



Key Considerations When Designing a Differential Premium System

- Guidance for Developing Differential Premium Systems -

Introduction

As part of fulfilling its mission, the International Association of Deposit Insurers (IADI) has undertaken researches to develop general guidance for countries considering the adoption of differential premium systems. The first guidance on differential premium system was introduced in 2001 by the Financial Stability Forum (FSF) Working Group on deposit insurance which was the forerunner of IADI. In 2005, IADI developed more detailed and comprehensive guidance in this area through issuing "[General Guidance for Developing Differential Premium Systems](#)". This Research Letter is prepared to highlight the issues addressed in this 2005 guidance paper and principally focuses on different approaches and premium categories to differentiate bank risk.¹

When deposit insurance systems are funded through ex-ante premium assessments on member financial institutions, policymakers have a choice between a flat-rate premium or a differential premium system that is differentiated on the basis of an individual institution's risk profile.² Flat-rate premium systems have the advantage of being relatively easy to understand and administer. Therefore, a flat-rate system might be suitable, given the potential difficulties associated with the design and implementation of a differential (or a risk-based) premium system. Most newly established or transitional deposit insurance systems have adopted flat-rate assessment scheme.³ Flat-rate systems, however, do not take into consideration the level of risk that a bank poses to deposit insurance system and can be perceived as unfair in that the same premium rate is charged to all insured financial institutions regardless of their different risk profiles. Primarily for these reasons, differential premium systems have become increasingly popular among deposit insurers in recent years.

According to the IADI guidance paper, the primary objective of most differential premium systems is to provide incentives for banks to avoid excessive risk taking and to introduce more fairness into the premium assessment process. However, it is difficult to find satisfactory methods of differentiating risk; obtain reliable, consistent and timely information and; ensure that rating criteria are transparent. As well, differential premium systems require authority, resources and information requirements to administer the

¹ The guidance paper (1) discusses issues for deposit insurance systems that are associated with developing and implementing differential premium systems; (2) examines the advantages, disadvantages and trade-offs associated with various approaches to these systems; and, (3) provides guidance with respect to these issues. The paper also includes case studies of six country deposit insurers which are adopting differential premium systems such as Argentina, Canada, France, Taiwan, Turkey, and United States. See page 3 of the guidance paper.

² Differential premium system is also called risk-based premium system.

³ See pages 52-59 of "Guidance for Developing Effective Deposit Insurance Systems, Volume II," FSF at following web site:

<http://www.iadi.org/html/App/SiteContent/CDIC%20Volume%20II.pdf>.

As well, see International Deposit Insurance Survey (IDIS) on the following web site:

<http://www.iadi.org/html/Default.aspx?MenuID=209>.

system appropriately.⁴ Hence, differential premium systems are not be suitable for all deposit insurance systems at all times. In this regard, the guidance paper mentions that it is important to perform a situational analysis that reviews country specific conditions and factors; identify gaps between existing conditions and more-desirable situations, and; thoroughly evaluate available options.⁵

Approaches Used to Differentiate Bank Risk

One of the most challenging aspects of developing a differential premium system is finding appropriate methods for differentiating among the risk profiles of banks. The guidance paper suggests that the approaches used to differentiate risk among banks and assign premiums should: (1) be effective at differentiating banks into appropriate risk categories; (2) utilize a wide variety of relevant information; (3) be forward looking; and, (4) be well accepted by banking industry and financial safety-net participants.

The approaches can be categorized into quantitative, qualitative and a combination thereof. Quantitative approaches mostly try to use measures that are factual or data driven to categorize banks for premium assessment purposes. Factors that are commonly considered for such systems usually include:

- A bank's adherence with regulatory capital requirements or other measures of the quantity, quality and sufficiency of a bank's capital;
- The quality and diversification of a bank's asset portfolio both on-and off-balance sheet;
- The sufficiency, volatility and quality of a bank's earnings;
- A bank's cash flows (both on- and off-balance sheet) and ability to generate and obtain sufficient funds in a timely manner and at a reasonable cost;
- The stability and diversification of a bank's funding; and
- A bank's exposure to interest rate risk, and where applicable, foreign exchange and position risk.

The advantage of quantitative approaches is that they rely on relatively objective factors and data and are reviewed as being transparent and less open to argument than more subjective approaches. However, the principal drawback is that their effectiveness is heavily dependent on reliable, consistent and timely data – which may be difficult to obtain in many financial systems. Furthermore, even when suitable data are available and the methodology employed is widely accepted, systems which rely primarily on quantitative criteria do not allow for consideration of important qualitative factors about a bank which may contain valuable information on the management and mitigation of risk.

On the other hand, qualitative criteria approaches generally rely on a number of qualitative factors to categorize banks into different categories for premium assessment purposes. The primary method used is reliance on some form of regulatory and

⁴ IADI guidance also points out that a balance needs to be struck between requiring necessary information for the classification of banks into premium categories and concern that the demands of the system not be unduly burdensome to banks. See page 15 of the guidance paper.

⁵ Situational analysis incorporates reviewing the state of the economy, structure of banking system, public attitudes and expectations, the strength of prudential regulation and supervision, the legal framework, and the soundness of accounting and disclosure regimes. See page 4 of the guidance paper.

supervisory judgement or rating system and information such as adherence to guidelines, standards, compliance measures or other supervisory or deposit insurance requirements. CAMEL(S) is one of the most well-known qualitative methods incorporated to categorize banks into different categories.⁶

The advantage of qualitative approaches are that they can provide important information on the current and future risk profiles of banks, which may not be captured by quantitative factors alone. However, such systems have drawbacks in that they are generally less transparent and utilize a higher degree of judgment and discretion compared to quantitative approach. As well, qualitative approaches by themselves do not give sufficient consideration to important quantitative factors. Thus, combined approaches which use both quantitative and qualitative measures to categorize banks are the most common differential premium systems.⁷

Premium Categories and Assignment of Premium Rates

Deciding on the number of premium categories is also an important consideration when designing a differential premium system.⁸ Using a large number of categories has the advantage in that it may result in less significant premium distinctions between categories and could provide greater risk differentiation between banks. Hence, it could potentially result in fewer requests for category review from banks. However, a large number of premium categories can increase the complexity of the system. As well, it may reduce the significance of, and therefore the incentive for, banks to move from one premium category to another.

In this regard, FDIC recently proposed to consolidate the number of assessment risk categories from nine to four with the evidence that the existing nine categories are not all necessary and some of the categories contain few, if any, institutions at any given time.⁹

In determining premium rates to apply to categories, the guidance paper suggests that rates should be set to ensure that the funding requirements of the deposit insurance system are met and to provide effective incentives for the sound risk management of banks. In order to help assess the correct premium rate to charge for each category, some differential premium systems have conducted simulations, which apply rates to the different categories to determine the impact on overall premiums collected and the relation this has to the total funding requirements of the insurer. As well, the spread

⁶ Although this approach may include quantitative elements, a high level of judgment is usually employed in determining weights and qualitative factors such as the quality of management may be heavily emphasized. See page 7 of the guidance paper.

⁷ An important consideration in these systems is the relative weighting between quantitative and qualitative factors. The tendency among the systems studied seems to weight more heavily quantitative elements than qualitative factors. See page 9 of the guidance paper.

⁸ Some insurers (e.g. FDIC and CDIC (Taiwan)) use up to nine premium categories while others (e.g. Canada) use four categories. Instead, the premium charged is a continuous function linked to the risk profile of the bank in Argentina and France. See page 10 of the guidance paper.

⁹ Recited from FDIC Press Releases "FDIC Proposes New Risk-Based Insurance Assessment System" dated July 11, 2006. For further information, please visit the following website: <http://www.fdic.gov/news/news/press/2006/pr06070.html> and see the Risk-Based Assessments proposal attached in the Press Release.



between the various premium categories should be as wide as possible to provide a significant incentive for banks to improve their risk management practices.

Others

The paper also suggests guidance on: transition issues from flat-rate to differential premium system; transparency of the bases and criteria used in a differential premium system; appropriate balance between the desire to promote accountability, discipline and sound management through disclosure and the need to ensure confidentiality of information, and; the need for updating and fine-tuning of a differential premium system.

Where to find the guidance paper?

The General Guidance for Developing Differential Premium Systems can be accessed in the IADI website: [Guidance Paper – Differential Premium System](#).

Question of the Month for Deposit Insurers

The purpose of this initiative is to provide our audience with updated information on frequently-asked questions by deposit insurers.

1. If your deposit insurance system is using target fund ratio method, what is the optimum (i.e. target) level of your deposit insurance fund (e.g. X.XX% of total deposits of the financial sector or X.XX% of total insured deposits)?
2. If you are adopting a differential premium assessment scheme, how many premium categories exist in your risk assessment system and what is the premium rate for each category?

This Research Letter was issued on 22 September 2006. The editor is looking forward to active participation on the "Question of the Month" from deposit insurers throughout the world and hopes to receive as many responses as possible by 20 October 2006. The results will be addressed in the upcoming Research Letter.

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