

Introductory

1.1 Deposit Insurance protects depositors against the loss of their deposits in case a deposit institution is not able to meet its obligation to the insured depositors. On the flip side, the parties to the deposit insurance viz. a bank and its insured depositors get an incentive to take more risk because the costs of risk, in whole or in part, are borne by others, generally a deposit insurance agency, e.g. Deposit Insurance and Credit Guarantee Corporation (DICGC) in India. This behaviour of the parties is termed as *moral hazard*. The financial crisis of 2008 has, along with the other issues concerning regulation and supervision, brought the debate on the moral hazard aspect of Deposit Insurance back to the table. The IADI (International Association of Deposit Insurers) Core Principles for Effective Deposit Insurance Systems (2014) have elaborated in detail on this issue.

Flat rate versus Risk based premium

1.2 The Deposit Insurance Systems around the world have evolved over time by reforms adopted by various jurisdictions based on experience, international developments, guidance from supra national bodies like IMF, IADI and other environmental changes from time to time. These reforms also included efforts to reduce the moral hazard, for example, through limited coverage levels and scope; differential premium systems (DPSs); and timely intervention and resolution by the deposit insurer or other participants with such powers in the financial system safety-net. Most deposit insurance systems initially adopt an ex-ante flat-rate premium system because they are relatively simple to design, implement and administer. However, these systems were open to criticism in that they do not reflect the level of risk that banks pose to the deposit insurance system. Flat-rate premium systems have also

been viewed as being unfair as “low-risk” banks are required to pay the same premium as “higher-risk” banks. With no inbuilt incentive for “higher risk” banks to improve their risk profile, a flat rate system would accentuate the moral hazard problem. Therefore the primary objective of most differential premium systems has been to provide incentives for banks to avoid excessive risk taking, minimise moral hazard and introduce more fairness into the premium assessment process. Introducing fairness into the system bolsters industry support for deposit insurance.

1.3 Keeping this perspective in mind, there has been an increasing recognition among the deposit insurance agencies around the world about the need for introduction of a DPS based on the risk profile of banks, also often referred to as Risk Based Premium (RBP). Keeping in view the challenges involved in devising a rating model and other related issues, the IADI prepared a note detailing General Guidance for Developing Differential Premium Systems (2011) for the Deposit Insurance Agencies (DIAs), which intended to switch over to RBP.

1.4 The Federal Deposit Insurance Corporation (FDIC), US, made a beginning in 1993 by introducing RBP. Since then, 26 of the 75 member jurisdictions of the IADI have adopted risk-based premium as on December 31, 2013.

Risk Based Premium in India

1.5 In India, the commercial banks, Regional Rural Banks (RRBS), Local Area Banks (LABs) and co-operative banks are covered by deposit insurance with the premium being charged at a flat rate of 10 paisa for Rs. 100. Historically, deposit insurance claims on the DICGC have generally originated on account of failure of co-operative banks, as these institutions have been more susceptible to frequent failures due to a number of factors. It is worth mentioning that the last claim settled in respect of a commercial bank was way back in 2002. As a result, a perception of cross-subsidisation in operation of the deposit insurance system has gained currency.

1.6 DICGC Act 1961 enables the Corporation to charge the premium at different rates for different categories of the insured banks. Various Committees constituted by the Government of India, Reserve Bank of India (RBI) and DICGC in the past have made recommendations for the introduction of risk-based premium for banks. The Narasimham Committee Report on the Banking Sector Reforms (1998), while focusing on the structural issues, recommended introduction of risk based premium system in lieu of the flat rate premium system. This view was echoed by the Capoor Committee on 'Reforms in Deposit Insurance in India' (1999). The Committee on Credit Risk Model (2006) constituted by the DICGC also recommended the introduction of risk based premium, to begin with, for Scheduled Commercial Banks (SCBs) and Urban Co-operative Banks (UCBs). Notwithstanding the recommendations of these committees in the past, the implementation of risk-based premium could not be operationalised, *inter alia*, due to co-operative and regional rural banks (forming over 90 per cent of insured banks) being under restructuring until recently, absence of robust supervisory rating for all insured banks especially co-operative banks, etc.

1.7 In India, there has been a persistent demand from stakeholders and public representatives in the recent past for a hike in deposit insurance cover from the current level of Rs.0.1 million. A hike in cover without calibrating the premium rates to the risk profile of the insured banks only exacerbates the moral hazard. Recognising this, it has been felt that introduction of RBP may be taken up to make ground for considering raising the insurance cover from the present ceiling of Rs 0.1 million.

1.8 Accordingly, a Committee on Differential Premium System for Banks in India (Chairman: Shri Jasbir Singh) was constituted vide Notification dated 31 March 2015 (copy annexed) to make recommendations for the introduction of risk based premium in India.

Composition of the Committee

1.9 The Composition of the Committee was as follows:

1. Shri Jasbir Singh	Executive Director	Chairperson
2. Smt. Meena Hemachandra	Executive Director, Reserve Bank of India	Member
3. Shri. Rajesh Mokashi	Deputy Managing Director, CARE Ratings	Member
4. Smt. Suma Varma	PCGM, DCBR	Member
5. Shri. Sudarshan Sen	PCGM, DBR	Member
6. Smt. Malvika Sinha	PCGM, DCBS	Member
7. Dr. S. Rajagopal	CGM, FSU	Member
8. Dr.A.R. Joshi	Adviser, DSIM	Member
9. Shri. Sonjoy Sethee	CFO, DICGC	Member
10. Smt. Jaya Mohanty	Adviser, DICGC	Secretary

The Terms of Reference

1.10 The terms of reference of the Committee were as under:

- i. To devise and recommend a model of risk assessment for banks, both commercial and co-operative.
- ii. To make recommendations for adapting the model of risk assessment so derived to the calculation of premium to be paid to DICGC.
- iii. To study international methodology of risk based premium to ensure that the rating system developed is in tandem with international best practices.
- iv. To make recommendation for institutionalising the flow of information between the supervisory Departments of RBI, insured banks and the DICGC at appropriate frequencies to facilitate the calculation of the risk rating.

- v. To recommend a matrix of premium rates corresponding to risk-ratings in a manner that there is least disturbance to the existing premium inflows.
- vi. To make recommendations for frequency and timing of revision in premium rates and relating the timing of revision to appropriate risk-rating reference date.

Approach of the Committee

1.11 Given the terms of reference and coverage of the wide spectrum of banking systems, viz commercial and co-operative banks, RRBs and LABs, the Committee deliberated on the following aspects in developing an appropriate framework for the rating model and the various other facets of risk-based premium.

- (1) A robust and simple model with qualitative and quantitative inputs appropriately weighted, with a good predictive power
- (2) Simulating the model for rating the banks into groups for risks and thereby assigning premiums as per the risk ratings
- (3) The data issues like frequency, quality, and integrity.
- (4) Issues connected with confidentiality of ratings, sharing of ratings with the banks, etc.
- (5) Frequency of setting/resetting premium rates with appropriate reference dates
- (6) The transition path

The Committee held three meetings on April 17, May 19 and on August 27, 2015 to crystallise its thoughts on the above issues.

Structure of the Report

1.12 The report is organised into five Chapters including the Introductory chapter. Chapter 2 provides the practice and experience on risk-based rating and methodologies adopted by some deposit insurance agencies in advanced and emerging market economies. Chapter 3 provides an analysis of

key considerations in developing a rating model for the introduction of risk-based premium, while the Chapter 4 presents the model. Chapter 5 summarises the key recommendations of the Committee.

Acknowledgments

1.13 The Committee benefitted from the fruitful discussions and deliberations by the Members of the Committee. The Committee wishes to thank officials of CARE Ltd., viz., Shri Arun Kumar, Shri Anuj Jain, and Shri Pankaj Naik for technical inputs in the provision of a rating model. The Committee places on record its appreciation for painstaking efforts put in by Dr. Pradip Bhuyan, Director, Banking Studies and Risk Modelling Division, DSIM in conduct of an elaborate simulation exercise and helping firm up the various ingredients of the model. Shri Alope Chatterjee, Shri R. Ravikumar, Shri Navin Nambiar and Shri D.P. Singh of Department of Banking Supervision and Shri Bhaskar Birajdar and Shri S.M. Mane of Department of Co-operative Banking Supervision were extremely helpful in providing data on various parameters relating to scheduled commercial banks and urban co-operative banks. Thanks are due to officials of NABARD Smt. Vijaya Lakshmi and Shri S.H. Khemchandani for provision of data relating to RRBs, and State and District Central Co-operative Banks. The officials of Reserve Bank of India, viz., Shri Ajay Kumar Sinha, Smt. Kumudini Hajra, Smt. Nimmi Kaul, Smt. Reeny Ajith were helpful in providing inputs to the deliberations of the meetings. The Committee would like to thank the officers of the Corporation Shri B.K. Panda and Shri M. Ramaiah for their support in the preparation of the Report. Ms. Darshana Naik and Ms. P. Pinto of DICGC deserve thanks for secretarial services.