Deposit Insurance Corporation Improvement Act of 1991*, *in* FDICIA ONE YEAR LATER, *supra* note 8, at 29. *But see* Karen Shaw, *FDICIA at One: A Troublesome Toddler at Best*, *in* FDICIA ONE YEAR LATER *supra* note 8, at 54.

16. For example, if the reinsurer charges the FDIC ten cents per $100 to reinsure $1000, resulting in a total premium of $1, the FDIC would charge the bank ten cents per $100 for all insured deposits, resulting in a $10 premium for reinsuring $10,000, or a $100,000 premium for $100 million of reinsured deposits.

preserves a price structure equivalent to the relative risk established by the market, but prices deposit insurance at rates which reflect the FDIC's needs more closely (relative risk pricing).[17] Third, the FDIC could use market prices as an alternative measure of bank safety and soundness, similar to the manner in which the CAMEL ratings[18] are assigned to banks (relative risk regulation). Regardless of how it utilizes the information, the FDIC also can use reinsurance to increase bank monitoring by structuring the terms of the reinsurance so that reinsurers have incentives to monitor continually the banks whose deposits they reinsure.

Unfortunately, reinsurance—the transfer of a portion of the loss the FDIC experiences in bank failures to third parties[19]—is not well-suited to protect the BIF. In theory, the FDIC has the ability to bear the costs of all bank failures through its premium structure. With the goal of financing the fund in mind, the FDIC premium payment to the reinsurer is an inefficient expenditure because the premium will contain a margin designed to give the reinsurers a profit. Furthermore, meaningful protection for the BIF requires reinsuring a significant portion of deposit insurance. As discussed below, transferring a large portion of bank risk to the private market may harm both the financial markets and the FDIC. Fortunately, no evidence exists to indicate that either the FDIC or Congress harbors any plans for using reinsurance in such a capacity.

17. In this case, the FDIC would employ a standard formula to adjust the premium that the reinsurer charged. This calculation could operate simply, adding or subtracting a percentage for differences (such as the FDIC's costs of bearing systemic risk or the private market's need for a return to capital) between the FDIC cost structure and the private market. In theory, this formula could become more complex as attempts are made to account for factors, unrelated to bank risk, that tend to lower premiums. This approach, however, increases the danger of political manipulation and FDIC miscalculation. As will be seen later in this article, other action can be taken, depending on the cause of variation between bank risk and risk to the reinsurer, in limiting that loss without creating such a formula.

18. "CAMEL," an acronym for Capital, Asset quality, Management, Earnings, and Liquidity, is an FDIC rating of bank safety and soundness. Ratings range from 1 to 5, highest to lowest. Currently, the FDIC employs CAMEL ratings as the primary predictor of bank failure. *See* FED. DEPOSIT INS. CORP., THE FEDERAL DEPOSIT INSURANCE CORP.: THE FIRST FIFTY YEARS 128 (1984).

19. In classifying various proposals for deposit insurance reform, the CBO Report includes reinsurance as a means of risk transfer. *See* CBO REPORT, *supra* note 11, at xix. Although reinsurance effectively transfers risk, the FDIC's primary advantage to be gained through reinsurance (in the context of the BIF) derives not from risk transfer but from the information obtained as result of the risk transfer. The FDIC may utilize reinsurance in determining the (efficient) price at which the bank's deposits can be reinsured.

Although private insurance of the BIF potentially offers substantial and attractive benefits, implementation of the FDIC Pilot Program[20] underscores the complexities of creating a partnership between the public and private sectors in a regulatory context. This article examines the potential for use of reinsurance by the FDIC for each of the three purposes stated above. Such examination provides insight into the feasibility of a full scale reinsurance program and highlights the difficulties common to all proposals for market reform of federal deposit insurance. The FDIC's ability to design a program that generates price information identical to the FDIC's costs (direct pricing) constitutes the primary subject of analysis, not because the FDIC necessarily should pursue that option, but because it represents the highest standard of compatibility between the FDIC and the private market.

A brief survey of reinsurance and the reinsurance options available to Congress precedes a presentation of the reinsurance Pilot Program proposed by the FDIC in response to the FDICIA. Next, the FDIC's options for structuring the reinsurance market lead to a review of possible market participants and special considerations for certain participants. This article then explores the compatibility of private pricing and FDIC pricing of deposit insurance, focusing on the unique aspects of the FDIC, followed by a discussion of the uses of reinsurance premium information available to the FDIC. Finally, this article concludes with a review of the strengths and weaknesses of reinsurance as a model for reform.

II. Reinsurance Background

A. *Economic Function of Reinsurance*

Reinsurance is sought by primary insurers[21] for various reasons. From an economic standpoint, reinsurance permits an efficient specialization of skills. In a simplified world, primary insurers are small, local, and specialized; reinsurers, on the other hand, are well-capitalized international corporations with highly diversified risk portfolios. Primary insurers, because of their proximity to and knowledge of the insured, have an advantage over reinsurers in soliciting customers, pricing policies, and mon-

20. Section 322(a) of the FDICIA is the basis for the Pilot Program.

21. Primary insurers also are known as reinsureds, cedants, or ceding companies.

itoring insureds for moral hazard. Reinsurers, on the other hand, have advantages in raising capital and diversifying and managing risk, particularly the risk of a catastrophe which might bankrupt a small private insurer. Insurers, therefore, can trade their advantages in pricing and moral hazard monitoring for the greater risk-bearing capacity of the reinsurer.[22] Primary insurers also may find reinsurance necessary in meeting regulatory restrictions that limit exposure to any individual risk.[23] By retaining only a portion of each insured risk, the insurer is able to insure a greater variety of risks with the same amount of capital, assuming that state regulators permit it to subtract reinsured risk from its reserve requirements.[24]

The FDIC is turning to the reinsurance market with a need almost opposite to that of the traditional insurer. Rather than trading superior monitoring and pricing for financial stability and regulatory compliance, the FDIC wishes to acquire superior pricing and improve its monitoring ability. For this reason, traditional reinsurance markets and reinsurers are poorly suited to satisfy the needs of deposit insurance.[25] The FDIC must look to the potential of the private market to produce well capitalized and diversified reinsurers that can price and monitor risk accurately.

22. *See* Yoram Eden & Yehuda Kahane, *Moral Hazard and Insurance Market Structure, in* RISK, INFORMATION AND INSURANCE 143-158 (Henri Louberge ed., 1990). Eden and Kahane argue that reinsurance transactions should not occur when the reinsurer itself must monitor the insured or when the primary insurer can bear the risk alone. *Id.* Although both conditions exist in the FDIC proposal, the regulatory environment in which deposit insurance was developed has caused market distortions which may permit such a relationship to thrive.

23. In doing so, they also make more of their own capital available for other transactions and are better able to diversify and manage risk internally.

24. INS. INFO. INST., INSURANCE INFORMATION INSTITUTE REPORTS, INSOLVENCIES/GUARANTY FUNDS (Ruth Gastel ed., 1993). The ability to subtract liabilities by reinsuring the risk is determined in most cases by the financial strength and qualifications of the reinsurer. Many States require reinsurers to submit to state licensing procedures to allow their clients to claim credit for reinsurance.

25. It may be argued that the program proposed by Congress and the FDIC is not "reinsurance." Although the FDIC's objectives for the program differ from those of typical cedants, *see supra* note 22, the basic element of reinsurance—transfer of risk borne by a primary insurer to a third party—exists. For example, insurance companies may reinsure their full liability under a policy to withdraw from a market entirely. Although the traditional model of reinsurance is based on a different market structure, the FDIC can create a similar market tailored specifically for its own purposes.

B. *Models of Reinsurance*

Nevertheless, in developing a model for the FDIC-created deposit reinsurance program, traditional reinsurance practices provide useful insights because they can be employed to provide generally effective schemes that enable the FDIC to obtain relative risk information.[26]

1. *Treaty Versus Facultative Reinsurance*

Generally, reinsurance is underwritten either on a treaty or a facultative basis. Reinsurance treaties create a contractual relationship under which all policies of a particular type issued by a primary insurer are reinsured by a single reinsurer. Once a treaty is in effect, neither the primary insurer nor the reinsurer may refuse to accept any portion of the risks associated with the treaty.[27] Given the size of the FDIC's obligations, treaty reinsurance is unlikely to be suitable for deposit reinsurance. Even if a treaty were created to reinsure only a portion of the FDIC's obligations, the reinsurer would be vulnerable to extraordinary losses due to systemic bank risk.[28] More importantly, the reinsurer might base premiums on the treaty as a whole rather than on individual bank risks that comprise the treaty, thus defeating the primary benefit of deposit reinsurance—relative pricing.

Facultative reinsurance represents a better alternative because it is negotiated separately for each risk (in the case of deposit reinsurance, each bank is one risk). This would provide the FDIC with price information about individual banks while allowing more reinsurers to participate.

2. *Excess Loss Versus Pro Rata Risk Sharing*

While it is clear that facultative reinsurance is better suited for deposit reinsurance than is treaty reinsurance, the choice be-

26. Two sources from the Practicing Law Institute excel as brief and informative guides. *See generally* Robert F. Hall, *Reinsurance Claims*, *in* LITIGATION AND ADMINISTRATIVE PRACTICE COURSE HANDBOOK SERIES: LITIGATION, INSURANCE EXCESS AND REINSURANCE COVERAGE DISPUTES 405, 405-49 (Barry R. Ostrager & Thomas R. Newman eds., 1988); *Overview of Reinsurance*, *in* LITIGATION AND ADMINISTRATIVE PRACTICE COURSE HANDBOOK SERIES: LITIGATION, INSURANCE EXCESS AND REINSURANCE COVERAGE DISPUTES, *supra*, at 299, 299-310.

27. *See Overview of Reinsurance*, *in* LITIGATION AND ADMINISTRATIVE PRACTICE COURSE HANDBOOK SERIES: LITIGATION, INSURANCE EXCESS AND REINSURANCE COVERAGE DISPUTES, *supra* note 26, at 299, 305.

28. Systemic risk involves the risk of a chain reaction of failures among banks resulting from inter-bank relationships in the payment system, correspondent banking, etc.

tween excess loss reinsurance and pro rata risk sharing may be more difficult.[29] In excess loss reinsurance, the reinsurer insures the cedant's losses above a certain amount or loss ratio (the loss threshold).[30] Once the cedant has reached its threshold, the reinsurer must bear all remaining loss, subject to any cap in the reinsurance contract. Pro rata reinsurance, on the other hand, provides for a division of losses at a predetermined rate. For example, in the case of deposit reinsurance under current law, the deposit reinsurer cannot bear more than ten percent of the losses on insured deposits in any one bank.[31]

In a deposit insurance context, excess loss reinsurance could work in one of two ways. The FDIC could bear the primary risk and reinsure excess loss with private reinsurers, or the private market could bear the primary risk and reinsure excess loss with the FDIC. For ease of reference, the former will be termed private excess loss reinsurance and the latter will be called FDIC excess loss reinsurance.

a. *Private Market Excess Loss Reinsurers*

Private excess loss reinsurance is unlikely to generate the necessary pricing information for the FDIC without significant manipulation of the reinsurance form. Premiums under a private excess loss scheme would be based not on the probability of bank failure but on the probability of bank failure resulting in losses greater than the excess loss threshold.[32] If the threshold for triggering excess loss is high, there is likely to be a significant differential between the free market price for deposit insurance and the premium set by the reinsurer. The reinsurer is likely to charge a much lower rate because it may avoid suffering any loss resulting from a bank failure. Furthermore, the relative risk of failure may not correspond to the relative risk of failure at a

29. Although § 322 of the FDICIA limits the scope of FDIC reinsurance experimentation to pro rata risk sharing, any method of reinsurance theoretically could be applied to deposit insurance.

30. A loss ratio is calculated by dividing the amount of premiums paid by the amount of claims made. By entering into excess loss reinsurance, the cedant guarantees itself a profit at least equal to the amount of premiums minus the loss ratio (or the loss amount), the reinsurance premium, and any other administrative expenses. The reinsurer bears the risk of losses exceeding the loss ratio or amount and the windfall of premiums against which no loss is claimed, such as when losses do not exceed the reinsurance threshold.

31. *See infra* note 41 and accompanying text.

32. For example, if the reinsurer agrees to pay for losses above one million dollars in a bank with two million dollars in deposits, the reinsurer will charge only for the risk of a bank failure that leaves depositors with less than one million dollars in assets.

given level of losses, thereby distorting relative risk information. As the threshold level is lowered, the FDIC pays less before reinsurance claims are triggered while the reinsurer becomes increasingly likely to bear a loss. Unless the threshold is very low, there still will be a significant possibility that the reinsurer will not suffer any loss from a bank failure. A very low threshold for excess loss claims, however, would transfer most of the loss in bank failure to the reinsurer.

Several ramifications occur when transferring a substantial portion of the loss to the private sector. First, deposit insurance will be more expensive because a larger proportion of premiums will be required to provide both a return to capital and a reserve for risk; when the FDIC retains the risk, however, a return to investment capital is unnecessary.[33] Second, the financial health of private reinsurers will become critical to deposit insurance, thereby prompting increased regulation of the private reinsurers.[34] Third, most systemic bank risk will be transferred to the private reinsurance market rather than be retained by the government.[35] This is particularly troubling because banks and reinsurers, as financial institutions, follow similar business trends. Fourth, because reinsurance premiums will absorb the income from bank insurance premiums in proportion to the amount reinsured, the FDIC will have a significantly diminished capital reserve to protect itself and depositors from reinsurer failure. Fifth, incentives for the FDIC to close an insolvent bank are reduced greatly once the threshold is met or exceeded because the government no longer bears any of the additional costs of keeping the bank open. Because industry and political pressure already is perceived to favor regulatory restraint, these economic incentives only would exacerbate one of the problems which initially prompted the enactment of the FDICIA.

33. This results from the FDIC's non-profit status. Thus, to the extent that the FDIC retains the risk of insuring deposits, banks receive a subsidy equal to the portion of the premium that the FDIC otherwise would pay to reinsurers to cover the reinsurers' costs of capital.

34. Currently, reinsurers are regulated only by States, if at all. Involvement in a deposit insurance system would require federal monitoring to ensure the protection of deposits, particularly because state insurance regulators focus on protecting their own constituency while deposit insurance is just as likely to occur on an interstate basis. This duplicative monitoring increases the costs of bank regulation.

35. In the case of a systemic crisis in banking, the reinsurers will have to bear a large proportion of the losses during a brief period of time. This would lead, in turn, to a risk of wide-spread failures among the reinsurers as well. Thus, systemic risk spreads to reinsurers.

Requiring the FDIC to place a cap on reinsurance would correct many of the problems of private excess loss reinsurance. To decrease the negative effects mentioned above, the FDIC would have to decrease significantly the amount of risk transferred to the reinsurer, requiring a relatively low cap on reinsurers' losses. The resultant structure—a low excess loss threshold accompanied by a low loss cap—is substantially the same as pro rata reinsurance with a loss cap, but it would produce a small (but needless) distortion in the amount of the risk of losses below the low loss threshold.

b. *Public Market Excess Loss Reinsurance (the FDIC as Reinsurer)*

Although excess loss reinsurance instituted through reinsurance of the FDIC is likely to be either ineffective or result in a needless contortion of pro rata reinsurance, reversing the roles may be more promising. By placing primary deposit insurance with private insurers and putting the FDIC in the position of an excess loss reinsurer, Congress could create an alternative to the reinsurance scheme established in the FDICIA. Under this FDIC excess loss system, banks would be required to seek insurance from private insurers who, in turn, would set prices according to their own evaluation of the particular bank's safety and soundness. Insurers then would reinsure on an excess loss basis with the FDIC. Under such an arrangement, insurers would experience a loss immediately upon a bank's failure. This would encourage the insurer to price insurance on the basis of the likelihood of bank failure rather than on failure resulting in losses above the threshold as in the private reinsurer example discussed above. The threshold level for excess loss reinsurance claims against the FDIC could be set low enough so that smaller insurers could offer deposit insurance and systemic risk would continue to be absorbed primarily by the government. In this way, most of the problems with a private excess loss insurance scheme would be avoided. In addition, placing the FDIC as reinsurer offers the intuitive appeal of following the basic reinsurance model.[36]

FDIC excess loss insurance, however, presents different obstacles to accurate free-market pricing. It is exceptionally vulnerable to distortion from anticipated regulatory hesitancy to intervene

36. *See supra* part II.A.

because private primary insurers would bear only initial failure costs, making those primary insurers disproportionately sensitive to the failure rather than to the cost of failure.[37] For the same reason, premiums under a FDIC excess loss system are unlikely to reflect the depth of losses. For example, a bank that has only one investment with a fifty percent chance of earning five dollars and a fifty percent chance of losing ten would be charged the same premium as a bank that possesses only one investment carrying a fifty percent chance of earning five and a fifty percent chance of loosing twenty dollars if the threshold for a claim against the FDIC is ten dollars or less. The premium for FDIC reinsurance may or may not offset this distortion. Because private insurers would pass on the cost of reinsurance to the banks, if FDIC reinsurance were priced to accurately reflect the risk to the BIF, banks would be charged the "correct" premium. The purpose of reinsurance, however, is to supplement the FDIC's inability to price risk effectively. The more likely scenario, based on FDIC deposit insurance to date, is that the FDIC will not charge premiums calibrated to real risk.[38] As a result, the insurers will pass a component of price on to the bank that is unrelated to risk, thereby limiting the incentive provided by private insurance to reduce risk. The size of the FDIC reinsurance component will be proportionate to the risk borne by the FDIC. The more that risk is borne by the FDIC, the greater the proportion of the private insurer's premium that will be determined by the FDIC. If the FDIC bears too little risk, however, the problems discussed above regarding private excess loss reinsurance will surface.

The radical differences between the current FDIC deposit insurance system and the proposed FDIC excess loss system would make replacing FDIC insurance with private insurance reinsured by the FDIC expensive to implement. A substantial portion of banking law—particularly in the area of FDIC powers and duties—would have to be rewritten, and some portion of FDIC staff would have to be replaced or retrained. Deposit insurance placed with private insurers also may expose banks to more free

37. This distortion is particularly important because it undermines the usefulness of all three uses of premium information—direct pricing, relative risk pricing, and relative risk regulation. This distortion flows from the fact that the likelihood of FDIC intervention is unrelated to risk. These types of distortions will be developed more thoroughly below.

38. The FDIC could price reinsurance premiums based on the insurer's premium to the bank, but, as discussed above, insurer premiums would not fully reflect relative risk.

market forces than the public or the government would be willing to accept.

If the public does not trust private insurers to protect their deposits as capably as the U.S. government, volatility in banking and the probability of runs on banks would increase. To avoid this, the government would have to make clear that the FDIC ultimately would protect insured depositors, which in turn, may distort the prices charged by private insurers. This ultimate liability could lead to a replay of the scandal that occurred in the Federal Housing Administration (FHA) in the late 1980s when the government's reliance on private actors in mortgage insurance proved to be misguided.[39]

From the regulatory perspective, the FDIC's relinquishing of the role of primary insurer by the FDIC also would entail relinquishing a certain amount of its control over banking. If banks were required to carry private insurance, the private sector would have the ability to close a bank by canceling the insurance. In a severe banking crisis, the federal government might not be able to ease a panic as readily as when a government agency operates as the primary insurer. Private insurance also directly subjects banks to a market-based regulator (the insurer) and a government-based regulator (the FDIC), thus exacerbating conflicts between government and private interests.[40]

c. *Pro Rata Reinsurance*

The program proposed by the FDIC is based on a pro rata reinsurance scheme under which the FDIC would serve as the primary insurer and a small portion of the insured deposits, up to ten percent, would be reinsured with private insurers. The

39. The FHA program ceded large portions of the evaluation, processing, and approval procedure for federal mortgage guarantee approval to private lending agents in an attempt to increase processing efficiency. In return for their increased powers, private lenders were required to coinsure a portion of each loan. Private coinsurers, however, relied on the generation of "up-front" fees to fund later activities, leading them to make poor—and sometimes corrupt—evaluations of the mortgaged property's value. Poor governmental oversight was blamed; while up-front fees either were siphoned off from the coinsurer or were insufficient to meet the costs of defaults, the FHA failed to prevent lenders from approving further risky loans. For a detailed account of the historical relationship between the FHA and the lender most responsible for the collapse of the FHA coinsurance program, see Harry Jaffe, *R.I.P. DRG: The Rise and Fall of a Real Estate Dynasty*, REGARDIE'S BUSINESS & REAL ESTATE OF WASHINGTON, Mar. 1990, at 50. *See also Assessing Recently Revealed Problems in FHA and Ginnie Mae: Hearings Before the Subcomm. on Housing and Urban Affairs of the Senate Comm. on Banking, Housing, and Urban Affairs*, 101st Cong., 1st Sess. (1989).

40. *See infra* part VI.C.

FDIC's choice undoubtedly was directed by the terms of the FDICIA, which permits the FDIC to reinsure deposit insurance[41] but does not permit the FDIC to reverse its role from insurer to reinsurer. The private excess loss arrangement potentially is more feasible under the FDICIA, but the ten percent limit effectively caps the potential loss to any insurer, resulting in a premium based on a narrow range and probability of loss, as discussed above.

Although the FDICIA makes the choice to the FDIC rather clear, Congress could, by legislative fiat, implement a FDIC excess loss reinsurance program. It is therefore important and relevant to compare the benefits of a pro rata reinsurance scheme to the FDIC excess loss version of excess loss reinsurance. The general advantages of pro rata reinsurance over excess loss will be discussed immediately hereafter, while more specific aspects of the FDIC's Pilot Program will be explored in the remainder of the paper.

Pro rata reinsurance achieves the substantial advantage of forcing the reinsurer to bear the same degree or proportion of loss as the FDIC. If the FDIC must pay 100% of deposits in a failure, the reinsurer will pay 100% on its portion of the deposits. This creates uniformity in the range of exposure, making reinsurance premiums a more accurate reflection of the full costs of insurance. Exposure to the full range of loss is fundamental to all three potential uses of deposit insurance because a narrow range of exposure undermines the relationship between risk and price upon which direct pricing, relative risk pricing, and relative risk regulation all rely.[42] Pro rata reinsurance also reduces the administrative burden of the program. Because the financial health of the reinsurer is important to protecting the FDIC investment but not critical to the viability of deposit insurance, monitoring reinsurers is not as crucial as monitoring private insurers in a FDIC excess loss model. A more fundamental advantage is that initial implementation of pro rata reinsurance does not require relegislation altering the FDIC and its role in banking.[43] Furthermore,

41. The FDICIA permits up to ten percent of insured deposits in a bank to be reinsured by private entities. *See* FDICIA § 322.

42. The relationship between risk and price is undermined by a narrow range of reinsurance exposure because the relative risk of failure over a small range of losses is not necessarily the same as the relative risk of failure over the whole range of losses.

43. Recent attempts to reorganize banking regulation, including the FDICIA, demonstrate how impractical and unsuccessful legislation is at altering bank regulation struc-

the public is less likely to feel threatened by a pro rata scheme because the FDIC remains fully responsible under its primary insurance contract. The FDIC also retains more control over banks, resulting in more uniform regulation of banks.[44] Finally, the fact that reinsurance is less regulated than insurance may permit easier entry into deposit reinsurance than deposit insurance.[45]

Although pro rata reinsurance offers advantages over other forms of reinsurance, its value depends largely upon its ability to cause banks to internalize risk. As the full effects of various price incentives can be determined only with empirical data, conducting a limited experiment in reinsurance would be the most prudent course. However, the FDIC can, in its experiment and in full implementation, radically alter the effectiveness of reinsurance. An examination of the FDIC's proposal and the options available to it follows, highlighting both problems unique to pro rata reinsurance and those inherent to reinsurance generally. This examination will help in determining the appropriate course for the FDIC, with a view toward maximizing the accuracy of information gleaned from reinsurers for all three reinsurance uses[46] and increasing the efficacy of bank monitoring and regulation.

III. The Pilot Program

Section 322(a) of FDICIA requires the FDIC to study the feasibility of private reinsurance of the BIF. Because section 322 authorizes the FDIC to reinsure up to ten percent of deposits in every bank,[47] the Pilot Program proposed by the FDIC in response to section 322(a) is expected to include actual reinsurance transactions.[48] The Pilot Program is divided into three stages, preceded by notice and comment periods and a small seminar for potential participants. Currently, the FDIC is receiving feedback from the public.

The first stage of the Pilot Program consists primarily of soliciting insurance industry participants through the publication of a

tures. Current efforts to consolidate segments of the three primary federal bank regulators further illustrate the problem.

44. *See infra* part VI.B.

45. This point is a double-edge sword, however, because decreased regulation increases the FDIC's monitoring difficulties.

46. *See supra* notes 16-18 and accompanying text.

47. *See* FDICIA.

48. Fed. Deposit Ins. Corp., Private Reinsurance Feasibility Study: Report to the Congress 1 (1993) [hereinafter FDIC Report].

Request for Proposals (RFP). The RFP's aim is to allow financial institutions that normally do not engage in reinsurance transactions, but which do satisfy applicable financial standards, to participate in deposit reinsurance.[49] After submission of proposals, the FDIC and interested reinsurers will draft a uniform contract. A uniform contract reduces competition to the price term of the contract and allows the FDIC to establish real relative risk without the need for converting other terms into risk information. Moreover, uniform contracts are useful to the government because they avoid the appearance of corruption or favoritism.

After development of a uniform contract, the second stage of the Pilot Program—the bidding process—begins. Participating insurers will have approximately six months to complete their analysis of institutions eligible for reinsurance and to submit bids.[50] The third stage contemplates that parties will enter into actual reinsurance contracts. The FDIC will evaluate the Pilot Program upon the expiration of the anticipated one- or two-year contracts.[51]

During the process of accepting public comments on the Pilot Program and attempting to conceptualize a uniform contract, the FDIC has encountered a number of implementation questions. These questions, such as whether the private market can be induced to participate and how the FDIC can interpret resulting information, will be examined below.

IV. Ability of Reinsurers to Enter the Deposit Reinsurance Market

A. *General Financial and Historical Inclination of Private Market to Enter*

Although the insurance and the reinsurance industries worldwide have reported poor financial performances recently,[52] no evidence suggests that reinsurers will lack the resources to par-

49. *Id.* at 25-27. The FDIC anticipates approval of foreign financial institution participation in the Pilot Program. *Id.* at 27. For discussion of other regulatory limitations on foreign bidders, see *infra* note 123 and accompanying text. For a discussion of the competitive advantages of this regime, see *infra* part V.E.

50. FDIC Report, *supra* note 48, at 24.

51. *Id.*

52. *See, e.g., Global Reinsurance Industry in for Consolidation*, The Straits Times, Aug. 17, 1993, at 36; Judy Greenwald, *U.S. Reinsurers Bemoan Little Change in Market*, Bus. Ins., Sept. 6, 1993; *S&P Sees Global Reinsurance Sector Profits Continuing to Decline*, AFX News, Aug. 18, 1993, *available in* LEXIS, Insure Library, Curnws File.

ticipate in FDIC reinsurance in the long-run. Indeed, an unprecedented string of large claims in catastrophic insurance constitutes a major factor in the recent losses in the insurance industry.[53] Financial guarantee insurance, the line of insurance most similar to FDIC reinsurance transactions, has been performing well, particularly in the municipal bond market.[54] Moreover, the set of potential reinsurers is not limited to traditional insurance or reinsurance firms.[55] The FDIC, at least initially, is accepting proposals from any financial institution that satisfies the proscribed health and capitalization standards.[56] Finally, if the FDIC permits reinsurance under terms and prices which provide competitive rates of return to reinsurers, then capital markets, in the long-run, should be willing to supply additional capital to reinsurers, enabling them to build up the necessary reserves to participate to the fullest extent possible in the reinsurance program.[57]

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53. *See* Richard Lapper, *Survey of Reinsurance*, FIN. TIMES, Sept. 6, 1993, at 15. Hurricane Andrew, the most expensive natural disaster in U.S. history, created $16 billion in claims. *See* Tom Gallagher, *Nation Needs Insurance Fund for 'Big One,'* USA TODAY, July 8, 1993, at 11A.

54. *See, e.g.*, Judy Greenwald, *Business Booming for Municipal Bond Insurance Market: Record Number of Issues Boosts Volume*, BUS. INS., Nov. 22, 1993, at 54; L.H. Otis, *Financial Gty. Outlook "Very Strong,"* NAT'L UNDERWRITER, Feb. 7, 1994, at 27.

55. In fact, one prominent member of the reinsurance industry has claimed that primary insurers will have to participate to provide enough coverage for the BIF because the two largest monoline reinsurers will not be able to raise enough capital. *FDIC Reinsurance Plan Will Need Primaries*, AM. BANKER-BOND BUYER, Apr. 26, 1993, at 1. It is not clear, however, if the commentator was including foreign reinsurers in his calculations or to what extent he considered possible participation by other financial institutions.

56. The FDIC has indicated that it intends to set broadly applicable and objective standards. At present, the only firm requirement of reinsurers is that the primary regulator of the institution consent to its participation in the program. *See* FDIC REPORT, *supra* note 48, at 26. This requirement provides independent and knowledgeable regulatory approval indicating that the institution has the financial strength to participate. Many reinsurers, however, are not regulated directly by one primary regulator. Large domestic and foreign reinsurers who do business on an international scale often are not regulated beyond the requirements are placed on the primary insurers with whom they contract. In addition to primary regulators, the FDIC is looking to industry standards, such as those of the National Association of Insurance Commissioners, and private sector ratings for further qualification measures, *id.*

57. Reinsurance and insurance industries are experiencing a boom on Wall Street. *Bank Deposit Plan Seen as Possible Insurance Boon*, AM. BANKER-BOND BUYER, Feb. 18, 1991, at 1; *U.S. Reinsurance Report*, NAT'L UNDERWRITER, July 5, 1993, at S28; *see also Return to Rating Discipline and Avoid Huge Cuts in Premiums, Reinsurance Firms Told*, THE STRAITS TIMES, Oct. 5, 1993, at 36. An insider to credit enhancement insurance claims that the credit enhancement sector could do a "fair amount" of business within its current capital structure and that the sector was willing to go to the market for more capital if it found such a course profitable. *Id.* Credit enhancement insurance, however, is unique in that its underwriting standards and credit enhancement insurers are unlikely to be willing or able to underwrite all of the deposits that eventually would be on the market. *See infra* part V.B.

Historically, private insurance in banking has been relatively common. Before the United States developed a Federal Reserve System or created the FDIC, banks and other financial institutions utilized a private system of coinsurance to minimize systemic risk.[58] The early experience of the United States banking system indicates that a private market for bank insurance will develop where there is a role for it. More recently, General Reinsurance Corporation, the largest reinsurer in the United States, demonstrated the willingness of private insurers to enter into the deposit insurance market. Early in 1993, General Reinsurance began to offer depositors insurance for deposits in excess of the FDIC $100,000 insured limit.[59] A similar program has been developed by Reliance National Insurance Corporation. Since 1990, MBIA, a municipal bond insurer, has been providing municipalities with guarantee bonds for bank deposits where state law requires such guarantees.[60]

Currently, General Reinsurance insures depositors at approximately three-fourths of all banks.[61] Unlike General Reinsurance, Reliance National does not offer its insurance directly to depositors. As a result, the twenty to twenty-five banks which Reliance currently reinsures are not representative of the number of banks that Reliance regards as insurable.[62] Reliance's history of clients, however, does provide useful insight into the insurability of banks. Reliance offers its insurance to deposit brokers who use the insurance to offset the risk associated with high risk, high return banks. This indicates that Reliance is willing to insure

58. *See* Charles W. Calomiris, *Is Deposit Insurance Necessary? A Historical Perspective*, 50 J. ECON. HIST. 283 (1990).

59. Private deposit insurance for depositors in excess of the $100,000 FDIC limit has become more lucrative with the enactment of the FDICIA. Section 141(a)(1)(C) of the FDICIA (codified at 12 U.S.C. § 1823(c)(4)(E)(i)(I)) seeks to limit FDIC payments to uninsured depositors to their pro rata share in bankruptcy. Recent federal legislation included in the 1993 budget amendment, however, improves the priority position of all depositors (including the FDIC, which steps into the shoes of insured depositors) in bankruptcy. Omnibus Budget Reconciliation Act of 1993, § 3001, Pub. L. No. 103-66, 107 Stat. 312, 336-37 (1993) (codified as amended in 12 U.S.C. §§ 1821(d)(11), 1821(c)(13), 1921(g)(4)).

60. Telephone Interview with Judy Radascz, Vice President & Manager of the Reinsurance Division of Municipal Bond Investor Insurance Corporation (MBIA) (Apr. 28, 1994).

61. Telephone Interview with William Murray, Insurance Agent with General Reinsurance (Apr. 7, 1994).

62. Telephone Interview with Michael Bigger, Underwriting Secretary of the Financial Products Division of Reliance National Insurance Corporation (Apr. 28, 1994). Mr. Bigger also expressed optimism that Reliance National will have a larger number of banks in its insurance base in the near future.

banks that are riskier than average.[63] MBIA, because it provides only the insurance that municipalities are required to secure by state law, does not offer an indication of how many banks may be readily reinsurable.[64]

It is not, however, the financial ability or general proclivity of financial institutions to enter into deposit reinsurance that will determine industry participation in the FDIC Pilot Program or any successor program. Private insurers are driven by the market forces that the FDIC hopes to utilize. As a result, financial institutions will enter the market according to their perceived ability to profit.

B. *Expectation of Profit*

The terms of the standard reinsurance contract, established by the FDIC, will define the contours of the deposit reinsurance market and determine the profitability of entry.[65] The contractual terms most important to the FDIC are duration, possible cancellation provisions or restrictive covenants, and the availability of FDIC-held information.

1. *Contract Duration*

A short-term contract of one or two years is most appropriate because the likelihood of failure in any one bank is subject to rapid fluctuation and because the FDIC is interested in receiving current relative price information. A short term contract, however, will allow insurers to exit the market when the banking cycle is in a trough. Not only will ability to exit rapidly make

63. *Id.*

64. The performance of each corporation in this new field will be analyzed *infra* part VI.A.

65. Because reinsurers have no guarantee that the FDIC will operate a reinsurance program long enough to allow them to recoup their initial capital investment, the FDIC currently is considering reimbursing reinsurers for a portion of their entry costs to encourage entry. *See* FDIC REPORT, *supra* note 48, at 27-29. Although it is common for an insurer to cross-subsidize various lines of insurance, this subsidization is based on the expectation of eventual profits. In the case of deposit reinsurance, that expectation is subject to FDIC or Congressional whim. As a result, the FDIC will bear a substantial portion of capital investment costs in increased premiums. Therefore, the FDIC could attempt to receive more representative information about premium pricing by directly reimbursing reinsurers. If the FDIC were to reimburse all investment costs, however, reinsurers would over-invest. The FDIC could avoid this dilemma by requesting that successful bidders itemize the components of their bids. This, in effect, would lead to reimbursement of only successful bidders for the capital investment included in one bid. The risk of losing investment capital may inhibit reinsurers. To offset this effect, the FDIC could offer a stipend to reinsurers who sign a contract to submit at least one good faith bid. Such incentives would no longer be necessary after initial capital investments are made.

information-gathering more difficult and probably less reliable in years when the banking industry is soft,[66] it likely will distort prices in all other years as well. Reinsurers will not be facing the long-term loss expectations of the FDIC, enabling them to charge lower prices in the good years because they will escape risk in the bad.[67]

Devising an accurate long-term contract which appeals to reinsurers, however, is complicated by the need for continued bank monitoring. Long-term contracts will have to allow reinsurers to change periodically the premium charged to reflect changes in bank risk so that premiums provide consistent incentives to banks and accurate information to the FDIC. One potential distortion of a long-term contract awarded on the basis of bids for the first year is that reinsurers will have an incentive to underbid the first year and overprice in each successive year until the close of the contract. Additionally, reinsurers will not possess sufficient information to accurately price contracts for an extended period because many events may alter the condition of any individual bank.[68] Furthermore, even in a steady or growing market, reinsurers may be unwilling to accept a long-term contract without being able to influence the insured's behavior through changes in premium rates.

Long-term contract prices must be able to respond to changes in a bank's condition. Because accurate and continuous pricing information is less likely to be generated in the absence of long-term contracts, a long-term contract with terms allowing for monitoring and change appears to be the best solution. Reinsurers could be awarded contracts on the basis of overall bids that would be subject to renegotiation in the event of specified changes in the condition of the reinsured bank or the market. For example, decreases in a bank's capital larger than a certain benchmark level could allow the reinsurer to request or propose a new rate. If the reinsurer and the FDIC cannot agree on the

66. A smaller number of bidders is less likely to achieve an environment of free-market competition which is the price setting mechanism sought.

67. To some extent, the problem of exit in a trough is mitigated by the fact that reinsurers probably would not leave the market entirely, but would only abandon individual banks that they perceive as the most likely to fail while continuing to profit on safer banks. Although such a reaction might create some distortion by decreasing prices in stable years, in the relative scheme, it would still provide the FDIC good information on the riskiest banks.

68. This aspect of bank reinsurance is very different from basic consumer insurance, which depends almost exclusively on the law of large numbers.

amount of an increase in the premium, the matter could be referred to arbitrators or the FDIC could put the remainder of the term of the contract up for a new bidding procedure.[69] Arbitration as the first recourse will prevent reinsurers from developing an expectation that they will be able to relieve themselves of their obligations through inflexibility in renegotiation.[70]

To preclude distortions of the opposite sort, the power to call for new rate must be bilateral so that improvements in the condition of a bank or the market will permit the FDIC to call for a decrease in the premium. Although the FDIC is likely to feel pressure from reinsurers to ignore improvements and continue paying a higher rate, banks, as the FDIC's primary constituency, and concern for its own image[71] will place sufficient pressure on the FDIC to request the decrease.

Although such clauses would increase the expense and complexity of a reinsurance program, the FDIC would gain the advantage of the insurance industry's considerable expertise in monitoring insureds as well as the more accurate prices resulting from a long-term reinsurance horizon. In addition, the cost of gathering information for a bid would be lowered because the initial bidding process and resulting duplicative costs of risk-evaluation would occur only once every few years rather than annually. Long-term contracts may also ameliorate the problem of banks that are costly to evaluate relative to the return on a bid as discussed below.[72] Because the contract duration term does not affect the relative risk of banks, the increase in expense to the reinsurance program may not be warranted if the FDIC utilizes premium information only to obtain relative risk rankings—as in relative risk pricing or regulation—rather than to achieve direct pricing information.

69. In cases where the remaining term is very short, however, new bidders may not surface because the return would not merit a full evaluation of a bank. The FDIC should reserve the right to begin a new long-term period for banks in these circumstances.

70. Under this scenario, the FDIC then accepts responsibility for achieving a fair, new rate. To set its reserve price effectively, the FDIC will find it helpful to compare rates at similarly situated banks, and perhaps even solicit informal bids, in determining what rate it could achieve if it discontinued negotiations.

71. FDIC prestige is tied to the health of the banking industry more than to the health of reinsurers. Lower reinsurance premiums will indicate better banking health and stability.

72. *See infra* part VI.B.

2. *Cancellation*

Although the FDIC appears reluctant to permit such a clause in the standard contract,[73] allowing reinsurers to cancel a reinsurance contract under certain conditions may be valuable to both the FDIC and to reinsurers. The ability to opt out of a reinsurance contract will make participation in the market more attractive to reinsurers because it will lower the risk associated with inaccurate pricing and the risk of paying a claim. This may, at first, seem to create a disparity between the FDIC's costs and the price set by the insurer because the FDIC is left paying for the losses while reinsurers are able to avoid them, at least in some circumstances. Because the FDIC has the authority to take action before any losses to the BIF are sustained, such disparity is a function of the FDIC's choice of when to liquidate or merge a troubled bank. Forcing reinsurers to bear the risk of FDIC inaction increases the price of premiums without any particular relationship to the bank's risk. This could distort the relative risk structure created by the market, and make reinsurance less suitable for any of the potential uses discussed in part I. If reinsurers increase premiums to protect themselves from detrimental FDIC (in)action, and the FDIC does not account for this in its premium to banks, banks may be induced to take less risk than is efficient.[74] As a result, bank risk-taking could be overburdened so that banks would accept less risky investments than similarly situated competitors. The FDIC can benefit from a cancellation clause by encouraging the receipt of information from reinsurers throughout the period of reinsurance rather than only during

73. *See* FDIC REPORT, *supra* note 48, at 36.

74. Although Congress and the FDIC currently are focused on reducing the risks accepted by banks, it is possible to go too far and inhibit banks from taking enough risk. Because the FDIC creates a perfectly safe investment (ignoring the $100,000 limit for now) for depositors, FDIC premiums, if they reflected perfectly the risk assumed by the FDIC, would be equal to the amount necessary to bring the rate of return otherwise expected from any given bank to the rate on a risk-free investment (such as a Treasury bond). Any amount that banks are able to pay for a deposit that is higher than the risk-free market rate results from the fact that the bank is not bearing the costs of creating this perfectly safe investment. Achieving a perfectly equal return in practice would be impossible, of course, because banks offer different services and more services than the Treasury. In addition, other practical distortions, such as tax, would interfere with this perfect relationship. Nevertheless, it is useful to remember that if the FDIC were to create a premium structure that would cause banks to offer a lower return than other perfectly safe investments, the banks would be inhibited from taking risks that they actually should be taking. It is therefore possible, though undesirable, for the FDIC to overcharge for deposit insurance.

the bidding process.[75] A short-term contract would be less distorted by fear of FDIC action because the reinsurer would have the opportunity to exit the relationship. As a result, a short term contract becomes more attractive if the FDIC limits itself to relative risk pricing or relative risk regulation and does not provide for cancellation.

If conditions for reinsurer cancellation are readily met by the reinsurer, its perception of risk will be skewed downward. Instead, cancellation conditions should be formulated to provide incentives for reinsurers to monitor their reinsured banks and to communicate information indicating financial distress to the FDIC immediately, while simultaneously limiting the reinsurer's ability to cancel in situations where FDIC action increases the likelihood of loss. Such a regime would increase the monitoring of insured banks as well as present the reinsurer with costs that more closely resemble those of the FDIC. For example, reinsurers could be permitted to cancel reinsurance contracts if the FDIC takes no action and the reinsurer notifies the FDIC that (1) a certain action is required of the FDIC by law, such as the prompt corrective action standards set forth by FDICIA; (2) the bank is likely to be or have been a victim of an illegal act; or (3) the bank is economically insolvent.

Under any cancellation provision, reinsurers should be required to provide notice of intent to cancel. An appropriate period may be three months—a standard duration in traditional reinsurance contracts. Such a provision will encourage reinsurers to monitor banks until the date of cancellation so long as the FDIC takes some action toward correcting the problem. A notice period will give the FDIC a meaningful opportunity to take action and will encourage reinsurers to look for early warning signals of trouble. At the same time, the FDIC will be able to retain control over banking regulation. Perhaps more importantly, a cancellation provision will help to achieve another of FDICIA's goals—overcoming regulatory hesitancy to intervene.[76] Regula-

75. This benefit is consistent with the philosophy that a reinsurance program properly focuses on acquiring information and providing incentives to banks rather than forcing a transfer of losses from the FDIC to the reinsurer.

76. The "prompt corrective action" standards, *see* FDICIA § 131, demonstrate the goal of improving regulatory reaction to signs of trouble in a bank. The opening statement of Representative John Conyers to the House Subcommittee on Commerce, Consumer & Monetary Affairs on October 3, 1990, at 5, indicates his belief that regulatory inaction was a primary cause of the problems experienced by the BIF. *Cf.* CBO REPORT, *supra* note 11, at 7. Several authors have attempted to measure the costs of delayed regulator interven-

tors will be subject to a higher standard of justification if a reinsurer cancels and the regulator takes no action; regulators will have to balance political and policy objectives against clear market imperatives.

The potential for disputes constitutes the most troubling aspect of a cancellation term. Reinsurers will maximize profits if they can cancel when it appears that failure is imminent, while the FDIC will benefit if cancellation is restricted. Arbitration could resolve many such problems at a relatively low cost because the relationship between the reinsurers and the FDIC most likely will be continuous and based upon more than one insurance contract. Furthermore reinsurance imposes a duty of good faith between the reinsurer and the reinsured which could be enforced by arbitrage tribunals.[77]

If protecting reinsurers from bad regulation will promote more accurate relative risk pricing, it follows that reinsurers should be compensated when the FDIC makes an incorrect decision about the appropriate corrective action.[78] Allowing reinsurers to collect for FDIC decisions, however, increases the incentives for reinsurers to initiate suit and to demand compensation for a portion of any disbursements made. The potential for recovery also decreases incentives to monitor during the contract term. At the same time, the potential for adverse legal claims may inhibit FDIC regulators from taking action detrimental to the reinsurer even in light of issues of systemic risk and depositor protection. An effective resolution could be achieved by limiting reinsurers to arbitration and to a measure of damages based on the deviation from the least cost resolution as mandated by FDICIA.[79] Although such a standard may appear to be open to *ex post* speculation, the reinsurer could be held to a higher level of scrutiny than an outside party victim because it

tion in the savings and loan debacle. *See generally* EDWARD J. KANE, THE S&L INSURANCE MESS: HOW DID IT HAPPEN? (1989); U.S. GEN. ACCOUNTING OFFICE, THE THRIFT INDUSTRY RESTRUCTURING AND THE NET WORTH CERTIFICATE PROGRAM (1985).

77. *See* Hall, *supra* note 26. This duty also may play a role in minimizing the publicity surrounding a change in reinsurers that could lead, if misinterpreted by the general public, to a run on the bank.

78. Current standing doctrine permits reinsurers to sue the FDIC for administrative decisions that they believe are not consistent with the FDICIA. *See* Clark v. Securities Indus. Ass'n., 479 U.S. 388 (1987). For a more general discussion on standing doctrine and reform, see Cass Sunstein, *Standing and the Privatization of Public Law*, 88 COLUM. L. REV. 1432 (1988).

79. *See* FDICIA § 141. This could be achieved by placing clauses in the standard contract but such provisions should be reinforced with regulations and law.

will have been able to present its case to the FDIC before any action was taken. The FDIC also could stipulate in the standard contract that the reinsurer bears all risk of ordinary negligence by the FDIC in its role as regulator. This standard would promote better communication between the reinsurer and the FDIC because the reinsurer will monitor for ordinary negligence and make the FDIC aware of potential errors, while at the same time relieving the FDIC of concern for unmeritorious legal claims.

3. *Covenants*

Because a standard contract by definition does not deviate from case to case, reinsurers will not be able to obtain specific covenants from the FDIC (or require the FDIC to obtain them from the relevant bank) with the flexibility of typical reinsurance contracts. The reinsurer's ability to call for new rates and, in extreme cases, to cancel entirely the reinsurance should reduce the need for such covenants, although it will increase monitoring costs to the reinsurer. For example, a reinsurer may be willing to reinsure a bank but for some concerns about that bank's proclivity toward a particular type of investment that the reinsurer believes is too risky. Traditionally, the reinsurer would insist on a covenant in the reinsurance contract limiting the bank's future involvement in that investment.[80] Under a pro rata regime with renegotiation and cancellation provisions, the reinsurer instead could indicate informally that it will monitor the dubious activity carefully, after having submitted a bid which included the cost of increased monitoring. This would increase the cost of deposit insurance but would provide specific monitoring for "trouble spots" in a bank and would prevent reinsurers from exercising the greater regulatory power inherent in covenants. Informal discussion could notify the bank and the FDIC of the problem. Ideally, the bank would desist in its activity to induce a renegotiation of its rate. Competition would prevent irrational monitoring because, if a reinsurer considered the risk to be greater than the general market evaluation, that reinsurer would be outbid during the bidding process.

80. Of course, the reinsurer in this hypothetical could not demand that the bank accept such a covenant, but the primary insurer could insist on such a requirement. In these unique risk situations, the reinsurer, primary insurer, and bank (on behalf of unknown depositors) could negotiate simultaneously, resulting in compatible contracts.

4. *Disclosure of FDIC Information*

The FDIC has retained discretion over how much information it will disclose to reinsurers.[81] Although it is possible to require reinsurers to obtain information for their bids solely through independent research, such an approach is not the most appealing. If the FDIC does not disclose its information, the reinsurer's perception of risk and the resulting price may not reflect accurately the risk facing the FDIC. In addition, to the extent that the Pilot Program attempts to stimulate constant monitoring of banks by their reinsurers, a lack of information could distort the focus of such monitoring.

Granting reinsurers access to all FDIC information also will decrease the amount of time which banks will have to spend on reinsurance transactions. Although reinsurers may require more information than that available through the FDIC, they will presumably conduct fewer investigations if much information already is available.[82] Smaller-scale on-site investigations also will minimize reinsurance premiums. The burden on banks can be controlled further by limiting the interaction between private reinsurers and banks by appointing FDIC intermediaries to funnel inquiries to banks whenever possible. Limiting contact between reinsurers and banks also will decrease the appearance of private market regulation of banking. Once one reinsurer has succeeded in its bid, however, the FDIC should permit greater contact between the reinsurer and the bank. As a result, the FDIC will be able to reinforce its monitoring at the reinsurer's expense.

Under any information gathering arrangement, reinsurers will wish to investigate aspects of the bank that the FDIC may not have on file.[83] In these cases, the burden of regulation on banks will increase. This increase represents an additional cost of the reinsurance program that will have to be offset by the benefits of the program. The Pilot Program is ideally suited for providing an estimate of these costs because it will give the FDIC an idea of how complete its own information about banks may be for the reinsurers' purposes. In the long-run, the FDIC may be able to

81. *See* FDIC REPORT, *supra* note 48, at 37-40.

82. *See* FDICIA § 112. The FDICIA requires banks to submit an independently audited annual report as required by the FDIC.

83. For example, the reinsurer may want to conduct an on-site inspection.

adjust its reporting requirements to include information consistently requested by reinsurers.

Sharing information with reinsurers also is likely to benefit the FDIC by reducing possible problems with securing bank cooperation. Banks will be unable to control the flow of information, thereby potentially interfering in the bidding process.[84] The FDIC and reinsurers will be more confident in the information supplied if it is subject to the FDIC's strong regulatory requirements for correct information and resultant penalties for providing misleading information.[85]

Finally, traditional reinsurance law creates a duty of utmost good faith between the cedant and reinsurer.[86] Under this doctrine, reinsurers could be relieved of their obligation to pay claims resulting from risks known to the FDIC but undisclosed to reinsurers.[87] The FDIC could stipulate in its contract with the reinsurer that this standard will not apply because of the specific and unusual purposes of the deposit reinsurance program, but it is difficult to argue that the nature of deposit reinsurance militates for less cedant disclosure rather than more. The possibility for a legal challenge could skew the prices set by reinsurers until the matter was litigated fully.

Affirmative steps will have to be taken to keep information traditionally kept confidential by the FDIC out of the public domain. Confidentiality could be established by a contract between reinsurers and the FDIC as a condition of receiving the information. A uniform format for the presentation of information, such as that provided by FDIC records, will make it easier for the FDIC to regulate what information must be kept confidential. Even information generated by reinsurers can be kept confidential by special contractual stipulation and the threat of revoking qualification for further reinsurance contracts.[88] To prevent banks

84. Banks acting extremely could refuse to provide any information and thwart the reinsurance program altogether.

85. For example, § 313 of the FDICIA provides penalties for false or misleading statements in a bank's certified statement—as low as $2,000 per day for inadvertent error and as high as $1,000,000 for an intentional or reckless statement.

86. *See* Hall, *supra* note 26.

87. *Id.*

88. This does not address the special problem of reinsurers sharing information with one another. The practice of sharing information, particularly historical loss information, is common in the insurance industry. The information allows insurers to make more accurate bids. Particularly because no insurer base of historic information exists, the FDIC should consider information-sharing among insurers independent from public disclosure.

from disclosing what reinsurers cannot, FDIC regulations such as those currently preventing banks from disclosing CAMEL ratings[89] could be expanded to include information about reinsurance bids.

Problems in the disclosure of information could arise, however, if competitors of reinsured banks were able to obtain and utilize the information made available to bidders, thus creating unfair competitive advantages. The protection of sensitive bank information is a problem whether or not the FDIC facilitates the collection of information and will be discussed in part V.A.2.

In addition to current information, when the Pilot Program first goes into effect, the FDIC should make historical data available to reinsurers. Because insurance generally is written on the basis of historical loss information, the availability of more complete historical information to reinsurers may decrease the time between institution of the Pilot Program and the point when the FDIC can expect actuarially accurate risk-based pricing from reinsurers.[90] Although it is difficult to determine how well FDIC information will substitute for historical loss information compiled by the reinsurance industry, the one-time legal cost of creating a binding agreement to protect bank confidentiality and any minimal costs in providing the information merit such disclosure.

V. Possible Market Participants

The discussion above reviewed how the FDIC can structure the reinsurance market to encourage private entry while protecting the integrity of risk information and increasing bank monitoring. The following section examines the most likely market participants and concerns with their participation.

A. *Banks and Bank Holding Companies*

1. *Generally*

Many reform advocates have proposed the involvement of banks as insurers in the federal deposit insurance scheme. Most

89. *See supra* note 18.

90. Judy Radascz of MBIA, a municipal reinsurer that has indicated strong interest in the reinsurance program, has predicted, on the basis of consultation with an actuarial consulting firm, that if reinsurers are provided all FDIC information, a development period of approximately one year will be sufficient. Telephone interview with Judy Radascz, MBIA (Apr. 28, 1994).

of these proposals are based on the system of cross-guaranties developed by banks in the United States in the early 20th Century.[91] With some modification, some of these proposals could function in a system of deposit reinsurance to garner some of the benefits cited by their proponents.[92]

Banks and bank holding companies have tremendous informational advantages in entering the putative deposit reinsurance market. Their own experiences in bank loss management may be employed to evaluate other banks. In addition, because they already maintain relatively broad risk portfolios, banks may be more willing than some other types of insurers, such as financial guarantee insurers, to insure riskier banks than some other types of insurers.[93]

Nevertheless, the potential for magnification of systemic risk[94] poses serious questions for bank safety and soundness. The most effective way to minimize this problem is to require nonbank subsidiaries of bank holding companies to conduct the reinsurance activity. The subsidiaries should meet stringent standards for capitalization and reserve requirements.[95] In addition, existing standards for consolidated financial monitoring of bank holding companies should be adapted to control more strictly the transfer of assets between the reinsurance affiliate and other subsidiaries of the parent company.

An additional barrier to reinsurance by bank affiliates may be their inability to diversify. Because present regulations prohibit banks and their affiliates from engaging in almost all insurance activities,[96] they will not be able to spread the risk of bank failure among other financial risks—or even more standard insurance risks—as will their competitors; banks and their affiliates will find themselves confined to diversification primarily within deposit reinsurance. The experience of small, state-run deposit insurance funds, such as in Rhode Island, suggests that this degree of

91. *See* Calomiris, *supra* note 58.

92. For example, the plan proposed by Wallison in his book, *supra* note 4, for developing regional cooperatives of banks that would insure bank deposits of other banks could be modified slightly and integrated into the reinsurance market.

93. See the discussion of financial guarantee insurers that follows immediately. Some banks already have expressed an interest in acting as reinsurers to the FDIC. *See* FDIC REPORT, *supra* note 48, at 26.

94. For an explanation of systemic risk, see *supra* note 10 and accompanying text.

95. Because other reinsurers also will be vulnerable to some of the same financial conditions that affect banks, the standards that will be set for other reinsurers may be stringent enough for bank affiliates.

96. *See infra* note 107, part V.A.3.

diversification may not spread sufficiently the risk of failure. Because the reinsurance program would allow reinsurers to diversify across a wider geographic range[97] and to insure a greater number of banks relative to the capital exposed,[98] however, state insurance experience may not predict accurately the ability of bank-affiliated reinsurers to meet financial requirements.[99]

2. *Conflicts of Interest*

If an affiliate of the reinsured bank may submit bids on its deposits, critical conflict of interest issues arise. Granted, affiliates may stand in the best position to evaluate all the risks that a bank faces.[100] But in the regime currently proposed by the Pilot Program, the holding company could attain an overall benefit by causing a non-bank subsidiary to submit an unrealistically low reinsurance bid on the bank subsidiary. Although the non-bank subsidiary may be forced to underprice insurance, its exposure will be limited to ten percent of deposits and the bank subsidiary will pay a lower total premium as a result of the FDIC's role as the primary insurer. Furthermore, if the bank represents the primary asset of the bank holding company, the bank holding company may not have much hope of surviving the bank's failure regardless of the condition of the reinsurer, thus making underbidding particularly attractive.[101]

Even when a bank holding company owns a healthy bank, paying standard premiums while operating a legitimate reinsurance

97. The FDIC provides deposit insurance on a nation-wide level.

98. Under a reinsurance program, reinsurers will accept the risk of only a portion of the insured deposit rather than the full insured amount.

99. The FDIC has not yet established the required financial standards, but a minimum rating by a commercial rating company is expected to be one of the requirements. *See* FDIC REPORT, *supra* note 48, at 26.

100. *See* Howell E. Jackson, *The Expanding Obligations of Financial Holding Companies*, 107 HARV. L. REV. 509 (1994). As a practical matter, however, the reinsurance scheme would not affect Professor Jackson's proposal to increase shareholder liability; Professor Jackson's proposal still encourages the bank holding company to support a troubled bank.

101. The reverse scenario, one in which a holding company reinsurance subsidiary submits large bids on competitors to increase their insurance premium, is not a concern because high bids (designed to extract exorbitant premiums from the competitor) would lose to the lower bids that price premiums at the efficient level. A problem could arise under a long-term contract structure. Long-term structures include renegotiation provisions, enabling the competitors to bid low initially, win the long-term contract, and subsequently renegotiate prices in the absence of competition. However, such tactics are unlikely to be attempted for two reasons. First, the reinsurer must gamble that an opportunity to renegotiate will arise, and this opportunity will be controlled strictly by the terms of the initial contract. Second, even if negotiations take place, the reinsurer must persuade the FDIC (the second party to the contract) that the request for higher premiums is not an attempt to drain money away from a competitor.

subsidiary which reinsures many banks, it still may benefit the holding company to submit below-market bids on its bank subsidiary. In that case, the cost to the reinsurance subsidiary becomes risk for which it is not compensated under the price of the contract. The bank holding company benefits through a decreased premium charged to the bank. In cases where the decrease in premium exceeds the increase in risk on ten percent of insured deposits, the bank holding company would induce the reinsurance subsidiary to submit "unprofitably" low bids to increase the overall wealth of the holding company.[102]

To avoid such a conflict of interest, the FDIC either can prohibit reinsurers from bidding on affiliated banks or can create a complex scheme of firewalls and evaluation of the bids submitted for affiliates. One method of evaluation could require audits for bids which are more than a set level under the next lowest bidder—perhaps five percent lower. A flat ban on affiliate reinsurance would destroy the potential benefit of a highly informed bidder. A scheme of complex firewalls and regulatory supervision, however, would exact high administrative costs. Moreover, such a complex scheme, if effective, would act primarily to prevent most of the unique inside information from reaching the affiliate. Therefore, it appears simpler and more efficient to prohibit reinsurers from bidding on affiliates.

Loss of superior pricing information through inside information may not pose a significant concern even in the absence of behavior influenced by conflict of interest. Conflicting interests within the bank holding company, overlaps in personnel, or bias in inside reporting not held to objective evaluation may all contribute to a view of bank risk skewed in favor of the bank.

Although the risk of underbidding to lower overall premiums is most acute with affiliates, the problem could occur even with unaffiliated reinsurers. In this case, the bank would have to compensate the reinsurer for the risk uncompensated through FDIC

102. A numerical example may illustrate this point more clearly: Bank A holds 125 in deposits, 100 of those insured by the FDIC; the market rate for its insurance is 0.25 on 100; as a result, A should pay 0.3125. (FDIC premiums are based on total deposits, not just insured deposits.) If reinsurance affiliate, R, submits a reinsurance bid of 0.20 on 100, A will pay 0.25 in total (0.20 on 100 for 125 in deposits). The savings of 0.0625 to the bank more than offsets the loss to R of 0.005 (0.05 out of 100 on ten percent of insured deposits, or 10). This numerical example indicates that basing premiums on total deposits rather than insured deposits exacerbates the risk of underpricing by affiliates. The problem would continue but with lesser overall savings (0.05) to the bank holding company if premiums were based solely on insured deposits.

premiums. Because one could more readily deter such transfers between non-affiliates and because proof of such dealings would be more substantial, reinsurers and banks participating in such schemes would face both a higher probability of detection and higher quality evidence. The FDIC could use higher quality evidence to pursue criminal action more effectively against reinsurers and banks. Reinsurers would require additional compensation to reflect the probability of excommunication from deposit reinsurance or criminal sanctions. Combined with the increased transaction costs of negotiation between non-affiliates, the additional costs of reinsurance fraud would require substantial bank savings on premiums, further increasing the probability of detection. Nevertheless, the FDIC will have to institute a certain level of monitoring to ensure that the costs of fraud outweigh the benefits to the bank.[103]

Another regulatory concern implicated by conflicting interests is the possibility that reinsurers will obtain inside information about competitors of their bank affiliates. Some protection already may exist for banks through "trade secret" law. Trade secret law, however, is largely state-based, and treatment of various types of information differs among States and even from case to case within a particular State. Trade secret law likely would serve as an arbitrary or inadequate source of protection for reinsured banks. To increase protection and support for trade secrets treatment, the contract between the FDIC and the reinsurer would have to include specific clauses regarding preservation of the secrecy of information obtained by reinsurers.[104] Additionally, governmental regulators could punish, either as a violation of fiduciary duty[105] or as an unfair trade practice under the Sherman Act,[106] any disclosure of confidential information to a par-

103. The only benefit obtained by banks, lower premiums, would be offset by costs to the bank and the reinsurer (which would be compensated from the bank's savings). Stated algebraically, the inequality reads: savings > transactions costs + P(punishment B) + P(punishment R), where "P" represents probability, "punishment B" represents the cost of punishment to the bank, and "punishment R" represents the cost of punishment to reinsurer. The inequality would have to be satisfied before it would benefit banks and reinsurers to pursue fraudulent activity.

104. To avoid difficulty with varying standards of interpretation resulting from different state laws, the FDIC also should seek regulations which support these clauses, trump state law, and provide uniform interpretation.

105. Reinsurance law imposes a duty as strong as a fiduciary duty between the reinsurer and the reinsured, but in the absence of a specific stipulation to the contrary, there are no third party beneficiaries to a reinsurance contract. *See* Hall, *supra* note 26.

106. The transfer of information from a client to an affiliate against the wishes of the client, to gain a competitive advantage or to achieve greater monopoly or oligopoly power

ent corporation that competes with the bank. By reserving the right to revoke a reinsurer's eligibility for future reinsurance participation or by invoking informal sanctions against the benefiting bank, the FDIC also could restrain unfair or anti-competitive disclosure by reinsurers.

Concerns for bank safety and soundness, coupled with the potential for conflicts of interest, advise against direct or indirect bank involvement in deposit reinsurance.[107] If the government permits any banking sector participation in deposit reinsurance, the non-bank affiliates of bank holding companies present the most viable candidates. Strict regulatory barriers on communication between the banking and reinsurance affiliates of the holding company would represent an inevitable prerequisite to any bank holding company participation in deposit reinsurance. This barrier, to remain most effective and to avoid the most tempting form of conflict of interest, would have to prevent reinsurers from submitting bids on affiliates. In addition, further precautionary measures designed to protect the integrity of affiliated banks require examination. The governing bureaucracy would have to apply scrupulously, and possibly heighten, existing eligibility financial standards. More importantly, the government would have to enforce vigorously current regulations on dealings between banks and their affiliates to minimize the possibility that weakness in either the bank or the reinsurer could lead to harm

in any part of banking, could be construed—and prosecuted—as a "conspiracy in restraint of trade or commerce," 15 U.S.C. § 1 (1988), or an "unfair method of competition," § 5 of the Federal Trade Commission Act, 15 U.S.C. §§ 41-58 (1988). Section 5(a)(2) of the Federal Trade Commission Act, however, specifically places banks beyond the Commission's jurisdiction. Thus banks have immunity from Commission sanctions but reinsurers do not.

107. For this reason, analysis of the legal ability of the banks and their direct subsidiaries to participate in the reinsurance industry requires no further development. However, § 92 of the National Bank Act contains a "negative pregnant" clause prohibiting banks from engaging in insurance activities as a principal. 12 U.S.C. § 92 (Supp. 1995). Bank subsidiaries may engage only in activities in which their parent corporations may engage. This would not conclusively preclude banks from engaging in deposit reinsurance if the Office of the Comptroller of the Currency (OCC) determined that the activity was related closely to banking and that § 92 did not apply (for reasons that will be discussed immediately following in the analysis of Bank Holding Companies in subsection 3). The courts probably would be constrained by the OCC's decisions in accordance with the familiar "clearly erroneous" standard. *See infra* note 114; *Nationsbank of N.C. v. Variable Annuity Life Ins.*, 115 S. Ct. 810 (1995); Independent Bankers Association of America v. Heimann, 613 F.2d 1164 (D.C. Cir. 1979), *cert. denied*, 449 U.S. 823 (1980) (permitting banks to engage in credit life insurance despite § 92), lends credibility to such an approach. Furthermore, the determination would reach the courts only if a private person or group chose to sue. The likelihood of private enforcement suits appears small because the most likely group of plaintiffs would be potential competitors that are mindful of the fact that they must cooperate with the FDIC to earn reinsurance business.

to the other. The FDIC also should provide special regulation of financial activity between the parent bank holding company and its reinsurance subsidiary to preserve the independence of the reinsurer and to sustain the ability of the bank subsidiary to turn to the parent for support.[108]

3. *Legal Issues*

In addition to precautionary standards, bank holding companies face legal obstacles to their participation in deposit reinsurance. The Bank Holding Company Act of 1956 (BHCA)[109] generally limits bank holding companies to the management and ownership of banks, unless the bank holding company or its nonbank subsidiary engages in activities "so closely related to banking to be properly and incident thereto."[110] Furthermore, this provision of the BHCA specifically indicates that underwriting insurance is not considered an incident to banking. However, the Federal Reserve Board (Fed Board), which administers the BHCA, maintains responsibility for determining the meaning of these terms, subject to judicial review. Bank holding companies could petition for Fed Board approval of deposit reinsurance activity on the ground that it is not insurance of the type contemplated by Congress when enacting section 1843(c)(8). Because the BHCA fails to mention reinsurance, and deposit insurance differs substantially from the types of activities included in defining the insurance restrictions, the Fed Board could view deposit reinsurance as a functional equivalent of an inter-bank guaranty or letter of credit,[111] (which is a permissible bank activity), rather than as insurance activity.[112] A Fed Board decision in favor of bank holding companies could face a challenge in court from the insurance or reinsurance industries if they believe that this decision poses a competitive threat. If the determination com-

108. The Federal Reserve's "source-of-strength" doctrine, which requires bank holding companies to provide capital injections to troubled bank subsidiaries, depends upon the parent's capital availability. Any reinsurance program that fails to preserve the Federal Reserve's ability to employ the source-of-strength doctrine probably will not receive Federal Reserve support. For a discussion of the source-of-strength doctrine, see Jackson, *supra* note 100, at 528-32.

109. 12 U.S.C. §§ 1841-1844, 1846-1849, *amended by* 12 U.S.C. §§ 1850, 1971-1978 (1988).

110. 12 U.S.C. § 1843(c)(8) (1988).

111. In fact, the unique risk analysis employed in deposit reinsurance is more similar to a financial guarantee than any traditional insurance.

112. *See* Republic Nat'l Bank of Dallas v. Northwest Nat'l Bank of Fort Worth 578 S.W.2d 109 (Tex. 1978).

ports with sounds administrative procedures and standards,[113] the Fed Board's decision would receive substantial deference from the court[114] and most likely would survive judicial review. If insurers and reinsurers perceive permission to enter into deposit reinsurance contracts as a serious competitive threat, they probably would lobby Congress to amend section 1843(c)(8). Given the FDIC's role in reinsurance, insurers and reinsurers may feel inhibited from taking any action at all, thus leaving unchallenged a Fed Board decision on this subject.

Even if regulators prevent bank holding companies from establishing reinsurance subsidiaries under section 1843(c)(8), they could attempt to enter the reinsurance market through an overseas reinsurance subsidiary. A domestic bank holding company can purchase or establish a reinsurance subsidiary abroad and engage in reinsurance of United States deposits, provided that the subsidiary's business in the United States comprises less than five percent of its total business and the bank holding company complies with the further requirements of Regulation K.[115] Because the Fed Board issued and interprets Regulation K, bank holding companies cannot circumvent a Fed Board determination that bank holding companies should not reinsure deposits by moving overseas.

B. *Financial Guarantee Insurers*

Financial guarantee insurance exists primarily to increase the investment ratings given to municipal bonds and other debt instruments. When used as a credit enhancer, financial guarantee insurance does not actually transfer risk so much as add third-party protection, particularly for regularity of payment. In some ways, this role resembles bank financial intermediation.[116] Credit enhancement of municipal bonds represents the most common form of financial guarantee insurance.

113. Specifically, the decision should be founded on the basis of the record and reasons for the decision must be presented at the administrative level rather than later in the process.

114. *See, e.g.*, Chevron U.S.A. Inc. v. EPA, 658 F.2d 271, 274 (5th Cir. 1981) (establishing that courts should accord administrative agency decisions substantial deference unless the decision was arbitrary or capricious).

115. *See* 12 C.F.R. §§ 211.1-211.603 (1994). Regulation K governs U.S. bank holding company activity abroad. A foreign subsidiary scheme would provide for greater diversification of the reinsurer. This may assuage concerns about systemic risk magnification, but it also may discourage bank holding companies from entering the reinsurance market.

116. See Michael E. Satz, *Worry-free Financial Guarantees; Reinsurance*, BEST'S REV., Dec. 1989, at 66, for further discussion of financial guarantee insurers.

In the typical municipal bond transaction, a municipality with a BBB/Baa investment rating[117] or better lowers the cost of interest payments on its bond issues by seeking a financial guarantee insurer that possess at least an AA/Aa rating. This combination on the market is traded at prices typical to A-rated municipalities. Because municipalities actually have a relatively low rate of default,[118] and municipal bond insurers have experience with identifying risk in municipalities, municipal bond insurers write to a "no-loss" standard. Recently, however, there has been a trend among municipal bond reinsurers to diversify through entry into other markets, including overseas municipal bonds, corporate bonds, and asset-backed securities.[119]

Financial guarantee insurers fit well into the Pilot Program because they have extensive experience in unique risk evaluation, unlike the many insurers who calculate risk on the basis of pooling large numbers, and because they pursue inherently secure financial policies. Insurers typically maintain a commercial rating agency rating of AAA, the highest rating possible,[120] to provide municipal bond insurance that increases municipal bond ratings sufficiently. To obtain such a rating, financial guarantee insurers must be more cautious than most financial institutions about assuming risk. Indeed, many do not engage in other lines of business.

The ratings that make financial guarantee insurers attractive to the FDIC, however, could limit the role that these insurers are willing play in deposit reinsurance. If financial guarantee insurers wish to enter the bank reinsurance market, they will have to maintain capital reserves adequate for the AAA rating needed for their traditional business. The cost of such reserves may prevent financial guarantee insurers from submitting bids for high-risk

117. Typically, Standard & Poor or Moody's assigns investment ratings.

118. "Even [at] the depth of the Great Depression, the cumulative gross rate of default [among municipalities] was only 16%." Marian Freedman, *Financial Guarantees: Too Hot to Handle*, BEST'S REV., Oct. 1985, at 18. Nevertheless, there are a few examples of stunning municipal defaults that have been costly to their insurers, including the 1990 default-scare on a major Philadelphia municipal bond issue. *See* Judy Greenwald, *Ailing Philadelphia Drag on MBIA Stock*, BUS. INS., Oct. 8, 1990, at 81.

119. *See, e.g.*, Judy Greenwald, *Venturing into New Growth Markets: More Municipal Bond Insurers Explore Corporate World*, BUS. INS., Nov. 23, 1994, at 47.

120. For a financial guarantee insurer to achieve a AAA rating, it must demonstrate that it has the ability to survive a worst-case economic scenario based on the Great Depression. *See* Satz, *supra* note 116. *But see* Judy Greenwald, *Municipal Bond Insurers' Ratings Questioned; But Ratings Agencies Say Insurers Put to Stringent Test*, BUS. INS., Nov. 22, 1993, at 57 (investigating a recent report that questions the validity of the AAA rating).

banks.[121] The limited range over which financial guarantee insurers participate in deposit reinsurance does not preclude an effective reinsurance program, but rather indicates only an area of greater competition and reliability.

The founders of the municipal bond reinsurers, large primary insurers, also may be encouraged to participate in deposit reinsurance, either directly or through subsidiaries and joint ventures. In addition, reinsurers such as General Reinsurance and Reliance National,[122] already involved in private deposit insurance for over-exposed depositors, can further develop and exploit their expertise through participation in federal deposit reinsurance. As the municipal bond insurance market illustrates, these primary insurers can effectively exploit opportunities to profit through insurance in the public sector. Because deposit reinsurance does not require credit enhancement features, reinsurers do not necessarily need top ratings. These lower investment rating requirements lead to lower costs of entering the reinsurance industry, thereby encouraging insurers to participate in deposit reinsurance.

C. *Other Entrants*

New insurance entrants will have to develop the expertise to evaluate and price accurately bank risk, as well as be able to satisfy the FDIC's financial standards before they will be qualified to submit bids for reinsurance contracts. The regulatory barrier to entry, combined with a lack of knowledge about bank safety, likely will inhibit insurance and banking outsiders from attempting to enter the FDIC reinsurance market (at least until the market is well established). Even when the market attracts new entrants, they may face diversification problems similar to those of bank-affiliated reinsurers as discussed above in part V.A.

D. *Foreign Entrants*

Potential entrants to the deposit reinsurance market include foreign banks and insurance companies. Federal regulations over foreign banks' activities in the United States will limit their entry

121. *See* AM. BANKER-BOND BUYER, *supra* note 57, at 1 (citing an industry insider as predicting that his credit enhancement company would be interested in participating in the reinsurance market, but only for "top tier" banks).

122. *See supra* notes 58-64 and accompanying text.

into the market.[123] In addition, foreign reinsurers must navigate state reinsurance law, much as domestic insurers do, to establish eligibility for the reinsurance program. This barrier to entry for foreign financial institutions should not be augmented by further federal regulations; free trade and reciprocity principles warrant permitting foreign institutions to participate in the reinsurance market on the same basis as similarly situated domestic institutions.[124] Allowing such foreign participation would secure the additional benefit of greater competition in bidding.[125] Arguments that foreign financial institution participation will threaten the U.S. banking system[126] have no relationship to the problems that carry the primary risks of bank failure—systemic risk and safety threats to the FDIC. Rather, the arguments react merely to the "concern" of increased competition for the domestic banks and insurers contemplating a role in the reinsurance market. Presently, the FDIC appears to favor permitting foreign institutions to participate.[127]

E. *Competition*

The success of the reinsurance program depends on the ability of the private market to price premiums accurately. Competitive markets generate "accurate" prices. In contrast, oligopolistic and monopolistic market structures lead to higher prices for the consumer. Under the latter two market scenarios, anti-competitive

123. In many countries, financial institutions are organized in conglomerates that may include banks, insurance companies, and securities firms. U.S. banking law prevents these foreign conglomerates from operating their banking and insurance divisions in the United States as they would in their home country. For a discussion of the regulation of foreign banks, see Cynthia C. Lichtenstein, *U.S. Restructuring Legislation: Revising the International Banking Act of 1978, for the Worse?*, 69 FORDHAM L. REV. S37 (1992); Patricia S. Skigen & John D. Fitzsimmons, *The Impact of the International Banking Act of 1978 on Foreign Banks and Their Domestic and Foreign Affiliates*, 35 BUS. LAW. 55 (1979).

124. Reciprocity in the United States commonly refers to a standard of judging international banking relationships based on national treatment of foreign banks. Because of the U.S. banking system's unusual regulatory structure, the United States has been perceived as unfriendly to foreign banks, particularly by the European Union, causing stress to U.S. international banking relationships and threatening the ability of U.S. banks to expand abroad. For a discussion of reciprocity standards and agreements in the context of international banking, see Joel P. Trachtman, *Recent Initiatives in International Financial Regulation and Goals of Competitiveness, Effectiveness, Consistency and Cooperation*, 12 NW. J. INT'L. L. & BUS. 241 (1991). For a discussion of problems caused by unilateral barriers to international banking, see Marilyn B. Cane & David A. Barclay, *Competitive Inequality: American Banking in the International Arena*, 13 B.C. INT'L. & COMP. L. REV. 273 (1990).

125. For a discussion of the importance of competition in the reinsurance market, see *infra* part V.E.

126. *See* FDIC REPORT, *supra* note 48, at 27.

127. *Id.*

prices imposed by the reinsurers would injure both the FDIC and banks, which would pay inefficiently high premiums or obtain an inefficiently low amount of reinsurance and undertake a less than optimal amount of risk.[128]

In response to this potential hazard, the FDIC should avoid imposing unnecessary barriers to entry and allow as many competitors into the industry as possible. Although necessary and inevitable, the FDIC should examine every safety and soundness measure, including the capitalization and reserve requirements, to ensure efficient bank protection. Permitting foreign financial institutions and institutions that normally may not engage in reinsurance transactions, such as primary insurers or bank holding companies, to participate, stands as one avenue for increasing the number of entrants into the deposit reinsurance market. In addition, the development and application of eligibility requirements for participation in the reinsurance market should not impose unnecessary expenses on domestic or foreign institutions that seek to enter the industry.

VI. Compatibility between Reinsurer Premiums and the FDIC

A. *Ability of Reinsurers to Price Accurately*

In determining whether the premiums charged by reinsurers are likely to reflect information useful to the FDIC in a relative risk or direct premium setting sense, the fundamental ability of the private market to measure risk and to price accurately must be established.

Rating agencies such as Standard & Poor or Moody's assess and publish their determinations of the credit worthiness of banks. A 1991 study by the General Accounting Office (GAO)[129] revealed that the private rating agencies agreed with bank regulators on the rankings of the most safe banks, but the public and private sectors differed significantly in their rankings of banks not classified in that top tier. The rating agencies generally considered those banks not in the top safety categories much less risky than did federal regulators. The rating agencies' and bank

128. *See supra* note 74.

129. GAO, Government Sponsored Enterprises: Using Private Risk Ratings for Exemptions from Federal Regulations (1991).

regulators' different goals[130] in assessing the banks partially explain this discrepancy in the rankings. Moreover, unlike the FDIC, the rating agencies expose their reputations but not their capital in making evaluations. Finally, the practical significance of FDIC ratings is not clear because until recently FDIC action has been highly discretionary. The GAO study could not identify whether the bank regulators or the ratings agencies were quicker or more accurate in detecting changes in a bank's condition. Despite the study's uncertainty, the private sector's greater incentive to correlate risk and price, even with facility merely equal to the public sector, will lead to improvements over the current FDIC pricing system.[131]

Recent failures among insurance companies suggest that even the private sector does not always price insurance correctly.[132] Nevertheless, when changes in risk factors result in incorrect pricing, market forces move private insurers to adjust prices.[133] Political action, the analogous force in the regulatory context, takes much longer to produce real price changes. Therefore, although the market may not price perfectly in a short-run or individual case, accurate pricing is more likely in the intermediate- and long-term contexts when performed by the private sector rather than by government agents.

In response to the new FDIC policy not to pay uninsured depositors more than they would receive in bankruptcy, private insurers have begun to offer private insurance to depositors for funds exceeding the FDIC insurance limit. For example, some insurers provide coverage for depositor holdings over $100,000 in escrow accounts or certificate of deposits. General Reinsurance (GenRe), the first private company to provide such cover-

130. The FDIC measures potential loss to itself; the rating agencies measure the potential loss to the uninsured depositor. Although the GAO Report indicates that the rating agencies do not take government bail-out of the institutions into account, they still might adjust for the likelihood of less direct government assistance before a bank fails, the depositor's priority in bankruptcy, and loss ratios in banking versus other industries that may be less significant to the FDIC.

131. *See supra* notes 13, 15 and accompanying text.

132. *See, e.g.*, Peter Harland, *World: A Year to Forget - Reinsurance 1992*, REUTER TEXTLINE, Jan. 9, 1992, *available in* LEXIS, Insure File, Curnws Library; Larry G. Mayewski & Michael L. Albanese, *Breaking with the Past*, BEST'S REV., Mar. 1993, at 17.

133. *See* Gavin Souter, *Overconfidence Causes Reinsurers to Underprice Coverages: Consultant*, BUS. INS., Sept. 20, 1993, at 47 (asserting that reinsurers have been underpricing). *But see* Lapper, *supra* note 53 (indicating that premiums are already responding with increases). This dialogue is based on incidents in catastrophic reinsurance because there is no deposit reinsurance yet and catastrophic reinsurance is the area of greatest concern in the industry recently.

age, currently offers deposit insurance at twenty-five to thirty cents per one hundred dollars in deposits; Reliance National has developed a similar program which averages twenty to twenty-five cents per one hundred dollars. Unfortunately, the infancy of these reinsurers' particular programs hinders their effectiveness as an indicator of how the private sector will price deposit reinsurance—neither has had the opportunity to develop a sufficient historical loss basis on which to base efficient pricing for the insurance. Consequently, both insurers currently rely on FDIC insurance pricing to serve as a guide until the insurers accumulate adequate amounts of their own historical data.

At present, GenRe has not started to differentiate premiums on the basis of risk. Although GenRe insures or rejects a bank on the basis of safety, once it establishes the insurability of deposits at particular bank, it gives no further consideration to risk. GenRe thus bases its insurance premiums on a statistical analysis rather than on an individualized analysis of each bank. Reliance, on the other hand, does consider particularized risk factors when negotiating individual insurance policies. This risk adjustment has caused policies to range in price from fifteen to thirty cents per one hundred dollars in deposits. With this greater level of individualized assessment of bank risk, Reliance believes itself able to engage in a number of transactions at the upper end of the risk scale.[134]

Finally, both GenRe and Reliance evaluate other common factors, such as size of the account, when determining premiums, which creates fluctuation in premium prices not related to risk. Moreover, with only two market participants, the prices set by GenRe and Reliance probably do not experience the pressures of a fully competitive market as other insurance industries do. Therefore, until the private market develops more fully, empirical data comparing private insurers to bank regulators will not be available. The Pilot Program can assist with this lack of information by providing early indicators of how a deposit reinsurance market might develop.

B. *Cherry-Picking*

The Pilot Program, according to a prominent reinsurance insider, likely will encounter the common insurance phenomenon

134. *See supra* notes 62-63 and accompanying text.

known as "cherry-picking."[135] Cherry-picking is the practice of insuring only the least-cost risks in any given set of risks. Insurers that employ cherry-picking strategies attempt to maximize profits at the expense of the insurance pool in one of two ways. The first strategy involves a systematic policy of refusing to insure those risks that are likely to result in large claims in favor of accepting those risks associated with smaller (or even no) claims.[136] The second manifestation of cherry-picking limits insurance to risks with a low variance. Stable or predictable risks are more easily and more accurately priced, thus enabling the insurer to control its exposure to claims (or charge an appropriately high premium) and increase its profitability.[137]

Both forms of cherry-picking are likely to affect the Pilot Program. Reinsurance contracts covering banks close to failure may receive no bids. In addition, banks possessing risks too difficult to estimate accurately, such as small banks, will also go "unpicked" from the reinsurance tree. This results because the relatively high costs of reducing the variance of small bank failure risk, by obtaining full and accurate information, likely outweigh the amount of business generated by the contract.[138] Rural settings amplify these risk evaluation problems. Pertinent data on housing values, economic growth, and other variables may not be available and, even if it were, would be of less value to the insurer (and therefore relatively more expensive in terms of opportunity cost) because the specific information will support only a few bids.

If the reinsurance industry refuses to bid on a bank because it considers the bank a high risk, the FDIC should interpret that result as a market signal that the bank requires immediate attention—the bank is either too risky to insure or the market will not

135. *See FDIC Reinsurance Plan Will Need Primaries, supra* note 55 (quoting an industry executive who predicts that, at least initially, reinsurers will cherry-pick banks, as is the practice in municipal bond insurance).

136. A familiar example from the health care context would be an insurance company's refusal to enter into a contractual relationship with a person who has a "pre-existing condition."

137. This assumes that the risk is not so large and so certain that the premium itself will not force the insured into bankruptcy. At this point, the risk becomes "uninsurable."

138. This assumes that the risk is inherently stable and that the primary reason that the reinsurer views it as unstable is that the costs of obtaining the information to quantify the risk are too high relative to expected profit on the transaction. Such a rationale is implicitly recognized by Congress in § 111 of the FDICIA, which mandates regular intervals for bank examinations but allows a longer interval for smaller banks (deposits less than $100,000,000) that have not yet exhibited signs of distress.

support a riskiness evaluation because of information acquisition problems. Assuming that reinsurance provides market discipline and relative risk evaluation rather than direct protection of the fund, refusal of the market to accept a risk under circumstances in which a bank faces a high probability of failure represents an effective outcome. Banks not faced with financial failure but nevertheless difficult for a reinsurer to evaluate, however, are a more significant concern.

The problem of hard-to-evaluate banks will be most acute when the Pilot Program enters its first set of reinsurance transactions. Reinsurers will need to develop new systems[139] to assess the risks associated with any particular bank. Quite possibly, the large capital investment required to investigate and analyze bank risk will lead reinsurers to undertake such analysis and to bid for coverage only on the biggest banks. Once the industry becomes experienced in measuring the risk for bank failure, however, difficulties with gathering information or in evaluating banks that maintain unusual portfolios may decrease, thereby reducing the likelihood of the second variety of cherry-picking.

Nevertheless, the possibility remains that reinsurers may find some banks unsuitable for reinsurance coverage. Some banks may be so small that reinsurance for those banks will not be cost effective at any level of reinsurer expertise. Other banks may have a management structure which reinsurers view as too difficult to assess accurately. Recently troubled banks may experience a probationary period before reinsurers commit to expend resources in evaluating them for a potential bid. Scant empirical data exists to indicate how many banks will receive reinsurance bids from the private market. General Reinsurance and Reliance National constitute the only sellers in the entire private reinsurance market for bank deposits.[140] This limited encounter with private insurers of bank deposits does not reflect reliably the potential deposit reinsurance experience because the two private

139. Current FDIC risk-measuring techniques and models created by academics will make it easier for reinsurers to develop these systems, but reinsurers still will have to develop historical loss data and transfer modeling techniques into practical pricing setting.

140. For a discussion of General Reinsurance's and Reliance National's limited activities in the reinsurance market for bank deposits, see *supra* note 134 and accompanying text.

insurance programs are still in development, and the private insurers are not yet able to adjust prices fully for risk.[141]

The public sector has faced the difficulty of providing insurance in a variety of situations. Most resolutions of these situations center upon formation of pools of insureds to diversify risk.[142] Occasionally, the government requires all insurers selling a particular line of insurance to share the burden of a high-risk group.[143] The design and purpose of the Pilot Program, however, will not function under the pooling method. Instead, the reinsurance project allows the private market to develop prices for deposit insurance so that each bank may pay an efficient federal deposit insurance premium.

To the extent that cherry-picking results from the high costs of risk evaluation relative to the value of the contract, the FDIC could attempt to reduce cherry-picking through subsidizing[144] the risk evaluation process or by increasing the return on the contract for the reinsurer. Concentrating on the return to reinsurers represents the more appealing solution because a subsidy could frustrate the objective—identifying the correct premium—by distorting the premium price.[145]

One possible solution, focusing on the contract return component, involves placing a larger percentage of the hard-to-price

141. The private insurers also have limits on how much exposure they will accept at any one bank. General Reinsurance will insure up to five million dollars in deposits in any one bank while Reliance will insure up to ten million dollars. Reliance claims that its limit results from limits on the availability of capital for the deposit insurance program in its early stages. Telephone Interview with Gary Dubois, Vice-President of Reliance National (Apr. 8, 1994).

142. For example, health insurance once was organized on a risk-diversification principle. In response to the development of HMOs and other types of insurance that allowed insurers to cherry-pick, the State of New York adopted a law requiring insurers to accept anyone into the program. *See* Salvatore R. Curiale, Superintendent of Insurance, New York State, Testimony before the Senate Finance Committee on Health Insurance Market Reform, Federal Doc. Clearing House, Feb. 1, 1994, *available in* LEXIS, News Library, Curnws File.

143. This could be achieved by establishing a residual market, funded partially by taxes or other fees on insurers in that market. For a discussion of residual markets, see INS. INFO. INST., INSURANCE INFORMATION REPORTS, RESIDUAL MARKETS (Ruth Gastel ed., 1993).

144. The FDIC already has been approached by the reinsurers to subsidize some of the costs of development, but it has declined. *See* FDIC REPORT, *supra* note 48, at 27-29.

145. Alternatively, a subsidy could be provided by awarding a portion of the business generated by a large, easy-to-measure bank to the winning bidder of a less appealing contract. This regime would be viable only if bids on the easy-to-price bank were accepted first and the winning bid price was extended to the winner of the hard-to-price contract. The winner of the hard-to-price contract, however, would then be subject to the risk that the bidders on the unrelated contract were incorrect in their estimations. If reinsurers are not confident in one another's pricing abilities, this scheme would fail to encourage bidding on hard-to-price banks.

bank's insurance on the market for reinsurance.[146] This approach would set the premium prices for these institutions without distortion or reliance on other reinsurers. For small banks that do not receive bids, there should be no concern about the FDIC reinsuring too large a portion of that bank's assets (allegedly creating a risk of failure in the reinsurer[147]) because the total cost of reinsurance is likely to remain small compared to the total cost of reinsurance for a large institution. A larger return also would be affected by a long-term contract.[148]

Other scenarios giving rise to high evaluation costs, such as a significantly unusual capital or management structure[149] or a probationary period after experiencing financial difficulties, likely will be rare. When these cases do emerge, however, the FDIC may need to intervene and establish the premium price. In these instances, the FDIC would benefit from the ability to examine the existing range of market prices for other institutions.[150] Although political considerations may pressure the FDIC to lower the premium price as much as possible, the pressure would remain restricted to a few specific banks and would have less impact on the banking industry than systematic underpricing of premiums.

The more significant problem related to cherry-picking revolves around the problem that the reinsurers will favor coverage

146. Such an increase in the contract size would be possible only with the approval of Congress because the FDICIA currently limits the FDIC to ten percent of any bank's insured deposits. *See* FDICIA § 322.

147. The risk of reinsurer failure is a danger because the FDIC will remain ultimately liable for losses to depositors in a bank failure but will lose most or all of the premium price. In addition, if a reinsurer faces a high risk of loss not offset by diversification with other risks (in other words, if one failure could force the reinsurer into insolvency), that reinsurer's shareholders could pressure it to increase risk. When they face a high likelihood of a total loss, shareholders find increasingly risky activities more appealing because these activities raise their expected value. Risk could be increased by substantially underbidding on other banks (particularly likely if that reinsurer does not or cannot engage in any other business), thereby distorting the prices charged for reinsurance as well as increasing the risk of its own failure. Although much can be done to prevent this sort of risk from materializing, the most simple and effective measure simply is to limit reinsurers' exposure.

148. *See supra* part IV.B.1. The increase in the return under a longer period of insurance would have to be discounted by the cost of continued monitoring (which probably would be lower once the initial investigation is completed), and by the probability of cancellation. Although these probabilities would be difficult and perhaps useless estimations initially, actuarially reliable answers could be developed over time with experience.

149. This is a particularly unlikely situation because banks are subject to federal regulation that imposes a certain degree of uniformity by requiring that safety and soundness standards be satisfied.

150. Presumably the range generated by the market will be greater than what the FDIC has generated. *See supra* note 17.

for large banks to the exclusion of smaller ones. Large banks may provide a greater return than small banks for a roughly equal evaluation expenditure;[151] reinsurers may charge a lower premium price per dollar of deposits for larger-asset institutions than for a smaller-asset institutions that happen to require approximately the same evaluation process costs as the bigger bank. Moreover, large banks disproportionately may attract reinsurers on the "too-large-to-fail theory." This doctrine, which the FDICIA attempts to counteract,[152] advocates that the FDIC "bail-out" large banks if it believes that systemic failure will result from the failure of an institution. If reinsurers bear the failure costs but not the bail-out costs, they will face a lower risk of paying a claim with a "too-large" bank than with a smaller bank, all other things being equal.

Both of these problems affect the relationship between risk and price. Because of its fairly easy detection, however, the FDIC could adjust for the reinsurers' predisposition to cover large banks by utilizing premiums for either relative risk-pricing or relative risk- regulation. To attain direct pricing, the FDIC would have to set the reinsured amount equal in all reinsured banks and cancel the too-large-to-fail doctrine. Theoretically, the former is readily accomplished but may require the approval of Congress.[153] The latter will be discussed below in part VI.D.

C. *Public Policy*

The FDIC, as a government agency, has a political agenda that fund reinsurers, as profit maximizers, likely do not share. To the extent that the FDIC acts to protect the fund, the reinsurers' and the FDIC's goals will coincide. When the FDIC acts in response to other duties, however, conflict with reinsurers may result.

The Community Reinvestment Act (CRA)[154] embodies an example of conflicting interests. In accordance with the CRA, the federal government has promoted bank investment in poorer

151. Large banks may require more evaluation because they have greater assets, but they are also more likely to keep better records and many already may generate significant risk and asset information for public share and bondholders.

152. *See* FDICIA § 1823(c).

153. Congressional approval might be required because the FDICIA limits the reinsurance program to no more than ten percent of deposits in any one bank. If the reinsured amount were to be set equal, the amount of reinsurance would be limited to ten percent of the smallest bank reinsured. This restraint might risk not providing enough room for the reinsurer profit that is necessary to induce the initial capital investment.

154. 12 U.S.C. §§ 2901-2905 (1988).

communities and regions to promote national interests. Reinsurers could interpret such credit allocation as atypical in degree of risk. Reinsurers then would expect a higher rate of failure among banks engaging in such activities. If the FDIC were to ignore such an effect and translate reinsurance premiums into bank premiums without making adjustments either through direct pricing or through insufficient adjustment in relative risk pricing, the FDIC would be creating incentives for banks to thwart the CRA and similar federal legislation.

The problem, however, is not likely to have a significant impact on federal deposit insurance or banking. Public policy goals of this kind do not occur frequently. Furthermore, the primary function of the FDIC remains protecting bank safety and soundness. The FDIC should not encourage banks to engage in any activity that endangers the safety and soundness of the industry.

The CRA seeks to correct banks' tendency to reject a lower income borrower because of his lower income rather than on his risk profile. Banks successful under the CRA regime claim to have developed better risk evaluation tools for this underdeveloped market. Some banks even claim that their rate of defaulting borrowers is lower in CRA programs than in traditional lending programs.[155] Reinsurers should be able to examine bank lending induced by the CRA in the same manner that the bank's other risk-taking strategy is examined. Increased premiums could offset the excessive risk-taking induced by government regulation, as well as help measure the real costs of such federal initiatives and assist banks in avoiding unreasonably risky regulations.[156]

If a significant problem develops when the federal government encourages an activity perceived as risky, the federal government could readily subsidize the risky activity by direct monetary incentives in proportion to participation by banks, by absorbing a portion of the risk to banks,[157] or by allowing banks greater regulatory freedoms in other aspects of lending. Exclusive em-

155. *See* Kevin T. Kane, *CRA Getting Good Grades*, MORTGAGE BANKING, June 1992, at 52; Jane Moss Snow, *The Community Reinvestment Act Business*, MORTGAGE BANKING, May 1990, at 75. *But see* Jonathan R. Macey & Geoffrey P. Miller, *The Community Reinvestment Act: An Economic Analysis*, 79 VA. L. REV., 291 (1993) (evaluating the CRA on a theoretical level to prove associated inefficiencies).

156. The measure of any increased risk to banks, however, is not a complete assessment of the costs of such a program. For other costs of the CRA, see Lawrence B. Lindsey, *A Balanced Response*, MORTGAGE BANKING, Oct. 1993, at 34.

157. The government already absorbs a portion of banks' risks in some situations. For example, the FHA already assumes some CRA risk when it insures CRA mortgages.

ployment of these methods support public policy goals and is a prerequisite for direct pricing. In relative risk pricing, reductions in premiums must be distributed in proportion to the degree of the risky activity undertaken,[158] while adjustments only can be applied uniformly in relative risk regulation schemes.[159]

Another troubling area of public policy likely to clash with the private structure is the too-large-to fail doctrine.[160] Although the FDICIA seeks to curb the use of this doctrine,[161] predicting whether the requirements imposed by the FDICIA will decrease the use of that doctrine remains difficult.[162] In addition, the Federal Reserve (the Fed) could exert its power as a lender of last resort to undermine the FDICIA or to force the FDIC's hand in taking action.[163]

The possibility of FDIC or Fed assistance generally increases with the size of the institution because of political pressure, as well as safety and soundness considerations.[164] The potential for Fed and FDIC assistance to failing banks will decrease premiums based upon the reinsurer's perception of the likelihood of such assistance.

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158. Across-the-board reductions in premiums would be less effective than proportional reductions because across-the-board reductions would encourage free-riders.

159. The inverse problem to the CRA is the potential for reinsurers to encourage violations of bank activity limitations, such as securities activity restrictions. Because such activities increase diversification and reduce bank failure risk, banks may seek lower premiums by engaging in these activities beyond the level permissible by law. Bank regulators are experienced at monitoring banks for exceeding these legal limits. These activities hold a great allure of profit and reduced premiums, and therefore have required enforcement virtually since the limitations' enactments. Reinsurers will ensure that banks only pursue those activities that reduce risk. Private reinsurance and improved relative risk information also will permit regulators and Congress to gauge more accurately which activities promote risk or safety, and by how much, when considering regulatory reform.

160. *See supra* part VI.B.

161. *See* FDICIA § 1823(c).

162. Although the FDICIA's requirements are quite strict when certain accounting measures are not satisfied, the FDIC retains control over calculations determining when those calculations are met. *Id.* As a result, regulators still may have the ability to exercise significant control over the application of the too-large-to-fail doctrine. Furthermore, the General Accounting Office has criticized the FDIC as reluctant to implement FDICIA-mandated changes. *See, e.g., FDICIA Implementation Criticized*, AM. BANKER WASH. WATCH, July 12, 1993, at 3.

163. In resolution of the Penn Square Bank in Oklahoma, the Fed threatened to continue to support the failing bank unless the FDIC bailed out uninsured depositors as well as insured depositors. *See* CBO REPORT, *supra* note 11, at 62. Although this problem is less likely under the FDICIA, which prohibits such FDIC payments, the Fed's power as lender of last resort could be used to threaten to continue to support a large failing bank unless the FDIC protects it under the procedures described in 12 U.S.C. § 1823(c). *But see infra* note 165.

164. Safety and soundness can be implicated in the form of systemic risk through interbank deposits and clearing accounts or in the risk of public runs on banks in reaction to the failure of a large bank.

The reinsurance program should not be affected in the case of direct Fed assistance. The Fed is a self-supporting agency that charges banks for its services, including direct and indirect subsidies through its own mechanisms. Any decrease in risk caused by direct Fed assistance will benefit the FDIC and reinsurers equally.[165] Decreases or increases in the risk of bank failure resulting from FDIC action, however, distort reinsurance premiums and therefore must be examined.

D. *Role of the FDIC and Skewed Ratings*

Because the FDIC supervises banks and, in the case of failure, decides the fate of a bank, the reinsurance market must take FDIC action into account in determining the likelihood that reinsurance disbursements will be made. Given the FDIC's efforts to protect depositors from both systemic risk and failure in any individual bank, the FDIC's solutions to a bank's financial distress may not coincide with the reinsurers' profit-maximizing solutions. Several factors mitigate concerns about the affect of the FDIC on the functioning of a reinsurance market.

First, the continuing relationship between a relatively small group of reinsurers[166] and the FDIC, combined with mutual concerns for reputation, will foster cooperation between the FDIC and reinsurers, thereby limiting the component of the premium charged for FDIC action. Courts also regularly require a duty of good faith and fair dealing in the relationship between the reinsurer and the cedant.[167] Cancellation and renegotiation clauses,[168] if properly implemented, will mitigate further the distortions of FDIC action.

Nevertheless, the FDIC's role as regulator and primary insurer creates a divergence of interests between the reinsurer and the FDIC which will result not only in differences in premium prices between the FDIC and reinsurers (thereby prohibiting effective

165. Because the Fed is a secured creditor, if the bank should fail despite Fed assistance, the FDIC and reinsurers will be harmed. From the perspective of minimizing risk to the bank system, Fed lending also can be deleterious if it creates moral hazard. The Fed, however, recently has announced that it will implement new regulations that will limit Fed lending to troubled banks. *See* Claudia Cummins, *Fed Proposes Curbing Access to Advances by Troubled Banks*, AM. BANKER, Aug. 12, 1993, at 2.

166. Although the FDIC should encourage the largest number of reinsurance participants possible, the requisite safety, soundness, and capital standards will provide barriers to entry that necessarily will make the group of participating reinsurers small relative to other industries that do not maintain similar requirements.

167. *See* Hall, *supra* note 26.

168. For a discussion of these clauses, see *supra* part IV.B.

direct translation of reinsurance premiums into primary rates), but will produce distortions in relative risk that will emasculate relative risk uses of premium information as well. Relative risk distortions occur because the likelihood of FDIC action or restraint is not dispersed randomly across all banks or based on relative risk. Rather, it fluctuates on the basis of bank size and regulatory bias, including industry and political power. The following discussion explores the impact on relative risk pricing of bank size and regulatory bias through examination of the too-large-to-fail doctrine and FDIC assistance or restraint.

The too-large-to-fail doctrine represents the policy that the FDIC should not permit banks over a certain size to fail because they are so large that their failure will have significant systemic risk consequences.[169] Section 1823(c)(4)(g)(i) of the FDICIA limits the FDIC's use of the too-large-to-fail doctrine by requiring the FDIC to comply with special procedures that include approval from the Secretary of the Treasury in consultation with the President.[170] FDIC regulators, however, generate the calculations upon which the determination of the least cost resolution is made. The reinsurer has no incentive to challenge these calculations because it will gain a windfall if the FDIC bails out its reinsured bank. Consequently, reinsurers will price large banks at less than the amount necessary to compensate for risk actually posed by the bank in the expectation that the FDIC will follow the too-large-to-fail doctrine.

A similar analysis applies to FDIC open bank assistance. The FDIC may provide open bank assistance in two situations. First, the FDIC will employ open bank assistance when it would serve as the least cost resolution to bank financial distress. In these instances, the FDIC determines that capital injection in the early stages of distress will resolve a short-run problem. The FDIC could ask the reinsurer to pay a pro rata share of the assist-

169. Most commonly, these consequences are observed through correspondent bank relationships by which banks maintain accounts with one another for clearance and payment purposes.

170. The section requires the FDIC to follow this procedure in any case where the FDIC does not implement the least cost resolution. The procedure requires the FDIC to receive approval from two-thirds of its Board of Directors, two-thirds of the Federal Reserve Board, and the Secretary of the Treasury in consultation with the President. The FDICIA also requires documentation of the Secretary's decision and presentation of that documentation to Congress. *See* FDICIA § 1823(c)(4).

ance,[171] but the reinsurer could resist such demands because the FDIC holds a weak bargaining position as a result of its larger share of the loss and ultimate burden in a bank failure contingency. The duty of good faith between the reinsurer and reinsured, however, would lead to court and arbitration rulings that likely would favor the FDIC. Furthermore, reinsurers generally consider themselves bound to assist when they perceive that their assistance would mitigate the losses.[172] Additionally, the FDIC should be able to recover the assistance outlays from the bank once its condition improves. If this repayment option exists, any disagreement between the FDIC and reinsurers disappears. The only cost to the FDIC then would derive from any disparity between the terms of the assistance made by the FDIC and the terms which were available to the bank on the open market at the time (discounting for information available to the FDIC but not market lenders).

The complexity of the problem increases, however, if the FDIC engages in open bank assistance for any other reason, such as regulator preference or political pressure.[173] Reinsurers are unlikely to be persuaded to pay a pro rata share of assistance in these situations because of their superior bargaining position. Additionally, the FDIC will encounter greater difficulty in seeking a contribution from the reinsurer because courts probably will not extend the duty of good faith (owed to the FDIC) beyond situations in which the FDIC provided assistance as the least cost method of resolution. Reinsurers will, however, charge lower premiums to reinsure banks when they expect regulatory bias to result in open bank assistance.[174] This result precisely mirrors the too-large-to-fail outcome.

171. This assumes that the standard contract does not require the reinsurer to do so already. If the standard contract were drafted that way, reinsurers would be less likely to enter the reinsurance market because their liability would be virtually unlimited (rather than capped at ten percent of insured deposits). In addition, any reinsurers entering the market would demand a premium for the additional risk that is related to FDIC preferences and not to bank risk, leading to a distortion between bank risk and reinsurance premiums.

172. Telephone Interview with Judy Radascz of MBIA (May 11, 1994).

173. The most infamous example of regulator response to political pressure occurred in the "Keating Five" savings and loan industry scandal. Although the Keating Five primarily pressured regulators into exercising restraint, the process would be the same in this context.

174. This consideration of the possible distortion stops short of considering open bank assistance that includes the regulatory takeover of bank management; takeover success is uncertain, and it unnecessarily complicates the analysis.

If the FDIC engages in either practice often enough to permit reinsurers to predict when the FDIC will adopt either practice, the reinsurers will factor this into premium calculations, thus destroying the FDIC's ability to use direct pricing. The FDIC could develop a formula that will correct for these distortions, thus enabling it to continue employing relative risk pricing. Because bank size is readily quantifiable in the case of the too-large-to-fail doctrine, this may be possible.

Reinsurer reaction to perceived regulatory bias in the FDIC, however, will be more difficult to quantify. FDIC ability to resist such bias presents the most successful resolution of the problem. Employment of premium information for relative risk regulation, rather than direct pricing or relative risk pricing, only would require regulators to make judgments about the effect of the perceived regulatory bias and expected employment of the too-large-to-fail doctrine. Although the FDIC's ability to "reverse engineer" the reinsurer's premiums becomes less crucial in this instance, relative risk regulation fails to preserve the strong market signals created and remains subject to variation on the basis of regulators' perceptions and qualifications. Therefore, even for relative risk regulation purposes, a system of risk evaluation that excuses the least amount of deviation from the rankings as possible is preferable.

FDIC restraint rather than FDIC action generally is perceived to be the greater problem.[175] In cases of inaction, the FDIC responds to industry and political influence by failing to assume management of operations of or liquidate a bank. This problem produces the reverse reaction in the reinsurer—the reinsurer charges a premium disproportionately high to the risk of bank failure. The results for the FDIC, however, remain the same—distortion between real relative risk and reinsurer premiums. The reinsurer's ability to cancel in the face of FDIC inaction[176] could mitigate this problem. Again, the best remedy is FDIC integrity in regulatory action. Because regulatory bias in FDIC decisions to restrain or assist failing banks produces opposite effects—thereby making it difficult to predict the overall effect of perceived bias—the Pilot Program constitutes an important first step in developing bank deposit reinsurance.

175. *See* Statement of John Conyers, *supra* note 76.

176. *See supra* part IV.B.

The too-large-to-fail doctrine and FDIC early assistance or restraint probably will operate only to distort the premiums charged by reinsurers. Offering assistance at market rates and limiting restraint represent the real solutions to the distortion problem. Unfortunately, these solutions depend on the FDIC's ability to overcome the very formidable problems that make market reinsurance so attractive—industry and political interference in the regulatory process. To compound the problem, industry and political influence over regulatory agencies often is viewed as a necessary safeguard against rogue regulator behavior. Reinsurance offered by the private sector, however, may offer an adequate substitute for legislative checks on rogue regulators through market mechanisms.

VII. Translation of Reinsurer Premiums into Bank Premiums

Once premium information is gathered, the FDIC will face the task of interpreting that data. As explained earlier, a lack of empirical evidence complicates efforts to predict the significance of reinsurance premiums. The meaning of reinsurance premiums will be least apparent at the inception of the Pilot Program. The reinsurers' need to recoup development costs[177] may drive initial premiums substantially higher than what will prove necessary to finance the insurance coverage. Moreover, lack of fully developed bank failure data also may contribute to inflated premiums at the outset of the market reinsurance program.[178] Reinsurers also may feel pressure to obtain above-average returns because of a general perception that higher risk attends new ventures. With this substantial uncertainty surrounding initial premium information, the FDIC may constrain itself to gathering information for reconnaissance purposes only. Industry-wide insight into relative bank risk predictions inevitably will develop because all the distortions inherent in a novel program presumably will affect all banks equally.

After an initial period of adjustment, assuming that the FDIC pursues the program further, reinsurance premiums will attain a long-run equilibrium range. At that point, the FDIC will need to

177. The FDIC currently is considering reimbursing reinsurers for part of their development costs. *See supra* note 65.

178. *See supra* note 90.

choose between the three uses of premium information discussed throughout this paper.

Direct pricing—pro rata passing of reinsurance premiums charged the FDIC on to the bank in its primary insurance premium—is unlikely to produce perfect FDIC compensation. Reinsurers require a return to capital which is unnecessary in government agencies. Private markets also have administrative systems and costs different from the FDIC. Moreover, the FDIC faces the costs of providing insurance for systemic risk and other public policy goals that do not concern private insurers. Most importantly, no private insurer will have the same risk portfolio as the FDIC.

According to basic portfolio theory, the cost to an entity of assuming a new risk depends upon the composition of its existing risk portfolio. Therefore the cost of assuming a particular new risk will not be the same for all reinsurers because each possess a different portfolio. For example, one reinsurer with several high-risk investments in its portfolio already will require a higher premium for yet another high-risk bank than would a second reinsurer that does not have as many high-risk banks in its portfolio. Not only will the cost vary across the range of reinsurers, but the FDIC's unique risk portfolio makes it unlikely that any of the reinsurers will face the same cost of reinsuring a particular bank, thus increasing the difficulty of direct pricing.

Although the cost of reinsurance to reinsurers will not equal the cost of insurance to the FDIC, this does not preclude direct pricing from entailing some advantages. Because competition determines the reinsurance premium, the market will induce the most efficient level of risk-taking by the insured bank. Therefore, if Congress intended to decrease bank failure to the efficient level, direct pricing presents the most appropriate use for reinsurance premiums. Congress, however, enacted the FDICIA as a response to the depletion of the BIF and the resultant increase in exposure of taxpayers to the costs of failed banks. As a result, if free market premiums sink below the costs to the FDIC of insuring banks, then the FDIC will need either to recalibrate primary insurance premiums to achieve its monetary requirements or to seek federal assistance to protect the BIF.[179] Because direct pricing may involve violating congressional or market imperatives,

179. This resolution is skewed by the savings to the FDIC associated with not paying a market return on investment capital. The lower cost to the FDIC of supplying capital for

the FDIC may decline to use premium information for this purpose.

Relative risk pricing—basing insurance premiums on the risk structure revealed by reinsurance premiums—offers a more workable alternative. It is this application of premium information that was envisioned by the FDIC.[180] Relative risk pricing allows the FDIC to adjust for differences between reinsurer costs and FDIC costs, regardless of whether those differences arise from structural variations between the FDIC and reinsurer or from the structure of the reinsurance market.[181] To the extent that the FDIC can reverse engineer fluctuations in relative risk that result from reinsurers' expectations of FDIC action, the FDIC will be able to improve on relative risk information.[182]

Relative risk pricing, however, will be subject to political and industry pressure to reduce both the rates and the range of premiums below market prices, precisely as occurs under the current FDIC pricing scheme.[183] Although the overall premium rate should decrease under risk-based pricing because fewer banks will fail in the long-run, it is in the short-run interest of those banks at the bottom of the risk rankings to exert pressure on the FDIC to deflate the rates even further. Therefore, effective employment of a relative risk pricing scheme depends upon protection of the relative risk scale as well as accurate calculation of adjustment factors.

Relative risk regulation leads to use of premium information as another factor for regulators to consider when evaluating a bank. This decreases reliance on the ability of reinsurance premiums to reflect the real relative risk of banks. It also allows banks to work directly and exclusively with the FDIC to lower risk and, concomitantly, the premiums. While regulators always can employ reinsurance premium information to improve their understanding of bank safety, this limiting use of premium information minimizes

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reinsurance is a subsidy to deposit insurance. Bank premiums would have to be adjusted by the amount of the subsidy to ensure efficient risk taking at the market price.

180. Telephone Interview with Jennifer Eccles, Senior Financial Analyst, FDIC (Apr. 28, 1994).

181. Structural differences include such differences as administrative costs, while the structure of the reinsurance market includes items such as contract duration. *See supra* part IV.B.1.

182. Of course the preferred route is to eliminate these fluctuations by limiting regulatory bias and the too-large-to-fail doctrine; relative risk pricing merely allows for such a "second-best" procedure.

183. *See supra* notes 13, 15 and accompanying text.

the power of the free market and maximizes the ability of interested groups to interfere in risk-based pricing and regulation. It also reduces the uniform application of risk information because regulators may differ in their interpretation of premium information. Varied interpretation of premium information would minimize further the ability of deposit reinsurance to induce changes in bank risk-taking.

A compromise could be achieved by allowing some portion of the reinsurance premium to be set on the basis of premium information obtained from the market, while simultaneously permitting some regulatory discretion in adjusting the market price of the premium. This compromise would frustrate the design of the private reinsurance program by devaluing the market's evaluation of bank safety. Nonetheless, the compromise position would be an improvement over retaining the current, entirely internally dictated deposit insurance system.

In addition to these three uses of premium information, reinsurance also will increase the monitoring of banks. The FDIC will obtain better information about specific, risky activities pursued by banks, as well as about banks' relative risk ranking. Premium information also enables Congress to review the consistency of FDIC action with market imperatives when it undertakes an evaluation of further reform measures.

VII. Conclusion

A private, free-market reinsurance system will succeed only if reinsurance transactions provide sufficient returns to make entry into the industry profitable for the reinsurance companies. Consequently, the structure of the reinsurance market, embodied primarily in the standard contract, will determine whether or not reinsurers will enter the market. Start-up costs, especially those involved in establishing reinsurer loss data, also may delay the point at which reinsurance provides a meaningful range of prices to the FDIC. The wide availability of tools required for establishing bids will decrease costs as reinsurers develop experience in evaluating the risk of bank failure, thus stimulating further entry into the industry. Although some banks may never attract private reinsurance business, the experiences of General Reinsurance and Reliance National indicate that the majority of banks will be

eligible candidates for reinsurance coverage.[184] The FDIC may devise cost incentives to lower the number of banks unable to obtain private reinsurance coverage, while seriously troubled banks need not be reinsured at all to establish better risk information.

Prices set by reinsurers may not correspond precisely to the prices that the FDIC should charge banks for deposit insurance. This results from a divergence of reinsurer and FDIC interests, and leads to two obstacles to a successful reinsurance program. First, reinsurance premiums do not equal the costs of the FDIC (although they do not impede relative risk rankings). This problem prevents the FDIC from pricing deposit insurance based directly on reinsurance premiums. Short-term contracts, for example, will cause reinsurers to charge lower premiums because they will not face the same loss horizon as the FDIC. This type of divergence can be overcome, either by adjustment of contract terms or through use of relative risk pricing or relative risk regulation.

Divergence resulting in distortion of reinsurers' relative risk perceptions of government action or inaction, such as FDIC restraint or CRA requirements, poses the second obstacle. In some contexts, such as the too-large-to-fail scenario, the FDIC may easily predict reinsurers' expectations about FDIC action, thus enabling the FDIC to determine how much to adjust primary premiums to account for adjustments made by reinsurers. In regulatory bias cases, however, it is more difficult to determine the reinsurance industry's expectations. In these situations, reinsurer expectations may obscure the relative risk of individual banks. Such irreversible relative risk distortion, if sufficiently severe, eliminates meaningful use of premium information by the FDIC except for the most broad relative risk regulation purposes. Regardless of the relative risk information generated, reinsurance offers the FDIC an additional, unique benefit. Not only will the private market have incentives to monitor bank safety and soundness, reinsurers also will benefit by reporting this information directly to the FDIC, thus increasing the likelihood that regulators and the market will respond cooperatively to any changes in a bank's condition.

184. *See supra* part IV.A.

From this analysis, the FDIC's dual roles of regulator and primary insurer pose the most difficult hurdle for reinsurance. The problem may be most clear in the case of reinsurance, but it is equally at issue in every other market-based reform. So long as the FDIC retains regulatory power over banks, the market will adjust for that regulation. If regulation responds to factors other than bank risk, the market will incorporate these extraneous factors that may have no relationship to bank risk. This is true, for example, in the subordinated debt model,[185] in which debt holders will account for the probability of application of the too-large-to-fail doctrine. This also holds true in private primary or coinsurance scenarios,[186] situations in which insurers will price on the basis of expected regulatory restraint or assistance. The isolation and reduction of regulatory "noise" while preserving protection against depositor losses and bank systemic risk remain the primary challenges facing deposit insurance reform.

The Pilot Program currently before the FDIC provides a comparatively low cost and effective method to experiment with bringing the FDIC closer to the market because the program operates within the current framework of FDIC insurance and will generate information over a wide variety of banks. Over a period of time sufficient to allow reinsurers to develop a sound actuarial base, the Pilot Program could develop invaluable information about how the private market evaluates banks and how the role of the FDIC distorts the private market's perception of bank risk. This information will retain importance for all market reform proposals for deposit insurance, and it may help the FDIC find the long-term solution to harnessing the free market.

185. For an analysis advocating the use of subordinated debt to promote better bank risk-taking, see Douglas D. Evanoff, *Preferred Sources of Market Discipline*, 10 YALE J. ON REG., 347 (1993).

186. *See* Ely, *supra* note 4; Wallison, *supra* note 4.