# Usha Thorat: Funding of deposit insurance systems

Keynote address by Mrs Usha Thorat, Deputy Governor of the Reserve Bank of India, at the International Conference organised by the Deposit Insurance and Credit Guarantee Corporation (DICGC) with the 8th Asia Regional Committee Meeting, Goa, 18 January 2010.

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Ladies and Gentlemen

1. 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”.

2. The theme of the Conference says it all – funding deposit insurance systems is the crux of the matter. The global financial crisis has underscored the need for a strong 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 to the credibility of the deposit insurance system is highlighted by the unprecedented decision this year by the Iceland Government to hold a referendum to approve or reject 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 Kingdom and the Netherlands to cover deposit insurance obligations in those countries.

3. It is quite clear that deposit insurance is not designed to deal with systemic crisis 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 funds factor-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 the adequacy of the deposit insurance fund to be able to arrive at some agreement on the principles, if not the rules.

## Deposit insurance premium

4. 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.

5. 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 banks 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.

6. Some deposit insurers provide for refund of insurance premium when their target reserve ratios exceed a particular level[1]. 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

7. 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

8. 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

9. 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

[1] Hong Kong (3%), Indonesia (2.5%), Russia (Stops collection of premium after RR reaches 10%).

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 cooperative sector even 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

10. 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

11. 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 countries[2], 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

12. 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 Schich[3] in his article published in one of the OECD Journals. Referring to the blanket guarantee extended by the Government in certain countries he says:

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[2] India, Kazakhstan, Philippines & Taiwan.

[3] "Financial Crisis: Deposit Insurance and Related Financial Safety Net Aspects" (2008) by Sebastian Schich, Principal Administrator, Financial Affairs Division, Directorate of Financial and Enterprise Affairs, OECD; hyperlink http://www.oecd.org/dataoecd/36/48/41894959.pdf.

*“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.”*

13. 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 countries[4] 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.

14. 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.

[4] Thailand (Up to 10.08.2011), Hong Kong, Malaysia, Singapore & Taiwan (All up to 31.12.2010).