Funding of Deposit Insurance Systems

Ladies and Gentlemen

It gives me great pleasure to be in the midst of the deposit insurers of the world. I have had the pleasure of meeting many of you at conferences in the past and I am delighted to see you again at Goa – a favourite tourist destination in India,famous for its beaches, churches and cuisine. I hope you find the time to enjoy what Goa has to offer in addition to conferring on the very relevant subject of "Funding Deposit Insurance System".

The theme of the Conference says it all - funding deposit insurance systemsis the crux of the matter. The global financial crisis has underscored the need for astrong and stable deposit insurance fund, without which, the credibility of the deposit insurance system can be eroded; it is also realised that a credible and transparent deposit insurance system is critical for maintaining public confidence in the banking system and thereby for financial stability. That the issue of funding is so relevant tothe credibility of the deposit insurance system is highlighted by the unprecedented decision this year by the Iceland Government to hold a referendum to approve orreject the terms of a state guarantee on the debts of the Depositors' and Investors Guarantee Fund, in particular a loan from the governments of the United Kingdomand the Netherlands to cover deposit insurance obligations in those countries.

It is quite clear that deposit insurance is not designed to deal with systemiccrisis of the proportions that we have witnessed and cannot be expected to be able to deal with a situation of widespread failure of banks. At the same time, given the contagious nature of bank failures, it is necessary that the deposit insurance fundsfactor-in the possibility of several banks failing simultaneously. In this context, I hope the conference will discuss the subject of how deposit insurers can determine theadequacy of the deposit insurance fund to be able to arrive at some agreement on the principles, if not the rules.

Deposit Insurance Premium

While the conventional wisdom has so far been on risk based premium involving assessment of risk of individual institutions, in the context of what we have experienced in the crisis, we may have to assess whether the premium based on the assessment of risk of individual institutions needs to be supplemented by a risk premium based on their contribution to systemic risk using some measure of size and complexity.

An issue that has been widely discussed in the context of the manner of charging premium for deposit insurance is the mitigation of moral hazard. Core Principles for Deposit Insurance Systems prescribe that moral hazard should be mitigated by ensuring, inter-alia, that the deposit insurance system contains appropriate design features. In India, we have not moved over to risk based premium but moral hazard is sought to be minimised through other design features, such as placing limits on the amount insured, excluding certain categories of depositors from coverage etc. The main reason for not moving over to the risk based premium system is the assessment of trade off between minimising moral hazard and placing additional burden on banks that are already weak. The banking system covered by insurance is extremely heterogeneous –ranging from large and strong commercial banks to small regional rural banks, urban cooperative banks serving local communities and rural cooperative banks. These ba nks serve the very important objective of financial inclusion and meet the requirements of sectors and communities not usually targeted by the larger commercial banks. Amongst these there are entities that are weak and the sector is in the process of being strengthened. The stability and

soundness of this sector is being enhanced by weeding out unviable banks through non-disruptive measures. Till majority of these banks meet the minimum standard prudential norms, we may have to continue with a uniform premium system which has an element of cross subsidisation. Moral hazard is also sought to be minimised by operating, through the supervisory mechanism, appropriate disincentives and penalties where there is discomfort on account of governance and risk management standards.

Some deposit insurers provide for refund of insurance premium when their target reserve ratios exceed a particular level. This practice could cut both ways inasmuch as the insurer may have to resort to collection of extra premium at the time of crisis when the system is already under strain. Whether some countercyclicality aspects could be introduced in the premium contribution is something which could also be discussed.

Income from Investments

The second important source of funding deposit insurance systems is income from investments. This income will obviously depend upon the size of the funds and the yield on relatively risk free investments. As such, older systems have an advantage inasmuch as they have accumulated a sizable level of corpus over a period of time. So far as DICGC is concerned, investments are permitted only in government securities. A portfolio approach of tracking a broad All Sovereign Bond Index is followed that which yields a reasonable rate of return. Only deposits mobilised by branches in India are covered by deposit insurance. In a systemic crisis situation, where market liquidity for even sovereign securities could be affected, it may have to be considered whether a collateralised back stop facility from the central bank could be thought of to enable the deposit insurer to meet immediate needs.

Recoveries

The third important source of funding of deposit insurance systems is recoveries from the assets of the failed banks. Principle 18 of the Core Principles for Effective Deposit Insurance Systems prescribes that the deposit insurer should share in the proceeds of recoveries from the estate of a failed bank. In some jurisdictions, deposit insurers have priority in the recovery over other unsecured creditors including larger depositors. In most countries the claims are subrogated to all depositors. In cases where the deposit insurer steps in with sizeable liquidity, there could be case for priority in recovery and in India we have taken this view where the State law accorded priority to other claims. Perhaps this is an issue which needs more examination.

Minimising Cost of Bank Resolution

Another way in which deposit insurance funds can be conserved is by adopting least cost solutions for bank resolution. The DICGC has a pay-box mandate under the DICGC Act, 1961. While the appointment of a liquidator or management of assets of the failed banks in India is not handled by the DICGC, the statute has assigned a role to the Corporation in resolution of troubled banks, either through a scheme of reconstruction or amalgamation with another bank. In such cases the Corporation is required to pay to depositors to the extent of shortfall in the asset coverage, up to the limits prescribed. Of late DICGC in close coordination with RBI has been using this provision for dealing with the legacy problem of insolvent cooperative banks rather than the liquidation option in case there are other cooperative banks or even commercial banks willing to take over such banks. Such solutions have the potential to serve as least cost option for resolution of troubled banks in the co-operative sector eve n within the existing legal framework. The incentive and advantage to the acquiring bank is transfer of branch licenses and

customer base. The realisation of bad assets in such cases is much better than in cases under liquidation. Moreover, depositors having deposits more than the insured amount also get back a substantial part of their deposits. At the same time, payout by the DICGC is substantially reduced. Moral hazard is sought to be reduced by restricting such solutions to the legacy cases and progressively bringing cooperative banks on par with commercial banks in terms of minimum prudential standards and supervisory rigour.

Line of Credit

In the context of funding deposit insurance, the availability of line of credit from the Central Bank / Government to overcome temporary liquidity problems in times of crisis is very important. In several countries deposit insurers heavily rely on such lines of credit. In India too there is a provision for such accommodation from the Reserve Bank of India. Though this facility is limited to INR 50 million (equivalent to a little over US dollar 1 million), it has never been used by the Corporation. A collateralised funding arrangement is something that may be explored when it is required to deal with situations where markets have become illiquid.

Taxation Issues

An important issue having a bearing on funding is taxation of income or surpluses available with the deposit insurance system. Taxation practice varies from country to country. In Asia region such income / surplus is exempt from tax in most of the countries, but there are certain countries3, including India, where tax is levied either on the premium income or on income from investments or the entire surplus of the deposit insurance system. In India, the entire net surplus of DICGC is subject to taxes. As a result, a major part of the funds collected by the Corporation by way of premium is paid to the government as taxes. You may be surprised to learn that DICGC is among the top five taxpayers in the country. Deposit insurance activity being a welfare activity to protect the interest of small depositors and help maintaining financial stability, there is a strong case for exempting deposit insurance from income tax. This will enable the deposit insurer to build up sufficient funds even to meet a situation of systemic dimensions.

Deposit Insurance for Financial Stability – some current issues

The recent financial crisis has highlighted the importance of deposit insurance in promoting financial stability. The steps taken by governments and deposit insurance systems all around the world have helped in restoring stability in the system but have also raised the issue of moral hazard, as aptly summarised by Sebastian Schich4 in his article published in one of the OECD Journals. Referring to the blanket guarantee extended by the Government in certain countries he says:

"While these measures did not address the root causes of the lack of confidence, they were nevertheless helpful in avoiding a further accelerated loss of confidence, thus buying valuable time. But they are not costless. First, like any guarantee, deposit insurance coverage gives rise to moral hazard, especially if the coverage is unlimited. Clearly, in the midst of a crisis, one should not be overly concerned with moral hazard, as the immediate task is to restore confidence, and guarantees can be helpful in that respect. Nonetheless, to keep market discipline operational, it is important to specify when the extra deposit insurance will end, and this timeline needs to be credible. Second, the co-existence of different levels of protection could give rise to unfair competitive advantages; vis-à-vis other forms of savings or vis-à-vis other deposit-taking institutions that do not enjoy the guarantee. Third, to make a guarantee

credible it is important to specify the manner in which it will be provided......... Looking ahead, a sharper policy focus will have to be placed on “exit strategies”, especially where unlimited guarantees have been extended. In this context, the fundamental question remains whether government guarantees can be a one-off proposition. There may be a general perception that once extended in one crisis, a government guarantee will always be available during crisis situations.”

As explained above, in all cases where emergency measures have been taken to overcome the situation arising out of the financial crisis, it is necessary to have an exit strategy with a credible timeframe. This is important for Asia Region also, where as many as five countries5 have temporarily extended blanket guarantee for bank deposits – most of them up to December 31, 2010. The issue is, however, not only confined to blanket guarantees but much wider, involving exit from several fiscal and monetary measures as well, taken earlier on an emergency basis.

To conclude, I must say that deposit insurance systems constitute an important element of the financial safety net having the twin objectives of protecting the interest of small depositors and promoting financial stability. Adequate funding of deposit insurance systems is crucial to achieving these objectives. Indeed, the theme of the conference is apt and the agenda for discussion has been drawn-up very thoughtfully – my compliments to the organisers and best wishes for success of the Conference.

Thank you

At the outset, on behalf of the Reserve Bank of India, I welcome you all to India and to this wonderful state of Goa. My thanks also to the Asia Regional Committee (ARC) of the International Association of Deposit Insurers (IADI) for giving an opportunity to the Deposit Insurance and Credit Guarantee Corporation (DICGC) to host this Conference. This event is particularly important for us because it is being hosted as a part of the Platinum Jubilee celebrations of the Reserve Bank of India (RBI).

Evolution of Deposit Insurance

Deposit insurance has historically been a reassuringly stabilizing force in a financial system notoriously susceptible to instability. In fact panics were a regular feature of American economic life even as banking was taking roots – most spectacularly during the Great Depression. It was the introduction of deposit insurance in 1933 that substantially reduced the vulnerability of American banks to runs.

Over the years deposit insurance has taken root all around the world. Collectively, we traversed a steep learning curve and learnt a number of lessons about the systems and processes of deposit insurance. The recent crisis has, however, thrown up a number of fresh questions about the financial sector, including about deposit insurance. Finding answers to these questions and addressing the consequent challenges is going to be the priority task for all of us in the financial sector. I want to talk about some of the issues, but first let me say a few words about deposit insurance in India.

Historical Perspective on Deposit Insurance in India

DICGC, a wholly owned subsidiary of RBI, is the second oldest deposit insurance system in the world. It was established in January 1962 initially only as a deposit insurance institution. However, in 1978 the Corporation was also entrusted with the responsibility of credit guarantee and was rechristened as the Deposit Insurance and Credit Guarantee Corporation (DICGC).The objective of extending guarantee cover to credit was to encourage commercial banks to extend credit to small borrowers belonging to weaker sections of society. But over time, it was felt that the credit guarantee schemes operated by the Corporation had outlived their utility and the schemes were discontinued. The Corporation has now reverted to being an exclusive deposit insurance system.

Over nearly 50 years, the DICGC has evolved and moved up the value chain - learning by doing as it were - and met many challenges along the way. By far the biggest challenge came in 2001 when a large co-operative bank in the state of Gujarat was in trouble. Since several banks, particularly many small co-operative banks, had exposure to this bank, its failure had the potential to precipitate a crisis in the banking industry. The Government and the Reserve Bank put in place resolution of this bank through a restructuring programme. The key element of this programme was proactive action by the DICGC towards prompt payment of claims to the depositors of the bank. This action by DICGC ensured that panic did not spread.

Global Crisis and Deposit Insurance

Let me now turn to the recent financial crisis. Though the crisis impacted the entire world, it affected different countries in different ways. After the collapse of Lehman Brothers in mid-September 2008, there was an abrupt breakdown of trust, which spread rapidly from the United States to other advanced economies, causing financial markets in all advanced economies go into seizure. Suddenly, there was a great deal of uncertainty about the extent of losses, the ability of banks to withstand those losses, the extent of risk in the system, where it lay and how it might explode. This uncertainty triggered unprecedented panic and almost totally paralyzed the entire chain of financial intermediation. Banks hoarded liquidity. Credit, bond and equity markets nearly froze. Several venerable financial institutions came to the brink of collapse. Massive deleveraging drove down asset prices setting off a vicious cycle. In such a situation, governments and regulators had to take extraordinary measures in a big way.

Not surprisingly, deposit insurance emerged as the most visible part of the financial safety-net in arresting a panic reaction. Several deposit insurance systems increased their insurance coverage limits; in some cases the governments extended blanket deposit guarantee. These measures went a long way in restoring public confidence in the banking system in economies where it came under serious threat.

Global Crisis and India's Response

That India was hit by the crisis dismayed many people. In the years before the crisis, the decoupling theory gained intellectual ascendancy. This theory held that even if advanced economies went into a downturn, emerging market economies would not be affected because of their improved policy framework, robust foreign exchange reserves, and sound banking systems. The crisis ruptured the credibility of the decoupling theory by engulfing almost every part of the world. India was no exception. The crisis spread to India through finance and real channels.

Importantly, the crisis also spread through the confidence channel. However, in sharp contrast to global financial markets which got paralyzed on account of a crisis of confidence, Indian financial markets continued to function in an orderly manner, even as the risk aversion of the financial system increased and banks became cautious about lending. The point to note is that, the global financial crisis did not pose any major threat to the banking system in India at any point of time. As such, the need for any special measures pertaining to deposit insurance did not arise. However, in line with the global trend, there was also some demand here to increase the deposit insurance cover. If one looks even at broad data, it becomes quite clear that this demand had no persuasive force. Under the existing insurance cover, number-wise almost 90 per cent of the deposit accounts are fully covered. Amount-wise, over 60 per cent of total insurable deposits are covered. We determined, therefore, that the co st-benefit calculus was not in favour of enhancing the deposit cover.

In India, the contagion of the crisis was effectively contained by coordinated fiscal and monetary measures taken by the Government of India and the Reserve Bank respectively. The results are evident from the marked improvement in the performance of the industrial sector in recent months - upturn in domestic and external financing conditions, revival of capital inflows, increased activity in the primary and secondary capital markets, softening of interest rates and substantial easing of liquidity conditions. GDP growth of 7.9 per cent during the second quarter of this fiscal (2009-10) was robust – up from 6.1 per cent in the previous quarter. There are, however, several challenges on the way forward including the timing and sequencing of exit from the expansionary fiscal and monetary policies. These issues are being debated all over the world and occupy the central place in our policy matrix too. The challenge for the Reserve Bank is to support the recovery process without compromising o n price stability.

Financial Stability

The global financial crisis has also underlined the critical role of central banks in systemic oversight of the financial sector and in preserving financial stability. This calls for a paradigm shift not only in banking but also in the prudential regulation of the banking sector. Financial stability needs to be understood and addressed both from the micro and macro perspectives. At the micro level, we need to ensure that individual institutions are healthy, safe and sound. But an important lesson of the crisis has been a reiteration of the fallacy of composition - that a collection of safe and sound financial institutions does not necessarily deliver a safe and sound financial sector. We need to take care of systemic stability as a separate and distinct obligation. This calls for safeguarding financial stability at the macro level through what has now come to be called macro-prudential regulation of the system as a whole.

Today, RBI is an active participant in several important international institutions that seek to promote more effective regulatory structures, and financial and systemic stability. We have, for some time now, been shareholders of the Bank for International Settlements (BIS) and member of the Committee on Global Financial System the Committee on Payment and Settlement Systems and the Markets Committee. Post-crisis, we have also become members of the Financial Stability Board and the Basel Committee on Banking Supervision (BCBS). And of course, we have been an active participant in the G-20 deliberations.

DICGC - Challenges for the Future

Let me now comment briefly on the challenges for DICGC on the way forward. One key challenge is reducing the time taken to settle claims. Though the Corporation has been able to

settle all claims within the statutory time limit, its goal is to go beyond the statutory prescription, and ensure settlement of claims within a few days of liquidation of a bank as against a few months taken now.Towards this end, effort is required in two directions. First, DICGC must have a computerised depositors' data base in respect of over 85,000 branches spread across the country. Second, the entire process of filing claims by the liquidator and their processing by the Corporation should be computerized with appropriate connectivity.The Corporation has already initiated steps to move in this direction by formulating an ambitious project of Integrated Claims Management System (ICMS).

The second challenge pertains to broadening the mandate of DICGC. DICGC is presently working as a pay box system. Going forward, we are examining the possibility of transforming it from a pay-box system to a system attending to all aspects of bank resolution. This may, however, require sweeping reforms including a thorough change in the DICGC Act, 1961. However, certain features of the financial sector supervision and regulation as prevailing in India may have to be kept in view. For example, it may not be necessary to have a separate supervisory machinery in DICGC independent of the Reserve Bank as is the practice in some other jurisdictions, notably the United States.

Deposit Insurance - Post Crisis

The global financial crisis has underscored the importance of a well designed explicit deposit insurance system in maintaining financial stability. By assuring depositors that they will get immediate payment to the extent of the insured amount, a deposit insurance scheme can contain financial contagion. Indeed, there are a number of contrarian examples to show that bank panics were exacerbated in situations where deposit guarantees were not explicit, not incentive compatible and did not have the resources to back their guarantee obligations. In order, therefore, to inspire the trust and confidence of stakeholders, a deposit insurance scheme must satisfy two criteria - first, it must be adequately funded, and second, it must have robust delivery systems in place to effect payments within, if not well within, the assured time.

This important lesson from the recent financial crisis has been clearly brought out in the Fifth Report (2007-08) of the Treasury Committee of the House of Commons, entitled "Run on the Rock". After analyzing the reasons for the run on the Northern Rock, the report concluded:

"All banks and building societies should be covered by a deposit insurance scheme, such that, in cases such as Northern Rock, or an even larger bank, the Government would not be required to step in to protect depositors."

The Report further observed that

"There should be a requirement in law that all insured deposits should have to be paid within a few days of a bank failing and calling on the deposit protection scheme."

The above observations are clearly self-evident. But every crisis has demonstrated how its root causes can be traced to the neglect of some basic tenets. An important preventive going forward will be to review the effectiveness of our deposit insurance schemes and repairing the deficiencies, if any, and strengthening the weak spots.

Deposit Insurance - Global Coordination

With increasing global financial integration, consistency in the basic principles that guide deposit insurance is essential to maintaining a level playing field internationally. In this context,

information exchange among deposit insurers gains importance. Today there are a large and growing number of cross border financial institutions functioning across multiple deposit insurance jurisdictions. There is need for clarity regarding the obligation of each deposit insurer in respect of each cross-border institution.While the 'Core Principles for Effective Deposit Insurance Systems' state that the deposit insurance already provided by the home country system should be recognised in the determination of levies or premium, there is need for a firm and shared understanding on this.

Relevance and Value of the Conference

I am glad to note that 'Funding of Deposit Insurance Systems' is the theme of the Conference. This is extremely relevant in the context of the present emphasis on promoting financial stability. I note from the schedule of the Conference that you will be addressing several aspects of funding of deposit insurance systems, including funding mechanisms and the management of funds.

I also note that there is an exclusive session for 'Core Principles for Effective Deposit Insurance Systems' with special reference to guidance on funding. It is indeed a rare privilege that we have, at this conference, distinguished speakers on the subject, not only from Asia, but from other parts of the world as well.

I would like to take this opportunity to flag for your consideration a few issues, which might be of importance to DICGC and many other deposit insurance systems around the world:

- In light of the recent experience which has challenged the concept of "too big to fail", is there a need to review the manner of defining 'risk' for the purpose of determining risk-based premium? How do we go about it?
- How do we factor-in the risk associated with all the nonbanking business of a financial conglomerate on its banking business? How should risk based premium factor in this risk?
- Should the entire income or the surplus of a deposit insurance system or any part of it be subject to taxes?
- Is it possible to define an international benchmark or at least a standard methodology for determining a benchmark for the Reserve Ratio (Ratio of Deposit Insurance Fund to Insured Deposit), signifying the adequacy of Deposit Insurance Fund?
- What countercyclical measures should a deposit insurance system take to build up its funds for the rainy day?

Needless to say, this conference has come in at a very appropriate time. I do hope that your deliberations over the next two days will result in enhancing our collective understanding of deposit insurance and provide pointers for action.

I wish the Conference all success.