Deposit Insurance – The Indian System

Address by Smt. Usha Thorat, Chairperson, Deposit Insurance and Credit Guarantee Corporation, at the 5th IADI-ASIA Regional Committee Meeting and International Conference, March 28-29, 2007, at Hanoi, Vietnam.

Ladies and Gentlemen,

It gives me great pleasure to participate in this very stimulating conference. Equally delightful is this opportunity to visit the charming city of Hanoi. The economic progress and improvement in human development indicators in this country is admirable indeed.
Being an exclusive gathering of deposit insurers world over, it is both a pleasure and a challenge to address you on the occasion of IADI s 5th Hanoi ARC annual general meeting. The recent years have seen significant changes in the financial systems world over, which are becoming more interrelated, and more complex. These rapid changes require us to constantly review and revise our policy responses. The main point that I will be making today is that, in this changing financial environment, we need to ensure that both supervision and deposit insurance, which are the two critical features of the financial safety net, evolve to meet the challenges of this new world.

Deposit insurance – historical perspective

Importance of deposit insurance has risen significantly in the last two decades. During this period, waves of systemic crises in banking have affected most of the countries around the globe. There have been as many as 112 episodes of systemic crisis in 93 countries and 51 episodes of borderline crisis in 46 countries (Caprio and Klingebiel, 1999). Total fiscal costs incurred in the 1997 Thai and Korean banking crises exceeded 30 percent of GDP, and in Indonesia, budgetary costs for the banking crises approached 50 percent of GDP (World Bank, 2001). Notwithstanding the increase in total fiscal costs, full costs of these crises go beyond direct fiscal costs in terms of welfare and loss of GDP.

In India, the issue of depositor protection came to the fore in 1938 on the failure of the Travancore National and Quilon Bank, the largest bank in southern India followed by the banking crisis in Bengal (Eastern part) between 1946 and 1948. In the early 1950s, both the Rural Banking Enquiry Committee and the Shroff Committee adverted to the advantages of insuring bank deposits. It was, however, felt that the measures be held in abeyance till the Banking Companies Act, 1949 came into force and comprehensive arrangements were made for the supervision and inspection of banks by the Reserve Bank of India. With the subsequent failures of Laxmi Bank and the Palai Central Bank in 1961, which shook the confidence in the banking system, the Reserve Bank responded quickly with a blue print for insuring bank deposits. After the passage of the Deposit Insurance Corporation (DIC) Bill in 1961, the Deposit Insurance Act, 1961 came into force on January 1, 1962 and the Deposit Insuran ce Corporation commenced functioning under the aegis of the Reserve Bank of India. Incidentally, the Reserve Bank, in 1971, had also promoted the Credit Guarantee Corporation of India aimed at encouraging commercial banks to cater to the credit needs of hitherto neglected sectors, particularly the weaker sections, by providing guarantee cover to loans and advances granted by credit institutions to small and needy borrowers under priority sector lending. With the integration of the deposit insurance and credit guarantee functions, the Deposit Insurance and Credit Guarantee Corporation (DICGC), as it is presently known, came into being in July 1978.

Incidentally, the Corporation is presently not operating credit guarantee schemes, as no credit institution is currently participating in any such schemes.

Financial safety net for banking sector

Financial safety nets are erected to make systemic banking breakdowns less likely and to limit the disruption and fiscal costs generated when they occur. Given the faster pace of liberalization and globalization, maintaining financial stability has become an all-pervasive objective. Financial institutions that accept deposits from the public are important in the economy because of their involvement in the payment system, their role as intermediaries between depositors and borrowers, and their function as agents for the transmission of monetary policy. Banks are in the business of assuming and managing risks. By their very nature, being highly leveraged, banks are vulnerable to liquidity and solvency problems, among other things, because they transform short –term deposits into longer- term, less liquid loans and investments. They also lend to a wide variety of borrowers whose characteristics are not always readily apparent. However, there is no guarantee that banks by the mselve s will assume the level of risk exposure consistent with their deposit liability profile. Thus, safety and soundness of the financial sector is a critical objective of any government. Hence the importance of strong and viable financial safety nets is being increasingly recognized in the vast majority of countries.

Financial safety nets generally have the following components: prudential regulation and supervision, lender of last resort, deposit insurance and a clearly defined resolution mechanism for banks in distress. Deposit insurance is a key tool in protecting small depositors and ensuring public confidence in the banking system. Where banks are publicly owned such insurance is less critical than when banks are privately owned as there is implicit assumption of bail-out when banks are owned by the government. However even when privately owned and controlled, there could be issues of being 'too big to fail' or systemic issues, which go beyond merely protecting the interest of small depositors or maintaining depositor confidence and are directly or indirectly related to ensuring financial stability.

Indian Financial system – an overview

The Indian financial institutions, comprising banks and non banks, are characterised by functionally varied and geographically widespread network of commercial banks, co-operative banks and non banking companies and firms. Banking in India has a well-developed and extensive financial infrastructure consisting of a vast network of more than eighty thousand branches. Currently, there is only one kind of banking license given by RBI that is valid for all activities - domestic, forex, wholesale and retail. Investment banks and mutual funds are under the securities regulator and do not accept public deposits. The commercial banking segment in India comprises public sector banks, private sector banks and foreign banks. Regional Rural Banks (RRBs) are licensed under a separate charter and are sponsored by mostly public sector banks that have 35 % ownership, with 50 % with the Central Government and the remaining15 % with the State government. Co-operative banks in Indi a came into being after the enactment of the Agricultural Credit Co-operative Societies Act in 1904. The co-operative banking structure in India comprises Urban Co-operative Banks (UCBs) and rural co-operative credit institutions. UCBs consist of a single tier, viz., primary co-operative banks. The rural co-operative credit structure has a three tire system with the primary level, district level and the State level. It is traditionally bifurcated into two parallel wings, viz., short-term and long-term. The current legislative framework provides for dual control over cooperative banks with banking related

functions governed by RBI directives and regulations, while incorporation, audit and management are under the purview of the State Governments.

Features of the Deposit Insurance Scheme (DIS) in India

Pay box system versus extended mandate systems

The DIS in India is a paybox system. Apart from infusing confidence of the common man in the banking system, a Paybox systems performs three major tasks: (i) Contributing to the smooth functioning of the payments system (ii) Reducing the potential for moral hazard by placing limits on insurance or introducing coinsurance (not in India so far) and (iii) Facilitating the exit of problem banks. All these advantages have been experienced in India especially when dealing with the urban cooperative banks in the recent past (2005 to 2007) when 40 banks have been taken into liquidation without any disruption or crises. With extended mandate, the involvement of DICGC in recovery and problem bank resolution could help in reducing the cost to DICGC by having greater control on liquidation process and there by reducing moral hazard to a certain extent.

Ownership and governance

The overriding argument in favour of a government-run scheme is financial integrity. A privately run system may lack credibility without government support and enforcement mechanism, while a government backed system would be tempted to set low premiums for financial self-sufficiency under assurance that government will cover the financial gap. To price its product and to reduce moral hazard the private deposit insurer will have to have an information gathering arrangement with the bank whose depositors are being provided the cover.

The credibility of DICGC in India stems from the fact that it has a government backing as it has been created under an Act of Parliament and is wholly owned by the Reserve Bank of India. The operations of the DICGC are closely linked with the Reserve Banks regulatory functions for safeguarding interest of the depositors. The deposit insurance scheme basically aims at the protection of small depositors of banks, with the premium being paid by banks.

Moral hazard in deposit insurance – how avoided?

The deposit insurance scheme in India is an explicit scheme where the amount of cover is restricted to Rs 100000 per depositor (approximately about US $ 2300), representing a cover of about 3.5 times of per capita GDP. Furthermore, only deposits with banks are covered. In case of commercial banks, they are subject to adequate regulation and supervision. In case of cooperative banks there have been problems arising out of dual regulation. In the wake of a shake out in this sector in 2002, the confidence in the urban cooperative banks was severely shaken. In the recent period, a clear cut policy of having agreements with the State Governments for strengthening the sector by having a coordinated and convergent approach for taking regulatory action has been brought in and this has slowly brought back confidence in the sector. The process of weeding out insolvent banks in a non disruptive fashion was greatly facilitated by the existence of the explicit paybox scheme of the DICGC wit h depo sitors of most of the UC Bs being covered by the DICGC. At the same time stiff regulatory action has been taken to avoid moral hazard problems.

Market discipline

Greater reliance on market discipline is a very important measure to address moral hazard. In India, Reserve Bank as regulator requires a high level of disclosure by supervised entities. Since 2005, penalties levied on banks are placed in the public domain. Most commercial banks are listed and the stock exchanges' regulations on disclosure further aid transparency. Significant deviations between audit reports and results of supervisory examination are taken very seriously and auditors are held accountable for disciplinary action. In the recent period, the Reserve Bank under the MOU with the State governments has insisted upon professional firms to audit the cooperative banks.

Scope and coverage of Deposit Insurance Scheme

As already indicated, the guarantee is a limited one and stands at Rs.100000 per depositor since 1993. Fully protected deposit accounts currently stand at 94% of the total deposit accounts (up from 79 per cent in 1961) and the insured deposits formed 59% of the total assessable deposits (up from 23 per cent in 1961). The scope of the scheme is considered broad and its coverage reasonable (Table 1).

Table 1: Insured Deposits Coverage

(Position as at the end of September 2005)

1	Total number of accounts (in millions)	537
2	Number of fully protected accounts (in millions)	506
	Percentage of 2 to 1 (%)	94
3	Assessable deposits (in US $ billions)	407
4	Insured deposits (in US $ billions)	239
	Percentage of 4 to 3 (%)	59

The total number of insured banks currently stands at 2472 comprising 84 commercial banks, 133 RRBs, four Local Area Banks and 2251 co-operative banks. The participation of entities within the scheme is compulsory avoiding the possibility of adverse selection. The bank category-wise position is given below:

Table 2: Bank category-wise position

Banks	No. of Banks	Number of insured accounts (in millions)	Assessable deposits (US $ billion)	Insured deposits (US $ billion)	Percentage of (4) to (3)
(1)	(2)	(3)	(3)	(4)	
Commercial banks* (A)	221 (8.9%)	423 (78.7%)	369.46 (90.7%)	211.49 (88.3%)	57.2%
of which: RRBs	133 (5.4%)	43 (8%)	9.89 (2.4%)	9.01 (3.7%)	91.1%
Cooperative banks (B)	2251 (91.1%)	114 (21.3%)	37.56 (9.3%)	27.83 (11.7%)	74.1%

Total (A+B)	2472	537 (100%)	407.03 (100.0%)	239.32 (100%)	58.8%

Source: Trend & progress of banking in India (RBI), 2006; DICGC Annual Report, 2006

* including 28 public sector banks, 27 private sector banks, 29 foreign banks, 4 Local area banks and 133 RRBs
(Figures in brackets indicate share in total)

Among the cooperative banks the position is skewed with 367 District Central Cooperative Banks accounting for a major share in the total insured accounts and assessable deposits (Table 3)

Table 3: Component-wise break up of Cooperative banks position

Banks	No. of Banks	Number of insured accounts (in millions)	Assessable deposits (US $ billion)
Cooperative banks			
Urban cooperative banks	1853 (82.3%)	48 (42.1%)	16.78 (44.7%)
State cooperative banks	31 (1.4%)	4 (3.5%)	3.71 (9.9%)
District central cooperative banks	367 (15.3%)	62 (54.4%)	17.07 (45.4%)
Total	2251 (100%)	114 (100.0%)	37.56 (100.0%)

Source: Trend & progress of banking in India (RBI), 2006; DICGC Annual Report, 2006

Insurance Premium and Deposit Insurance Funds

Ideally, the insurance premia applicable must be weighted by some objective measure of risk of each entity, so as to avoid a situation where entities at higher risk are subsidized by those operating with a lower degree of risk. In India, we have a uniform premia irrespective of the risk and there is a view, especially among the commercial banks that they are subsidizing the cooperative banks. Work is, however, under way to move over to risk based premium system. There are two views on ex post and ex ante funding. It has sometimes been argued that the ex post financing of the scheme is preferable to the ex ante approach, because it is less onerous for the banks. On the other hand the interest foregone by banks on their contribution increases the value of the fund and feeds into lower premia. The Deposit Insurance Fund (DIF) of DICGC is funded by collection of premia from member-banks (ex-ante) and the fund is invested only in Central Government securities. The interest income from such investments and cash recovery of assets of failed banks also contribute to DIF. As on March 31, 2006 the Reserve Ratio stood at 0.86 pre cent. The DIF has, in the event of shortfall, a line of credit available from the Reserve Bank.

Information sharing and inter-relationship between the safety-net players

Information sharing and co-ordination of the activities of the deposit insurer and other safety-net players is a high priority for the majority of deposit insurers. Depending on country circumstances, insurers use both formal and informal mechanisms to exchange information and co-ordinate their activities. The common mechanisms are legal agreements, representation on the Board of Directors, MOUs and specially designated co-ordination committees. DICGC has an information sharing arrangement with Reserve Bank of India that enables it to arrive at the actuarial liability of the impact of liquidation / mergers / reconstruction on its Deposit Insurance Fund (DIF). Even though the, present act provides for a 'pay box' set up for DICGC, the information provided helps it to exercise the ex-ante option of deciding the deposit insurance premium to be charged from the insured entities to strengthen the DIF, thereby helping the Corporation to arrive at an appropriate pricing for the deposit insur ance cover. In India, a Deputy Governor of the Reserve Bank is the Chairperson of the Board of Directors of the Corporation. A representative of Government of India is also on the Board. DICGC maintains close liaison with the supervisory departments of Reserve Bank and NABARD for efficient discharge of its functions.

Reimbursing Depositors promptly

A basic function of all deposit insurance systems is to reimburse depositors promptly for the losses they would otherwise suffer when a financial institution closes. Reimbursements to depositors including the speed and convenience of payment vary across countries, and can affect public confidence in the capability of the deposit insurance system. As per DICGC Act, the Corporation is required to settle the claim of the depositors within two months from the date of receipt of the claim list from the liquidator. The liquidator is required to submit the claim list of depositors within 3 months of taking charge as liquidator. However, it is observed that liquidators of cooperative banks generally fail to submit the claim within the statutory time frame of 3 months, resulting in delay in settlement of depositors claims.

Delays in settlement of claims of depositors are one of our major concerns. Delay in submission of claim list by the liquidators is mostly due to delay in audit of accounts, poor maintenance of records /non-availability of proper records, deficiency in the claim list and inclusion of ineligible deposit accounts resulting into protracted correspondence with the liquidators, non production of required information/documents to the Chartered Accountants deputed for verification of claim list , filing of appeals against the liquidation order, by the directors of the bank and other stake holders etc. The power to appoint the liquidator for the co-operative banks vests with Registrar of Cooperative Societies. It is observed that usually, one liquidator is appointed for more than one bank for liquidation work and this duty assigned to him is in addition to his other regular duties. Often the liquidators do not have expertise or knowledge about banking practices and worki ng. They depend upon s taff of failed banks and external agencies for preparation of claim list. In spite of detailed guidelines issued to the liquidators, the claim list is not prepared strictly as per the provision of DICGC Act 1961 and guidelines.
The Corporation has taken various steps to reduce the time lag for depositors to get their dues vz. (i) periodically reviewing the position of receipt, settlement and pending claims, (ii) appointment of CAs for verification and certification of claim lists prepared by the liquidators, (iii) reducing the time lag between the date of liquidation and date of submission of claims (iv) list of common deficiencies observed are being provided to the liquidators, (v) conduct training programmes for the liquidators and State Government Auditors. Besides, the Corporation is also exploring ways for ensuring appointment of competent liquidators

The total amount settled by the Corporation towards depositors claims as on March 2006 along with share of commercial and cooperative banks and recovery performance is as follows:

Table 4: Amounts settled by DICGC along with recovery position – March 2006

(Amounts in US $ Million)

Category of Banks	No. of Banks	Amount Settled (% share)	Recovery Amount(% share)
Commercial Banks *	27	65.00 (14%)	20.00 75%
Co-operative Banks	147	400.00 (86%)	6.00 (25%)
Total	174	465.00 (100%)	26.00 (100%)

*(incl. Local Area Banks and RRBs)

Claims, Recoveries and Depositor Priority

In India, when the assets of failed banks, whose claims are settled by the Corporation, are disposed off, the liquidators/insured banks/transferee banks are required to repay the Corporation after making provision for expenses. This is another area where substantial improvements are required. Settlement of claims has always had precedence over all other matters in view of the statutory liability cast on the Corporation and the need for protecting confidence of the public in the banking system. Keeping in view of the need for recycling of funds, the Corporations recovery function also requires proper focus. While the overall recovery performance is far from satisfactory, the poor performance is more pronounced in the case of Cooperative banks. The liquidators in respect co-operative banks do not possess any special skills/ knowledge in realistaion of financial assets, leading to low realisation, both in terms of volume and cost. Further, there is a large gap in the valuation by the inspectors of the regulatory department and the actual amounts realised. The borrowers, encouraged by the legal delays, prefer to default and settle their dues at reduced levels. This translates into long drawn closure processes resulting in deterioration of quality of assets, higher costs of liquidation and lower net inflows. In the case of cooperative banks, once they are placed under liquidation, practically, there is no monitoring of the process of liquidation/ winding up and it is totally left to the liquidators appointed by the Registrars of Coperative Societies.

The Corporation has initiated several measures to improve the recovery performance, viz. (i) Corporation has set up a recovery cell to follow up and expedite the recovery process in respect of claims settled (ii) More proactive role in the post liquidation process till the bank is finally wound up by regulatory department, (iii) appointment of professionally qualified liquidators is being taken up by the Regulator at the TAFCUB meetings. Further, the Corporation has initiated action for suitable amendment to the relevant provision in the DICGC Act for according distinct priority to the Corporation in the recoveries so that there is no scope for ambiguity or misinterpretation of the DICGC Act.

Public Information and Awareness

A feature common to deposit insurers in many countries is the requirement that the member institutions be responsible for providing to the general public information provided by the

deposit insurer. Inadequate public awareness of deposit insurance contributes to lack of public confidence, thereby, eliminating any benefit that deposit insurance can bring to the stability of the financial system. The Corporation's public awareness program is established through a well-developed web-site with comprehensive information/ material. Further, a text on deposit insurance containing FAQs and necessary publicity material is forwarded to all banks for printing in different languages for the benefit of account holders. The availability of deposit insurance cover upto Rs.1,00,000/- for deposits held in the same capacity and same right is especially highlighted. Complaint cells have been set-up in all regional offices and wide publicity is given about them.

Our experience with a large cooperative bank failure

Before I end, I would like to share with you our experience in the failure of a huge cooperative bank in 2001

A Multi State Urban Co-operative Bank in Gujarat witnessed a sudden ‘run on its branches following rumours of its large exposure to a leading Stock Broker at Mumbai, who suffered huge losses in his share dealings. There was large-scale withdrawal of deposits resulting in severe liquidity problems for the bank. The bank was also holding a substantial amount of inter bank deposits from as many as 233 banks out of the 326 urban co-operative banks in the State. On account of the contagion effect of a large number of banks facing liquidity problems, there was a severe systemic risk for the cooperative banking sector in the state. In order to protect the interests of the depositors of the bank, to prevent a run on a large number of other banks and to protect the Co-operative Banking System in the state, the Government of India formulated a Scheme of Reconstruction for the bank with the approval of RBI, but for which the financial position of the cooperati ve banks in the state would have been adversely affected and the systemic impact would have been of very serious proportion. The Reconstruction Scheme envisaged infusion of funds, retention of existing deposits, c onverting call money borrowings from banks/institutions into term deposits, DICGC meeting its obligation in full to bank's depositors, management aspects etc. However, the reconstruction scheme has not performed as envisaged for various reasons including slow recovery of the bank's dues from its main defaulter.

Nevertheless, given the magnitude of the crisis at the time it broke out, the aftermath of the fallout on the cooperative banking system in the state has been mitigated to a large extent. The post crisis strategy has focused on identifying the banks which are not viable and paving the way for their smooth exit through mergers or liquidation, without disrupting the system. Breathing time has been provided to banks with a substantial exposure to the bank to insulate themselves in the event of any further adverse developments. The proactive strategy adopted by the DICGC and the central bank in handling the crisis especially as regards treatment of affected banks and repayment of public deposits has served to provide a pad for soft landing of the worst affected banks and revival of public confidence in the system.
Deposit Insurance indeed has far reaching significance. I hope, I have been able to give you a fairly detailed picture of the Indian System of deposit insurance. I conclude with my thanks to our hosts and to you all.

Thank you

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