Deposit Insurance Reforms in India State of the Debate *

I am honoured at being invited to inaugurate this seminar on Deposit Insurance Reforms in India. As you are aware, reform in deposit insurance is a crucial component of financial sector reforms. The importance accorded to this area is reflected in the composition of the Committee on Reforms in Deposit Insurance which had eminent bankers and academicians as members besides all the three Deputy Governors of Reserve Bank including myself. Union Finance Minister Shri Yashwant Sinha had mentioned this item as a major agenda item for reform in his last budget address to the Parliament. The issue is also topical in the sense that at the international level, the Financial Stability Forum (FSF) which has been convened by the G7 Finance Ministers and Central Bank Governors to promote international stability in the wake of the East Asian financial crisis, has already created a Study Group on Deposit Insurance. This Study Group has recently published an "International Guidance on Deposit Insurance" as part of the consultative process.

2. In India, the Report on the Reforms in Deposit Insurance in India was submitted to the Governor, RBI in October 1999. We have had extensive informal discussions within the Reserve Bank and with the Ministry of Finance on the recommendations of the Report. We had also initiated consultations with various sections of the financial sector to examine the recommendations of the Report and it is in this context that I am happy to note the response to this Seminar organised by NIBM at the initiative of its Chairman Mr. M.G.Bhide and Director Mr. Ganti Subrahmanyam. I am sure that the deliberations here will be rich, fruitful and will provide us vital inputs in the implementation of the recommendations of Report.

3. The main issues regarding Reforms in Deposit Insurance in India are :

(i) Need for reform in the present system of Deposit Insurance in India;
(ii) Criteria for risk-rating of banks and risk-based pricing of deposit insurance ;
(iii) Whether the deposit insurance cover should be extended to Non Banking Finance Companies and other Financial Institutions ;
(iv) Role of the Deposit Insurance Corporation as a liquidator and receiver ; and
(v) Institutional issues of the Deposit Insurance Corporation.

With your permission, I would like to flag certain issues for discussion in each of these areas.

Need for reform in the present system of Deposit Insurance in India

4. As you are aware India was one of the earliest countries to introduce deposit insurance way back in 1961. Later, in 1978, credit guarantee schemes were also appended to the deposit insurance schemes. The Deposit Insurance and Credit Guarantee Corporation (DICGC) has been handling both credit guarantee and deposit insurance claims reasonably well. But the credit guarantee schemes were not viable and even banks found it unattractive at a later stage forcing them to opt out. Similarly the flat fee based deposit insurance scheme had created moral hazard issues. In fact the need for reforms in deposit insurance was pointed out by Narasimham Committee on Banking Sector Reforms (1998) and others as well.

5. One of the fundamental issues in the debate on financial architecture is the objective of a deposit insurance system. There is a certain amount of consensus that the principal objective of a deposit insurance system is to protect small deposits and to contribute to the stability of the financial system. Given these objectives, should participation in deposit insurance system be mandatory or voluntary ? Once this issue is addressed, the second question is how the objectives of deposit insurance system can be achieved ?

6. Policy makers have a number of instruments to achieve objectives of deposit insurance system viz. imposing relatively low insurance average limits, applying some form of co-insurance, etc. It is in this background that the issue of the limit of deposit insurance cover in India, which is at present Rs.1 lakh, has to be seen. In India there have been demands to raise the insurance cover limit. Although the Report has not recommended any change in the deposit coverage limit, it has recommended introduction of a limited co-insurance for deposits between Rs. 90,000 to Rs. 1 lakh. Research and international best practices show that the deposit insurance cover should ideally be twice the amount of per capita income. In India, Rs. 1 lakh deposit insurance coverage limit would be 6 times our per capita income; Africa has the highest coverage which is 6.2 times, U.S. has 3.2 times and Europe 1.6 times. A related issue is the issue of introducing the concept of per depositor concept for post insurance cover. As you are aware, at present holding of deposits in the 'same right and capacity' has resulted in numerous separately insured accounts within a single bank through separated insured rights and capacitities like joint accounts. Besides issues such as inclusion of foreign currency deposits has also been examined by the Committee. Views of the distinguished participants on these issues would be welcome.

7. One of the controversial issues in the Indian context was the operation of the Credit Guarantee Fund, which was in deficit in recent times. This scheme was similar to the 'paybox system', which meant that the DICGC was largely confined to paying claims on its credit guarantees. This had considerably affected the viability and sustainability of deposit insurance system in India since both the activities were to be handled by the same institution. One of the recommendations of the Report is to dispense with the Credit Guarantee schemes altogether and rename DICGC as Deposit Insurance Corporation (DIC). SIDBI has decided to enter the field of credit guarantee which would take the burden off the DICGC managing credit guarantee functions.

Criteria for Risk Rating of Banks and Pricing of Deposit Insurance

8. It has been universally agreed that a flat fee based deposit insurance system provides adverse incentive and promotes moral hazard issues. The Report has recommended the introduction of risk-based insurance. Here there are many issues – what should be the basis of assessment of risk profile of banks. The literature points to FDIC model of supervisory rating (CAMELS), risk adjusted assets basis and option pricing models. Besides these, are there any more approaches to risk-based pricing of insurance ? Given the multiple regulatory and supervisory framework for co-operative banks, is there a need to address this issue differently ? Another related issue is the size of the deposit insurance fund – should it be like FDIC - 1.25 per cent of insured deposits or 2 per cent as the Report has recommended. In the US the best banks do not pay any insurance premium and whether such a scheme is feasible in the Indian context is one more issue, which needs deliberation.

Should deposit insurance be extended to deposits of NBFCs and FIs

9. An issue that has raised some controversy is the extension of deposit insurance cover to deposits mobilized by NBFC's and FI's. I must confess that this issue has been the most delicate one confronted by the Committee. The Report had recommended against the extension of deposit insurance cover to NBFC's for the time being and suggested that the matter be re-examined later when the supervisory mechanism concerning the NBFCs is fully stabilised. As regards FI's, the Report has not considered favourably the extension of the deposit insurance cover. In this context, it would be important to discuss whether the

insurance is intended to safeguard the payment system alone or it has to discharge certain social responsibilities as well.

The Role of DIC as a Liquidator / Receiver

10. At present DICGC is a passive player in the financial scene, with its role confined to 'paybox' in the case of a bank failure. The Report has recommended that DIC should be vested with powers to appoint liquidator/receiver in the case of failure of insured entity - to appoint parties to take over the assets, sell them and realise the proceeds to meet the liabilities of the insurer. This involves untying a number of legal knots. At present several enactments including Bank Nationalisation Act and State enactments on co-operatives present hurdles in DIC acting as receiver/liquidator. For example, under the nationalization act, only the parliament has the power to close a nationalized bank. The legal issues involved in this respect, like the right to take over the assets of failed entities and realise the proceeds to meet liabilities of the insurer, are similar to those confronted by banks in the recovery of NPAs.

Institutional Issues

11. Besides there are a number of institutional issues as well. Although the Report had recommended on FDIC model of deposit insurance system except the supervisory role, DIC does need to monitor financial health of the insured entities. The Report has recommended a well-defined platform for exchange of information between DIC and the Reserve Bank, which include access to inspection reports, post-inspection discussions and to be actively involved in action plans for banks and in compliance with the action plans.

12. I hope the above issues and other issues mentioned in the Report will merit your attention and we look forward to your views which would have a bearing on our future course of action. I am sure we will have very useful deliberations.

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* Inaugural address at the" Seminar on Deposit Insurance Reforms in India" for Chairman of Banks at National Institute of Bank Management, Pune on August 19, 2000.