

# **Report on Reforms in Deposit Insurance in India**

## **SUMMARY AND RECOMMENDATIONS**

Reforming the deposit insurance system is one of the major items of the second phase of financial sector reforms in India. The Narasimham Committee Report on the *Banking Sector Reforms* (1998<sup>1</sup>), while focusing on the structural issues, observed:

"Deposit insurance has increased public confidence in the banking system, promoted savings in bank deposits and has enabled banks to perform the intermediation function more effectively... Deposit insurance and the aversion to bank failures could create a moral hazard that distorts the incentives for banks and create competitive distortions... The Committee is of the view that there is need for a reform of the deposit insurance scheme. In India, deposits are insured up to Rs.1 lakh. There is no need to increase the amount further. There is, however, need to shift from the 'flat' rate premiums to 'risk based' or 'variable rate' premiums..." (paras 5.30 to 5.42)

1.2. In India, the feasibility of extending deposit insurance to non-banks, which mobilize substantial financial resources from the so-called small depositors, has become another compelling force behind reforming the deposit insurance system. The concern arises from the fact that several non-banks in the country are prone to failure. The Shere Committee (1997) and the Vasudev Committee (1998<sup>2</sup>), which went into this aspect, advised against extending deposit insurance to the non-banks on the grounds of moral hazard, among others. In fact, the Committee on Banking Sector Reforms (1998) also endorsed this view. Thus, given the increasing signs of vulnerabilities in certain segments of banks and non-banks, a review of the deposit insurance system was overdue.

1.3. It was in the above-mentioned context that the RBI constituted, on April 9, 1999, an Advisory Group and a Working Group under Shri Jagdish Capoor, Deputy Governor to look into this issue. The Groups consisted of the following persons:

### **Advisory Group**

- 1) Shri Jagdish Capoor, Deputy Governor Chairman.
- 2) Dr. Y.V. Reddy, Deputy Governor.
- 3) Shri M.G. Bhide, Former Chairman, Bank of India.
- 4) Shri S.H. Khan, Former Chairman, IDBI.
- 5) Dr. Ganti Subrahmanyam, Director, NIBM.
- 6) Dr. Ajay Shah, Professor, IGIDR.
- 7) Shri A. Chandramouliswaran, E.D., DICGC.

### **Working Group**

- 1) Shri V.S.N. Murty, CGM, DNBS, RBI.
- 2) Shri M.R. Das, Chief Manager, SBI.
- 3) Dr. Mathew Joseph, ICICI.
- 4) Shri J.P. Sharma, GM, DICGC.

- 5) Shri K.V. Subba Rao, DGM, UBD, RBI.
- 6) Dr. D. Ajit, Director, DEAP, RBI Convenor.

Shri S.P. Talwar, Deputy Governor was a permanent invitee.

1.4. The terms of reference of the Working Group are as follows:

- a. Review the role of Deposit Insurance in financial sector and economic developments, including a review of the international experience with regard to Deposit Insurance.
- b. Conduct a detailed survey of the nature of Deposit Insurance in India –instruments, institutions and regulatory legal framework.
- c. Propose changes in the existing system in regard to deposit coverage, institutions to be brought within the ambit of the Deposit Insurance, regulatory systems to be put in place in the case of each category of institutions accepting deposits from public as a prerequisite for extension of the Deposit Insurance, risk-based premium and the parameters relevant for the assessment of the risk in regard to each category of the institutions and the ownership and capital of the existing Deposit Insurance Agency.
- d. Consider any other matter referred to it by the Advisory Group.

The major recommendations of the Report are as follows:

### **Coverage of Deposits**

#### **Types of Deposits Covered**

The Group recommends exclusion of CDs from the deposit insurance coverage. The Group also recommends that deposit insurance cover should not be extended to deposits taken as cash collaterals as also to deposits which are created by transferring subordinated liabilities, at least 6 months prior to a bank failure/ moratorium, whichever is earlier (Para 4.10).

#### **Institutional Coverage**

The Group recommends that while the deposit insurance cover for banks would continue to be compulsory, it would not be obligatory for the Corporation to provide it (Para 4.18). Banks, which at present enjoy the deposit insurance cover but do not meet the following criteria, should be excluded from the purview of deposit insurance: (i) Non-compliance with CRAR prescriptions (not mandatory for RRBs and co-operative banks) and (ii) Entities with CAMEL rating of "C" or below consistently for three years. Besides, if the Corporation notices any deterioration of the financial position of the weak banks within the stipulated three years, deposit insurance coverage may be withdrawn (Para 4.20).

The DFIs are not under the same regulatory regime as that of banks. As they transform themselves to banks or NBFCs, as envisaged by the Khan Working Group, and would in the former case be covered under Deposit Insurance (Para 4.21).

It is premature to extend deposit insurance cover to NBFCs. But denying their access to deposit

insurance cover indefinitely may not be prudent. Once these entities are adequately regulated and supervised, and there is some degree of regulatory parity vis-à-vis banks extension of deposit insurance could be considered. For this purpose, a review may be made after two years (Para 4.25).

### **Level of Deposit Insurance Coverage**

The Group recommends no change in the present deposit insurance coverage which, at present, is Rs.100,000 per depositor in the same right and capacity. But given the relatively high deposit coverage, a limited coinsurance for deposits between Rs.90,000 and Rs. 1 lakh with a cover of 90 per cent is recommended; deposits upto Rs. 90,000 will, however, continue to be covered at 100 per cent (Para 4.14).

### **Deposit Insurance Fund**

Two deposit insurance funds may be instituted, one for the commercial banks and the other for the co-operative banks (Para 4.37). Maintaining a deposit insurance fund of 2 per cent of the insured deposits is thought to be reasonably adequate. As in the case of FDIC, whenever a particular fund falls below the threshold level, the premium for that segment will have to be altered in tune with the change in the risk profile. In the case of DIF exceeding the target level, insurance premium will have to be adjusted downwards (Para 4.38). To test the waters, the Corporation may explore possibilities of re-insuring 2.5 per cent of the insured deposits (Para 4.39).

### **Premium System**

Risk-based pricing of the deposit insurance premium is recommended in lieu of the present flat-rate system. In fact, the introduction of risk-based pricing would minimize moral hazard. The risk-based pricing of deposit insurance should be set high enough to cover the expected reimbursement that would be needed in the event of one or more bank failures and vary with the riskiness of the individual bank -with weak or poorly capitalized banks being forced to pay more. It would be desirable to base pricing of risk-based premium on the latest available CAMELS rating. In the case of entities, which do not have a reliable CAMELS rating (like RRBs and co-operative banks), one may have to opt for flat-fee based deposit insurance till the CAMELS database becomes available. However, the flat-fee based premium will be higher than the lowest/best premium rate for the scheduled commercial banks (Para 4.33).

Banks, which do not report data to the deposit insurance agency in time and thereby increase the asymmetry of information, may be levied a penalty of 50 to 100 basis points more deposit insurance premium (Para 4.33).

### **Withdrawing Credit Guarantee Fund**

The function of credit guarantee on loans may be withdrawn from the Corporation and the DICGC renamed as "Deposit Insurance Corporation" (Para 4.51).

## **Capital of the Corporation**

The capital of the Corporation may be fixed at Rs.500 crore and contributed fully by the Reserve Bank. The capital increase should be in a phased manner and be done only after securing the income-tax exemption. Besides, it should also have a lender of last resort facility from the central bank or the Government. Ideally, it can have collateralised liquidity support from the Reserve Bank and financial support from the Government to meet any contingencies (Para 4.41).

## **Tax Concession**

Keeping in view the social obligations served by the Corporation and also the position that the Corporation is not a company within the meaning of the Companies Act, 1956, the Corporation should be exempted from payment of corporate tax, as was the practice before December 1986. In fact, the FDIC is exempt from corporate tax (Para 4.43).

## **Board**

The Corporation should not have any nominee from the insured entities in its Board. The representatives of the supervisors of the commercial banks and co-operative banks of fairly senior ranks should be in the Board. In addition, five directors may be nominated by the Reserve Bank (Para 4.44).

## **Inspection and Supervision**

A well-defined platform be statutorily mandated where periodical exchange of information between the Corporation and the Reserve Bank shall take place. The Corporation shall have access to inspection reports, post-inspection discussions, and to be actively involved in action plans for banks and in compliance with action plans (Para 4.45).

## **Role of Liquidator and Receiver**

The Corporation should be assigned the role of liquidator and receiver. In this respect, the Corporation should be vested with powers to appoint liquidator/receiver in the case of failure of the insured entity; to appoint parties to take over the assets, sell them and realize the proceeds to meet the liabilities of the insurer; to take steps and to adopt suitable measure for the reconstitution of the insured entity or for the amalgamation of the insured entity with any other institution (Para 5.7).

## **Public Awareness Programme**

The general depositors, even sometimes the sophisticated ones, are not aware of the facility of deposit insurance in India. With the changing times, there arises a need for the deposit insurance agency to educate the people about the safety nets available for financial entities through various media. Secondly, branches of various banks should be advised to display clearly in the branches that the depositors' money is insured up to Rs.1 lakh to elucidate the point. Thirdly, the deposit insurance agency must develop a suitable logo, which would be displayed in the bank branches,

account opening forms, etc., so as to exude necessary confidence among the depositors (Para 5.13).

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1. Government of India, (1998) *Report of the Committee on Banking Sector Reforms*, April, New Delhi (Chairman: M. Narasimham).
  2. Government of India (1998) *Report of the Task Force on Non-Banking Finance Companies*, October (Chairman: C.M. Vasudev), New Delhi.