

CHAPTER II

THE NATURE AND ROLE OF DEPOSIT INSURANCE

Investors' confidence is critical to sound and stable functioning of financial markets. A domestic safety net for ensuring investors' confidence includes mechanisms that have the following dual objectives: (a) Containing the disruptive consequences of financial distress once it arises (crisis management), and (b) by the same token, instilling confidence in the financial system so as to limit the risks of strains emerging in the first place (crisis presentation). A domestic safety net³, thus, covers three main elements: emergency liquidity assistance, deposit protection schemes and exit policies. History reveals that in the absence of such safety net arrangements, financial failures impose enormous costs on the individual investors and the economy as a whole. Deposit insurance is one such safety valve through which the losses of the so-called "unsophisticated" depositors of banks can be plugged, albeit to a stipulated limit, in case banks fail, and thereby help arrest cataclysmic impact of bank runs.

2.2 The chapter is structured as follows: Section I deals with the objectives and characteristics of deposit insurance, Section II describes the international experiences in this regard, Section III focusses on countries which have no deposit insurance schemes and Section IV constructs the issues relevant for reforming the deposit insurance system in India.

³ See (a) Colomiris, C.W. (1997), *The Postmodern Bank Safety Net: Lessons from Developed and Developing Economies*, Washington D.C. The AEI.

Section I

Objectives of Deposit Insurance

2.3 Deposit insurance can substantially reduce the external diseconomies arising out of bank failures. These externalities are broadly of two types: (i) micro-externalities and (ii) macro-externalities. The micro-externalities refer to an agent and justify deposit insurance on the grounds of protecting small depositors, increasing competitive equality among different size banks and protecting the bank as a financial intermediary performing a unique role in the economic system. The macro-externalities, on the other hand, look upon deposit insurance as a mechanism to prevent the disastrous consequences ensuing from contagious bank runs, primarily relating to the money supply and the payment system. Net currency outflows from the banking system cause unexpected variations in the aggregate stock of money, reduce money supply and eventually settle in economic recession and subsequently depression.

2.4 One of the most important arguments for deposit insurance concerns the protection of small depositors. A ‘small depositor’ is conceptualized as one who generally does not fully understand bank risks, who may panic on rumours regarding a bank’s solvency and is assumed to be more adversely affected in a bank run. In such cases deposit insurance intends to protect the ‘naïve’ behaviour of depositors who, no doubt, want a reasonable return, but require safety and liquidity, first and foremost. Deposit insurance, by protecting these ‘unsophisticated’ depositors, aims at preventing bank runs caused by rumours.

2.5 The second objective of deposit insurance is to facilitate competitive equality among banks in the sense that without an effective protection system, large banks might be considered as intrinsically safer than their smaller counterparts. This might make

(b) Bank for International Settlement (1999), *The Design and Operation of Safety Nets*, September.

smaller banks less lucrative, and they might not be able to compete with the larger banks. In other words, the safety net of deposit insurance helps improve competitive efficiency in the banking system.

2.6 Banks provide the payment mechanism among economic agents including banks themselves, a function so very fundamental to the working of the economic system. Because of this, a single bank failure could have serious transmission effects involving agents in a systemic risk. Thus, thirdly, deposit insurance protects the payment system, too.

Insurance vis-à-vis Deposit Insurance

2.7 Both deposit insurance and general insurance contracts are based on same insurance principles. In a general insurance contract the insurer promises to third party beneficiaries that they will be wholly reimbursed in the event that the parties carrying the insurance do not pay their claims. The same principle when applied to deposit insurance would read as: the agency – the insurer – promises to pay depositors – third party beneficiaries – that they will be wholly reimbursed in the event that the banks – the parties carrying the insurance contract – do not redeem deposits – pay their claims. It is evident from this that deposit insurance uses some typical tools to protect itself against risk. It : (i) frames rules for the applicability of the insurance, (ii) collects information on the likely risks that the insured parties will impose on it, (iii) practises coinsurance and (iv) limits the amount of the insurance offered to the insured.

2.8 But deposit insurance differs from a typical insurance contract in a more fundamental sense. The nature of risks to be insured against by deposit insurance and other kinds of insurance are different. The probability of a bank failure does not belong to the same actuarial category as the probability of death, illness, fire or car accident. In these cases the probability of the risk to occur is determinable and hence measurable in terms of a fair premium for the insurance. In contrast, the risk of bank failure is difficult to determine, measure and price.

Section II

The International Scene

2.9 The US introduced deposit insurance in the 1930s. The proliferation of crises during the 1980s and 1990s has led a large number of countries to initiate, or consider instituting, an explicit system of deposit insurance. In fact, 52 of the 68 countries now known to have an explicit Deposit Insurance System in operation established it during the past 19 years. During the same period, 18 countries reformed the system that they already had in place, often to improve its incentive structure in the light of experience (IMF (1999⁴)). Table 2.1 and 2.2 provides, in brief, the important characteristics of the deposit insurance systems across the globe.

Table 2.1: Characteristics of Deposit Insurance Scheme (DIS) by Continent

Continent	Number of DIS		Compulsory DIS		Has a Fund		Administration					
							Private		Joint		Government	
	1995	1999	1995	1999	1995	1999	1995	1999	1995	1999	1995	1999
Africa	4	10	4	4	4	10	0	1	0	6	4	3
Asia	7	9	4	5	7	9	1	0	2	1	4	8
Europe	23	32	11	30	13	24	7	10	5	12	7	12
Mid East	2	3	1	3	1	2	1	0	0	2	0	1
Americas	11	14	6	13	9	13	0	2	4	2	6	10
Total	47	68	26	55	34	58	9	13	11	23	21	34

Source: Garcia, G (1999) "Deposit Insurance: A Survey of Actual and Best Practices", IMF Working Paper, 1999.

Table 2.2: Coverage of Deposit Insurance Scheme (DIS) by Continent

Continent	Coverage								Risk-adjusted Premiums	
	Household		No Inter-bank		No Forex		All			
	1995	1999	1995	1999	1995	1999	1995	1999	1995	1999
Africa	1	0	3	2	3	9	0	1	0	6
Asia	0	1	5	5	3	5	2	4	2	2
Europe	5	12	11	29	4	9	4	1	0	9
Mid East	0	0	0	2	0	1	1	1	0	0
Americas	0	3	2	7	1	3	1	4	2	4
Total	6	16	21	45	11	27	8	11	4	21

Source: Same as Table 2.1.

The US Experience

2.10 The US experience with deposit insurance stands as a unique experience, and the FDIC model became the role model for many deposit insurance systems in the developed and developing countries.

⁴ Garcia, G (1999) "Deposit Insurance: A Survey of Actual and Best Practices", IMF Working Paper No.54.

2.11 The US introduced deposit insurance at the national level with the signing of the Banking Act of 1933 on June 16, 1933⁵. This followed the massive deposit withdrawals and the wave of bank failures that accelerated during the period 1930-33⁶. The US Treasury and the 12 Federal Reserve Banks contributed to the capital of the FDIC. The FDIC has a five member Board of Directors, all of whom are appointed by the President of the US. The Comptroller of the Currency and the Director of the Office of Thrift Supervision are two of the five members. Deposit insurance was initially limited to US \$ 2,500 for each depositor, which was raised to US\$ 5,000 in July 1934. The member banks admitted to insurance under the initial scheme were assessed a premium at the rate of half a per cent of insurable deposits. This was changed to one-twelfth of 1 per cent of total deposits from August 1935.

2.12 The admission of banks to the deposit insurance scheme was based on certain entry standards. The minimum net capital (net of assets of worthless or of doubtful value including bond depreciation) required for safety was considered to be at least 10 per cent of deposits, and all banks not meeting this requirement at the time of admission, were reexamined during the first six months of 1934. After these two rounds of examinations – one at the time of admissions and the second for capital adequacy – the FDIC focused on developing permanent examination policies and procedures. They were meant to determine asset quality, identify practices leading to financial troubles, appraise management, and identify irregularities and violations of law.

⁵ Some states within the US introduced deposit insurance earlier. While not the first national deposit insurance system in the world (Czechoslovakia introduced it earlier), US's is the oldest and largest deposit insurance system still in operation (Tanoue, 1998 and Garcia, 1999, Footnote 16 at p.15)

⁶ About 9,100 banks failed during the four-year period, 1930-33 involving US\$ 6.8 billion. The crisis reached high proportions with state after state declaring bank holidays to prevent deposit withdrawals and by 4 March 1933, the Inauguration Day of President Franklin D. Roosevelt, every state in the Union had declared a bank holiday. One of the new President's official acts was to proclaim a nationwide bank holiday to commence on the 6th March and last four days (See FDIC (1998) History of

2.13 The supervisory role of the FDIC includes its power of approval required for banks which are not members of the Federal Reserve System (mostly State-chartered banks) to open new branches or reducing their capital. All insured banks need approval from the FDIC for merging or consolidating with non-insured institutions. If the FDIC find any insured bank follows unsafe or unsound practices, it is reported to the appropriate supervisory authorities and the bank's insurance can be terminated. The Corporation was also given the authority to make loans to, purchase assets from or provide guarantees to an open or closed insured bank to enable its merger or consolidation with another insured bank, provided the merger reduces or avoids the risk of loss to the Corporation. The Banking Act of 1935 entitled the FDIC to prohibit the payment of interest on demand deposits in insured non-member banks and to limit the rates of interest on savings and time deposits. The FDIC was also empowered to prohibit insured non-member banks from paying any time deposit before its maturity.

2.14 Federal deposit insurance was considered a success with the dramatic fall in bank failures after its introduction. The FDIC handled 370 bank failures from 1934 through 1941 and most of these were small banks. The Corporation had positive net income in all but the first year of operation and the insurance fund continued to grow. At the end of 1941 the fund balance constituted 1.96 per cent of insured deposits, the highest reserve ratio in the history of the FDIC. The success of the scheme was mainly due to the improved economic conditions, which have played an important role in improving the financial conditions of banks.

2.15 The deposit insurance fund continued to expand during the 1940s, exceeding US \$ 1 billion at the end of 1946. Many observers felt that a US \$ 1 billion fund was sufficient to cover almost any economic contingency. The Congress legislatively mandated repayment of the

original capital subscriptions. The US \$ 150 million contributed by the Treasury and \$139 million in capital stock purchased by the Federal Reserve Banks were fully repaid by the end of 1948.

2.16 Despite the repayment of capital, the fund had reached US \$ 1.2 billion and bankers had voiced concern that the premium rate was too high. Premium income had been growing at a high rate, reflecting the rapid growth in bank deposits during the war and post-war years. Deposit insurance charges were effectively reduced by the Federal Deposit Insurance Act of 1950, through a rebate system⁷. As a result, the effective premium rate fell to 3.7 cents per US \$ 100 against 8.3 cents per US \$100 (one-twelfth of 1 per cent) during 1934-49. Insurance coverage limit was raised from US \$5000 to US \$10,000 in 1950, to US \$15,000 in 1966 and to US \$20,000 in 1969.

FDIC in the 1970s and 1980s

2.17 The remarkable stability in the post-World War II period came to an end in the 1970s. The breakdown of the Bretton Woods par value system and oil shocks gave rise to exchange rate, interest rate and price volatilities and this had significant implications for banks. Banks also began to face stiff competition from non-banking companies and capital markets. Faced with diminished opportunities for commercial and industrial lending, banks moved into real estate lending, which adversely affected them when real estate markets slumped in the mid- and late-eighties. On the liabilities side as well, banks faced rising competition from non-bank financial intermediaries particularly the money market mutual funds (MMMFs); the ratio of MMMF balances to comparable commercial bank deposits (small time and savings deposits) rose from virtually zero in mid-1970s to 36 per cent in 1981 and, despite the abolition of most interest rate controls in 1983, this ratio rose further to 39.5 per cent in 1991.

⁷ According to the rebate system introduced in the Federal Deposit Act of 1950, after deducting operating expenses and insurance losses from gross assessment income, 40 percent was to be retained by the FDIC, with the balance to be rebated in the form of assessment credits to insured banks (FDIC, 1998 op.cit. p.43).

2.18 The insurance coverage was increased from US \$20,000 to US \$40,000 in 1974 and to US \$100,000 for deposits held by States and political sub-divisions. In 1978, the coverage was increased to US \$100,000 for individual retirement accounts (IRA) and Keogh private pension plan accounts. The deposit insurance coverage for all accounts was increased to US \$100,000 in 1980. This big increase, which raised the ratio of insurance cover to per capita GDP to almost nine⁸, was meant to facilitate the retention of large certificates of deposit (CDs) in many banks and savings-and-loan associations facing disintermediation in the context of high interest rates.

2.19 A number of banks failed in the 1970s and early 1980s, but those failures remained within historical levels. The picture soon began to change. From 1982 to 1991, more than 1,400 FDIC-insured banks failed with total insurance losses exceeding US \$1 billion in any of these years, rising to US \$6 billion in 1988, 1989 and 1991. The insurance fund, which had been growing till 1987, began to shrink, and with the mounting losses, it went into a deficit of US \$7 billion by the end of 1991.

2.20 The reserve ratio (ratio of the amount in the reserve fund to insured deposits) was determined to remain in the range of 1.10 per cent to 1.40 per cent and the rebate of assessment credit percentage was to be adjusted if the ratio falls outside this limit. As the losses to the insurance fund increased, assessment credits were reduced during 1981-83 and stopped thereafter. The effective insurance premium rates, which were below 4 basis points during 1970s, rose rapidly as insurance losses mounted throughout the 1980s and early 1990s. The rates were raised to 23 basis points in 1991.

2.21 The FDIC played an important role in the USA in the early 1980s, when the banking and thrift industry faced a financial crisis of

⁸ In 1999, after 19 years of this hefty increase in insurance coverage, the ratio has reached a more incentive-compatible level of three times the per capita GDP. This very high coverage is attributed to be one of the factors behind the S&L crisis in the 1980s (Garcia, 1999, p.14, footnote 13).

magnitude not seen since the Great Depression of the 1930s. As a result of the crisis, depositors lost US \$ 1.4 billion and as many as 9,755 banks were closed down. The insolvency of FSLIC insurance fund ultimately led to the creation of the Resolution Trust Corporation in August 1989. During 1980 to 1994, 1,617 federally insured banks with US \$ 302.6 billion in assets were closed or received FDIC financial assistance. During the same time, 1,295 S&L institutions with US \$ 621 billion in assets also were either closed by the FSLIC or the RTC or received FSLIC financial assistance.

2.22 At the end of 1990, there were approximately 900 out of 41,000 thrifts which collapsed costing the insurer US \$ 300 billion and the taxpayer US \$150 billion [Benston and Kaufman (1997⁹)]. Bank failures which averaged six (mostly small banks) per year from 1946 to 1980, also rose exponentially, averaging 104 per year during 1980s. It has been argued that bank failures as opposed to S&L failures were mainly due to regional recessions magnified by restrictions that prevented banks from operating across State lines (Glass - Steagall Act of 1933) thereby limiting their ability to reduce risk through geographical diversification. The FDIC tried to reduce demands on its insurance funds by merging problem banks with healthy banks. Consequent upon the liquidation of a large number of banks, the Federal Savings and Loan Insurance Corporation (FSLIC) insurance fund was reported to be at negative \$75 billion in 1988, and the ratio of losses to all insured deposits rose to 1.48 per cent, a level exceeded only in 1933. The FSLIC, which is the insurance fund for the thrift industry, was declared insolvent in early 1987, as was its regulator, the Federal Home Loan Bank Board (FHLBB). Instead, two new deposit funds were created, the Bank Insurance Fund (BIF) and Savings Association Insurance Fund (SAIF) to replace the dissolved FSLIC.

⁹ Benston, G.J. and Kaufman, G.G. (1990) 'Understanding the Savings and Loan Debacle', *The Public Interest*, **99**, 79-95.

2.23 The U.S. Government has provided necessary legislative support for effective functioning of FDIC. Until the 80's, most of the FDIC's resolution powers emerged from the legislations enacted in 1930's and 1950's. As a fall-out of the S & L crisis of the early 80's, the Congress passed the Competitive Equality Banking Act (CEBA) in 1987. This Act contained several provisions that were particularly significant for the FDIC. It expanded the Corporation's emergency inter-State acquisition authority and permitted it to establish temporary bridge banks.

2.24 In the U.S., concerns about moral hazard were an important part of the legislative response to the banking and thrift crises that affected the financial industry from 1982 to 1994. The banking crisis also involved 1,617 banks that failed or were kept open with the FDIC support. The Congress questioned the approaches the financial regulatory agencies had taken to the crises. The U.S. Federal Reserve System was criticized for lending from the discount window to too many banks that were, or became, insolvent. The FDIC was criticized for providing financial support to keep many insolvent banks open.

2.25 To limit moral hazard issues, the U.S. Congress enacted the legislation titled the Federal Deposit Insurance Improvement Act (FDICIA) of 1991. This law touched upon a wide range of regulatory issues, such as, Prompt Corrective Action (PCA) for failing institutions. The federal regulators were required by the FDICIA to establish five capital levels, ranging from the well-capitalised to the critically undercapitalised that would serve as a basis for the PCA. As an institution's capital declines, the appropriate regulator must take increasingly stringent measures. One of the aspects of PCA that directly affects the FDIC's approach to resolutions prescribes mandatory measures for critically undercapitalised institutions, which are banks with tangible equity to or less than 2 per cent of total assets. The provisions of the FDICIA also require that a receiver must be appointed not later than 90 days after an institution falls into the critically undercapitalised category. The appropriate Federal

Regulatory Authority can grant up to two 90-day extensions of the PCA if it is of the view that those extensions would better protect the relative insurance fund from long-term losses. The FDICIA also requires that if the FDIC does not liquidate a failing institution, then it must take the least costly resolution alternative.

Federal Deposit Insurance Corporation Improvement Act (FDICIA)

2.26 By 1991, more than 1,000 commercial banks with aggregate assets exceeding US \$500 billion were on the FDIC's list of problem banks, many of which were expected to fail. The Bank Insurance Fund was depleted and became insolvent by US \$7 billion. The response was the Federal Deposit Insurance Corporation Improvement Act (FDICIA) enacted by the Congress in December 1991. The important provisions of the Act are the introduction of:

- a risk-based premium system.
- prompt corrective action by regulators.
- least-cost resolution of failed banks.
- treatment of banks “too big to fail”.
- higher borrowing authority for FDIC.

Risk-based Premiums

2.27 When the Congress enacted federal deposit insurance in the U.S. in 1933, it was intended as a tool for helping small banks and lower-income individuals and for restoring the liquidity of bank deposits [Calomiris and White (1994¹⁰)]. Even, during that time, some authors had pointed out that deposit insurance could have incentive effects. For example, Emerson (1934¹¹), and Scott and Mayer (1971¹²) argued that deposit insurance would intensify risk-taking incentives at banks unless it was properly priced. But it was not until the massive failure in the U.S. of thrifts (Savings and Loan Association and

¹⁰ Calomiris, C.W. and White. (1994) 'The Origins of Federal Deposit Insurance' in Goldin, C and Libecap, G. (Ed.) *The Regulated Economy: A Historical Approach to Political Economy*, Chicago: University of Chicago Press for the NBER, 145-88.

¹¹ Emerson, G (1934) 'Guaranty of Deposits under the Banking Act of 1933', *Quarterly Journal of Economics*, XLVIII, 229-44.

¹² Scott, K and Mayer, T. (1971) 'Risk and Regulation in Banking: Some Proposals for Deposit Insurance' *Stanford Law Review*, **23**, 857-902.

Savings bank) in the 1980s and 1990s that the debate on the moral hazard costs of deposit insurance came to the forefront.

2.28 The FDIC introduced a risk-based premium system in January 1993 whereby assessment schedules were adopted separately for banks (BIF) and (SAIF)¹³. Under this, institutions were classified along a capital sub-group (1, 2 or 3) and a supervisory sub-group (A, B or C). The supervisory dimension is based on regulators' judgments regarding asset quality, loan underwriting standards and other operating risks. Since each sub-group has three categories, an institution is placed in any one of the nine-cell matrix, with rates ranging from 23 cents per US \$100 of assessable deposits to 31 cents. The best-rated institutions were in cell 1A, and the weakest one was in cell 3C (Table 2.4). The minimum premium was set at 23 basis points by the FDICIA until each fund fully realises a reserve ratio of 1.25 per cent of insured deposits.

2.29 With the BIF recapitalised in 1995, the FDIC could reduce deposit insurance assessments for BIF members. The rates were reduced from a range of 23 to 31 basis points to a range of 4 to 31 basis points, effective June 1, 1995. With substantial improvement in the health of the banking system, the vast majority of banks (almost 92 per cent) was in the 1A category and qualified for the lowest rate. The average premium rate was 4.4 basis points, down from 23.2 basis points before recapitalisation of the BIF. By raising the spread from 8 basis points (23 to 31) to 27 basis points (4 to 31), the FDIC expected to provide extra incentives to weaker banks to improve their condition. The BIF premium rates were further lowered to a range of 0 to 27 basis points effective January 1996.

2.30 Unlike the BIF, SAIF remained substantially short of the designated reserve ratio of 1.25 per cent; by mid-1995, the SAIF

¹³ Deposit insurance for savings & loan associations were earlier done with Federal Savings and Loan Insurance Corporation (FSLIC) which was closed down following its insolvency with the deepening crisis in the thrift industry, and the management of the savings bank fund was transferred to FDIC in 1989 .

balance was US \$2.6 billion, and its reserve ratio just 0.36 per cent. The Deposit Insurance Funds Act of 1996 provided for a special assessment on all SAIF-assessable deposits to bring the fund to full capitalisation. The FDIC set the special assessment rate at 65.7 basis points, which brought in substantial sum and raised the fund balance to US \$8.7 billion. This led to the full capitalisation of the SAIF and the assessment rates were brought down to the level of BIF members in a range of 0 to 27 basis points from October 1996.

2.31 Although the FDIC is required to set assessment rates independently for each of the insurance funds, currently the assessment rate schedules for the two funds are identical. With the funds' memberships having different risk profiles, it is likely that rates could differ in the future. The FDIC supports a merger of the two insurance funds on grounds that a combined fund would have a larger membership and a broader distribution of geographic and product risks. Arguments against a merger of the funds come primarily from bankers who are opposed to exposing their insurance fund to a repeat of the thrift losses of the 1980s.

Table 2.3: Schedule of FDIC Deposit Insurance Premiums Effective January 1, 1993 (Cents per \$100)

Capital Group	Supervisory Group		
	A. Healthy+	B. Supervisory Concern++	C. Substantial Supervisory Concern+++
1. Well capitalised*	23	26	29
2. Adequately capitalised**	26	29	30
3. Undercapitalised***	29	30	31

*Total risk based greater than or equal to 10 per cent, Tier I risk based greater than or equal to 6 per cent, Tier I leverage greater than or equal to 5 per cent.

**Total risk based greater than or equal to 8 per cent, Tier I risk based greater than or equal to 4 per cent, Tier I leverage greater than or equal to 4 per cent.

***Does not meet the capital criteria for well or adequately capitalised depository institutions.

+Financially sound and only a few weaknesses.

++Weaknesses that if not corrected could result in significant risk to the fund.

+++Substantial probability of loss to the fund unless effective corrective action is taken.

Source: Saunders, A (1997), 'Deposit Insurance and Other Liability Guarantees', in *Financial Institutions Management: A Modern Perspective*, 2nd Edition, , McGraw-Hill Companies Inc., USA., p.374.

Periodicity of Premium Assessment

2.32 Assessment rates are set semi-annually, and institutions pay premiums at the end of each quarter. The deposit base on which assessments are charged is defined to be total deposits, less a downward adjustment for “float” which is larger for commercial banks than for thrifts.

2.33 In the categorisation of institutions in the rate-cell matrix, that for the capital sub-group is to be determined semi-annually, using the most recent report of condition. For the supervisory sub-group, the categorisation is determined mainly based on an institution’s most recent rating review, although other factors are sometimes considered. Generally, institutions are examined every 12 to 18 months. Therefore, those undertaking undue risks would not be penalised by the assessment system unless and until the risk-taking resulted in a supervisory rating downgrade.

Prompt Corrective Action

2.34 The Act required regulators to establish five capital zones ranging from well-capitalised to critically undercapitalised that serve as the basis for mandatory prompt corrective action by regulators. Institutions whose tier I capital fall below 2 per cent are critically undercapitalised and face closure if the situation is not corrected within 90 days. By closing institutions before their capital was totally eroded, losses to deposit insurance funds would be reduced. This authority for the FDIC to close a failing insured bank became available with FDICIA (that power rested earlier with the licensing authority, i.e., the Comptroller of the Currency or the State).

Least Cost Resolution

2.35 Earlier, the FDIC had been protecting even uninsured depositors, for example, by transferring all deposits of a failed bank to an acquiring institution. The FDICIA required to follow a resolution strategy that carries the lowest cost to the insurance fund. This involves passing more of the costs of insured bank failures on to the

uninsured depositors, thereby enhancing their incentives to monitor banks. In implementing the least cost resolution (LCR) alternative, the FDIC is to consider and evaluate all possible resolution alternatives on a present value basis and document their assumptions in arriving at the selected alternative.

Too Big To Fail

2.36 An exception to using the least cost option arises in cases where a large bank failure could result in a systemic risk to the whole financial system by undermining public confidence. However, in order to restrict the use of this systemic risk exemption clause, the Act has stipulated that such an exemption is allowed only if a two-thirds majority of the boards of the Federal Reserve and the FDIC recommend it to the Secretary of the Treasury, and if the Secretary of the Treasury, in consultation with the President of the US, agrees. Further, the cost of such a bailout of a big bank would have to be shared among all other banks by charging them an additional deposit insurance premium based on their size as measured by their domestic and foreign deposits as well as their borrowed funds, excluding subordinated debt.

Borrowing Authority

2.37 The FDIC's authority to borrow from the Treasury to cover insurance losses was also enhanced from US \$5 billion to US \$30 billion. These borrowings were to be repaid through deposit insurance assessments.

2.38 The three primary responsibilities of the FDIC are to act as: (a) Insurer, (b) Receiver, and (c) Supervisor. Two of these roles - those of insurer and receiver - require that the FDIC play an active role in resolving failing and failed FDIC-insured institutions. The interaction between the FDIC as insurer and as receiver is important in promoting efficient, expeditious and orderly liquidation of failed banks and thrift institutions to maintain confidence and stability in the US banking system.

2.39 The FDIC seeks to maintain stability and the public confidence in the nation's banking system, by providing the public (i) with ready access to their insured funds and (ii) timely and quick resolution of failed institutions. In order to minimise disruption to the public during the resolution of failed institutions, the FDIC tries to dispose of the remaining assets of a failed institution as soon as practicable. This allows for quicker payment to the remaining creditors of the failed institutions.

Methods of Handling Bank and S&L Failures

2.40 The three basic resolution methods for failed and failing institutions are (i) purchase and assumption (P&A) agreement, (ii) deposit pay-off, and (iii) open bank assistance (OBA).

(i) Purchase & Assumption Agreement

2.41 The Purchase and Assumption agreement is a closed bank transaction in which a healthy institution purchases some or all of the assets of a failed bank or thrift and assumes some or all of the liabilities, including all insured deposits. The acquirer usually pays a premium for the assumed deposits reducing the FDIC's total resolution cost. For most of the FDIC's history, P&A transactions have been the preferred resolution method.

(ii) Deposit Pay-off

2.42 A deposit pay-off is usually resorted to only if the FDIC did not receive a less costly bid for a P&A transaction. In a pay-off, assets and liabilities are not purchased/taken over by another institution. As soon as the bank or thrift is closed, the FDIC is appointed as Receiver and all the depositors with insured funds are paid, directly or through an agent, the full amount of their insured deposits. The FDIC's insurance limit is US \$ 1,00,000. Any amount over this limit, including interest, is uninsured. The FDIC determines the amount in each depositor's account entitled to deposit insurance and pays that amount to the depositor. The owners of uninsured claims are given

receivership certificates entitling them to a share of the collection from the receivership estate.

(iii) Open Bank Assistance

2.43 Open Bank Assistance (OBA) was a resolution method in which the FDIC provided an insured bank at risk of failure with financial help in the form of loans, asset purchases, assumption of liabilities, contributions or deposits. Generally, the majority of failing institution's assets remains intact. OBA is resorted to when a distressed financial institution remained solvent with the aid of financial assistance from the Government. The FDIC would normally require a new management ensured that the shareholders' interest was diluted to a nominal amount and called for private sector capital infusion. OBA was also used to facilitate the acquisition or the merger of a failing bank or thrift by another healthy institution.

Forbearance Programmes

2.44 The forbearance programmes developed in the 1980s include (a) Income Maintenance Agreement and (b) Net Worth Certificates etc.

2.45 One of the FDIC's resolution strategies in the early 1980s was to force weaker savings banks to merge into healthier banks or thrifts by guaranteeing a market rate of return on the acquired assets through an income maintenance agreement. The FDIC paid the acquirer the difference between the yield on acquired earning assets and the average cost of funds for savings banks, thereby assuming the interest rate risk. If interest rates declined to a level where the cost of funds would be below the yield on earning assets, the acquirer was required to pay the difference between the cost of funds and the yield on earning assets to the FDIC. Between 1981 and 1983, income maintenance agreements were used to resolve 11 of the assisted mergers of the FDIC insured mutual savings banks. These banks did not technically fail because they were merged into operating institutions. Depositors and general creditors, therefore, suffered no loss. In most cases, however, the failing bank's senior management

was requested to resign, and subordinated note holders received only a partial return of their investment. Because there are no stockholders in a mutual savings bank, the FDIC did not have to concern itself with the interest of existing stockholders.

2.46 Another resolution strategy was the Net Worth Certificate (NWC) Program. The program's purpose was to buy time for savings banks to correct rate sensitivity imbalances and restore capital to acceptable levels. Under the program, eligible institutions received promissory notes from the FDIC representing a portion of current period losses in exchange for certificates that were to be considered as part of the institution's capital for reporting and supervisory purposes. The FDIC established a working formula to purchase certificates equal to between 50 per cent and 70 per cent of the institution's net operating loss. The NWC program allowed solvent, well-managed institutions to survive until the results of restructured balance sheets produced profitable operations or until unassisted mergers with stronger institutions could be arranged.

2.47 By the mid-1980s, many regional banks with a concentration of assets, mainly loans in the energy and agricultural sectors began having serious credit problems and showed signs of failing. To save some of these banks, the FDIC developed a resolution strategy of forbearance, which exempted certain distressed institutions that had been operating in a safe and sound manner from capital requirements.

Other Resolution Strategies

2.48 The FDIC employed other strategies to resolve distressed institutions. These are:

(a) Bridge Banks / Conservatorships

2.49 A bridge bank **is** a temporary banking structure that is controlled by the FDIC and designed to take over the operations of a failing bank and maintain banking services for the customers. Initially, the FDIC organises bridge banks for up to two years, with the possibility of up to three one-year extensions. The bridge bank

structure is designed to “bridge” the gap between the failure of a bank and the time when the FDIC can implement a satisfactory resolution of the failing bank. The temporary bridge structure provided the FDIC time to take control of a failed bank’s business, stabilize the situation, and determine an appropriate permanent resolution. It also enabled the FDIC to gain sufficient flexibility for reorganizing and marketing the bank.

(b) Branch Breakups

2.50 In inter branch breakups, portions of a failed multi-branch bank or thrift are sold to more than one bank. The branch break-ups transactions enhance the franchise value of the failing institution by increasing bidder participation, competition and flexibility for the resolution process.

The U.K. Experience

2.51 The U.K was one of the few countries in the world, which had a deposit insurance scheme for banks and non-banks (building societies) as well. In contrast to the U.S. system, the depositor protection scheme in the U.K., is less generous than arrangements in many other countries. This reflects concerns that full cover would reduce the incentives for depositors to take a view on the soundness of individual banks and therefore reduce market discipline. In the U.K., no depositor is fully insured. Besides, in the U.K system, institutions are levied generally only after a failure according to the amount of insured deposits¹⁴. In fact, in the U.K. there are five different compensation schemes, viz., (i) Deposit Protection Board (under FSA), (ii) Buildings Society Deposit Protection Scheme, (iii) Investor Compensation Scheme, (iv) Policy Holders Protection scheme (covering insurance policies) and (v) Friendly Societies Protection Scheme. These schemes are, at present, administered by different

¹⁴ The present deposit insurance scheme in the U.K is guided by the European Union Directive on Deposit Guarantee Schemes (94/19/EC). All members of the European Union have to meet certain minimum standards.

entities and there is a move at present to bring them under one umbrella.

2.52 The Deposit Protection Scheme covers all banks incorporated in the U.K., including their branches in the European Economic Area (under Banking Act, 1987), deposits of banks in their U.K offices.

2.53 Under the original scheme set up in 1982, each depositor could receive up to 75 per cent of the sterling deposits up to Pound 10,000. In 1987, this was increased to 75 per cent of the sterling deposits up to Pound 20,000 and in 1995 was increased again to 90 per cent of deposits (in EEA currencies or Ecus) up to Pound 20,000 equivalent (or the sterling equivalent of 22,222 Ecus, whichever is greater); thus the maximum protection under the scheme is Pound 18,000 or the sterling equivalent of Euro 20,000, whichever is greater.

2.54 The deposit protection fund has a minimum corpus of Pound 5-6 million. The deposit protection scheme is funded by payment of “one-off initial contribution”; the minimum initial contribution is Pound 10,000 (for new banks¹⁵) and a maximum of 300,000. Except new banks (which do not have a deposit base), the initial contribution is linked to deposit base. On an average, this fund comes to 0.01 per cent of their deposit base. The initial fund contributed by the banks is not refundable.

2.55 When the deposit protection fund falls below Pound 3 million, the fund is supplemented by an additional levy (further contributions) on depositories (around 350). In 1985, the fund fell below Pound 3 million pounds following the BCCI episode and, hence, an additional 5 million was raised through additional levy. Besides, “special contribution” is also levied if payments from the fund are likely to exhaust its cash resources before the end of the financial year.

¹⁵ In practice, newly authorized institutions will generally have no deposit base and hence will pay the minimum contribution of Pound 10,000.

Following the BCCI episode in 1992¹⁶, an additional 80 million pounds was mobilized through special contributions.

2.56 The Deposit Protection Scheme for Building Societies in the U.K., was introduced as per the Building Societies Act, 1986. However, it has never been used. If there were a failure of a building society, the remaining building societies would be subject to a levy of up to 0.3 per cent of their total share, deposit and loan liabilities, which would be used by the Building Society Investor Protection Board, a statutory body, to meet the deficiency, as far as possible, in that society. However, since the scheme has never been used, no levy has ever been made. Hence there is no fund.

2.57 The Investors Compensation Scheme is the rescue fund for customers of investment firms, which have gone out of business. It was set up by law in 1988 as part of the investor protection framework under the Financial Services Act. The scheme can pay compensation of up to Pound 48,000 each to private clients of UK authorized investment firms, which fail.

2.58 At present, the investor protection scheme pays compensation of 75 per cent of the Pound 20,000 subject to a maximum of 15,000. This was modified recently to 90 per cent of the first 20,000 pounds.

Canada

2.59 The Canada Deposit Insurance Corporation (CDIC) was established in 1967. The CDIC is fully funded by its member financial institutions (banks, trust companies and loan companies). Insured deposits in Canada include savings and demand deposits, term deposits, such as, guaranteed investment certificates and debentures

¹⁶ Since the introduction of deposit protection scheme in 1982, 29 UK authorized banks have been placed either in administration or in liquidation. Payments to depositors have amounted to only Pound 144 million gross and 88 million net, after the recovery of funds from the liquidation or administration. See, Jackson, P (1996) 'Deposit Protection and Bank Failures in the United Kingdom', Financial Stability Review, Autumn, pp.38-43.

issued by loan companies, money orders, drafts and cheques and travellers' cheques issued by member institutions.

Asian Countries

2.60 Among the Asian countries, India, Japan and Philippines had one of the oldest deposit insurance schemes. Singapore does not have a deposit protection scheme. On the other hand, the establishment of deposit insurance schemes in Thailand, Korea and Hong Kong are mainly an outcome of East Asian financial crisis. China has an informal stated policy of protecting the interest of depositors; more formal system for medium and small-sized deposit-taking financial institutions is planned. Similarly, there is also an informal promise in Indonesia to guarantee commercial bank obligations to depositors and creditors and a formal system is under study.

Japan

2.61 In Japan, deposit insurance is provided by the Japanese Deposit Insurance Corporation (DIC) (since 1971), which covers deposits with banks and various other deposit-taking institutions. The DIC has, in practice, been used to finance mergers and takeovers rather than to compensate depositors, largely because no Japanese institution has been allowed to fail in the conventional sense. Under the DIC law, there is a pay-out ceiling of ¥10 million per depositor but this has, in practice, not been enforced.

2.62 The scheme is funded by a flat percentage (recently raised to 0.048 per cent) of deposits levied on member institutions annually. In addition, a temporary special levy (at 0.036 per cent) has recently been set to cover pay-outs above the ceiling. Funds provided to facilitate mergers and takeovers have substantially reduced the DIC fund, which stood at the equivalent of ¥ 5 billion one or two year ago.

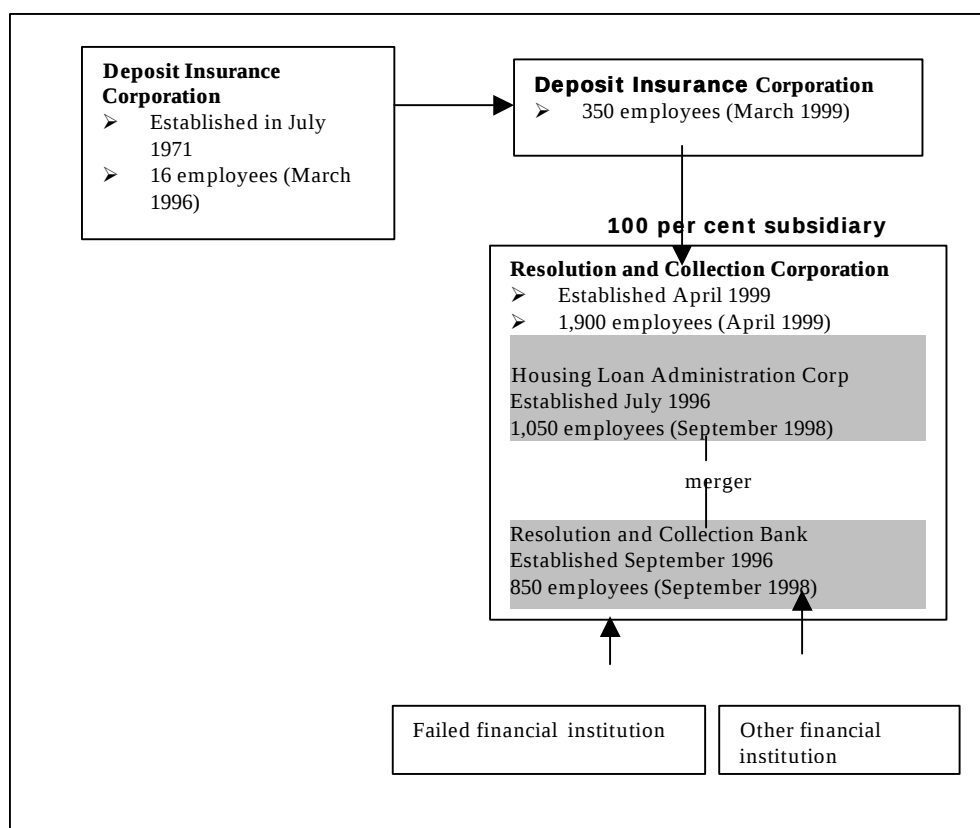
2.63 The collapse of a number of Japanese financial institutions in 1995 provided a jolt to the Japanese financial system. Until very recently, the Japanese banking system was believed to be sound both

operationally and in terms of assets. This over-optimistic view was shattered when a regional bank and two credit unions failed because of unsound management of assets, particularly problem loans to *jusen* (housing-finance companies).

2.64 Following the further worsening of the bad loans problem in the Japanese financial sector in the wake of the East Asian crisis, the DIC established the Resolution and Collection Corporation (RCC) (in April 1999) by merging the existing (since July 1996) Housing Loan Administration Corporation and Housing Loan Administration Corporation (HLAC) (existing since 1996) (See Chart 1). The RCC is empowered to purchase bad loans not only from the failed banks but also from the solvent operating banks, helping them to remove their bad loans from their balance sheets.

2.65 To equip DIC to deal with the financial instability problem, the financial base of DIC was strengthened by an amendment to the Deposit Insurance Law in February 1998. The DIC carried out auctions to borrow money from private financial institutions on a government-guaranteed basis. The auctions to finance the DIC were successful with active participation from foreign institutions. As a result, the DIC was able to raise ¥ 6.3 trillion at a cost well below the current official discount rate of 0.5 per cent. The remaining ¥ 1.2 trillion was financed by the Bank of Japan at the official discount rate.

Chart II.1: The Structure of Japan's Safety Net



Taiwan

2.66 The deposit insurance system in Taiwan was established in September 1985 when the Central Deposit Insurance Corporation (CDIC) was set up as a government-owned corporation. The insurance cover is NT\$1 million (US \$ 3,140) for each depositor at each bank. The deposit insurance is voluntary; at the end of November 1998, 57 per cent of all the financial institutions' deposits and trust funds were insured by the CDIC. Under the revised Deposit Insurance Act, which became law in January 1999 and came into force in July 1999, the deposit insurance system has been made compulsory, and insured institutions will be assessed for deposit insurance purposes on the basis of a risk-based assessment rate.

2.67 The responsibilities for financial regulation and supervision are shared by the Ministry of Finance (MoF), the Central Bank of China and the CDIC. The MoF is the financial regulatory authority. The responsibilities are shared by the MoF, the CBC and the CDIC.

Korea

2.68 Korea has deposit insurance for banks as well as non-banks. In fact, as early as 1980s a deposit insurance scheme was operated by the Korea Non-Bank Deposit Insurance Corporation. For banks, deposit insurance scheme was introduced in June 1996 by the Korea Deposit Insurance Corporation (KDIC). The KDIC was modeled on the FDIC of the U.S. The coverage of bank deposits is W20 million (approximately US \$ 27,000) for each depositor.

2.69 The Deposit Insurance Fund, established under the KDIC, is financed by contributions from member banks and the Government, borrowings (to a maximum of W 500 billion) from the Government or the Bank of Korea, premium paid by participating banks, and profits and earnings from the operations of the Fund. The mandatory contributions from participating banks are fixed at 1 per cent of the bank's capital.

2.70 The KDIC can charge either flat-rate insurance premiums or risk-adjusted premiums. Under the Government's plan, a flat-rate premium scheme was adopted in the initial stage until the deposit insurance system is well established. Under the flat-rate premium structure, all participating banks must pay insurance premiums of up to 0.05 per cent of insured deposits and the initial premium rate was 0.02 per cent. After the initial phase, if a risk-based premium system is adopted, it will charge different premiums against banks up to a limit of 0.05 per cent of insured deposits on the basis of each bank's business management and financial conditions.

2.71 The KDIC has limited bank supervisory powers; it can inspect banks that are at risk.

Thailand

2.72 Thailand did not have a deposit insurance scheme till 1995, when it established the Financial Institutions Development Fund (FIDF). Although the FIDF was set up as a separate entity, it is housed in the Bank of Thailand (BOT) and the staff is mainly drawn from the BOT. The FIDF provides guarantee to both depositors/creditors and provides liquidity assistance to financial institutions; the guarantee scheme is compulsory. A unique feature of the FIDF is that it provides guarantee also to foreign borrowing and covers all deposit taking entities including non-banking entities like finance companies (Credit Fonciers).

2.73 The fund for the FIDF is mobilized by levying a flat fee of 0.04 per cent of outstanding deposit liabilities of deposit taking entities. In recent times, there is a move towards introduction of risk-based premium.

Deposit Insurance Systems in Latin America

2.74 Colombia established its deposit insurance scheme (FOGAFIN) in 1985 after a banking crisis. The Tequila crisis of 1995 forced Argentina to establish a new deposit insurance scheme (SDESA) in April 1995, just three years after the authorities had decided to abolish deposit insurance in favour of arrangements, which gave small depositors preference over bank assets in cases of bank liquidation. Brazil also introduced a deposit insurance scheme encompassing all financial institutions subject to liquidation or intervention following the adoption of the Real Plan.

Colombia

2.75 In Colombia, deposit insurance is compulsory; it covers most of the deposits except foreign currency deposits. At present, there is a limit of pesos 10 million per person for deposit insurance coverage, and this scheme is proposed to continue till 2001, when coinsurance, i.e., 75 per cent to US \$5,500 is proposed to be introduced. The deposit

insurance agency, FOGAFIN is owned by the Government and is under the control of Ministry of Finance. It has a deposit insurance fund and is funded through a flat rate annual premium of 0.03 per cent of deposits. The premium system in Colombia will become risk-based in the year 2000. The deposit insurance agency, FOGAFIN, has been at the center of bank restructuring in Colombia. FOGAFIN extends credit line up to one year to recapitalise weak banks. In July 1999, one bank has applied for such credit and at least three others are likely to follow soon.

Section III

Countries with No Deposit Insurance

2.76 There are a few countries like Singapore, South Africa, New Zealand and Australia that do not have any sort of deposit insurance system. It is worth examining how these countries have managed without a formal deposit insurance system, while many countries have gone for it.

The New Zealand Experience

2.77 New Zealand does not have a deposit protection scheme in any shape or form. The New Zealand banking supervisory regime differs from the more conventional approaches to financial regulation by placing greater reliance on market discipline through an elaborate public disclosure system. Under this system, each bank is required to issue public disclosure statements every quarter in two forms:

- *A Key Information Summary*, aimed at the ordinary depositor, including
 - the bank's credit rating (or a statement that the bank has no credit rating);
 - the bank's capital ratios, measured using the Basle framework; and
 - information on peak exposure concentration, peak exposure to related parties, asset quality, shareholder guarantees (if any) and profitability.

- *A General Disclosure Statement*, aimed principally at the professional analysts, containing wider-ranging and more detailed information on the bank including:
 - corporate information and some information on parent banks (where applicable);
 - comprehensive financial statements (including a five year summary of key financial data);
 - credit rating information (including any changes to the rating in the two years preceding a bank's most recent disclosure statement balance date);
 - detailed information on capital adequacy, asset quality and various risk exposures (including exposure concentration and related party exposures);
 - information on funds management and securitisation activities, risk management systems and a summary of the prudential regulations imposed on the subject bank by the Reserve Bank of New Zealand; and
 - information on the bank's exposure to market risk, both peak and end of period (and in respect of the full banking book).

2.78 This extensive disclosure system is meant to induce prudent and responsible behaviour from bank management under the influence of market discipline (Brash, 1997¹⁷). With information on the banks' financial performance and risk positions available frequently and in a detailed manner, the markets can react to developments affecting their financial conditions, rewarding those banks that are well managed and penalising those that are not, contributing to the development of a sound and stable financial system. Most importantly, it is hoped that this is likely to reduce the possibility of contagion and runs on the banking system, as deposit holders are in possession of the information needed to make the distinction between the healthy and not-so-healthy banking institutions.

2.79 One of the important features of the disclosure framework is the development of institutions of accountability and corporate

¹⁷ Brash, D. T. (1997), 'Banking Soundness and the Role of the Market', Speech to the IMF Conference on *Banking Soundness and Monetary Policy in a World of Global Capital Markets*, Washington, D.C., January 30.

governance. Directors of banks are required to attest the disclosure statements as not containing any false or misleading information, subject to not only criminal penalties but also unlimited liability for creditors' losses. This sharpens the focus on the incentives for the directors of banks to ensure that their banks have the necessary systems in place to identify, monitor and manage adequately the various business risks, and put in place suitable accountability mechanisms within their internal management hierarchies. An important benefit, which the authorities seek to derive from the market-based regulatory system, is the reduction in pressure on the Government to rescue banks in distress, given the development of a perception that the directors alone have the responsibility for the management of banks' affairs. This is important because in the traditional forms of on-site examination based supervisory systems, the regulators are often perceived to be ultimately responsible for the management of banking risks, forcing the Government to take responsibility for rescuing banks in trouble.

2.80 The banking supervisory system in New Zealand is not entirely bereft of a regulator. The Reserve Bank of New Zealand continues to exercise its monitoring role on a quarterly basis using banks' public disclosure statements, and the banks are still subject to minimum capital requirements in line with the Basle Capital Accord.

2.81 This market-based approach to banking supervision is criticized on the following grounds:

- It might be politically difficult to enforce such a framework of strict disclosure requirements of banks and stiff penalties for disclosure of erroneous information, and unlimited liability. The advantage enjoyed by New Zealand in this respect is that over 90 per cent of its banking system is foreign-owned¹⁸.

¹⁸ There are 19 registered banks operating in New Zealand as of end-November 1997, 18 of which are foreign-owned. Of the foreign-owned banks, 8 are locally incorporated, with the other 10 operating as branches of overseas incorporated banks. Foreign ownership is 100% in all cases except one where it is 75%.

- The success of a market-based regulatory approach is closely related to the penetration of readership of disclosure statements. It must be said, though, that the source of market discipline need not lie necessarily in wide readership by deposit holders themselves but rather in the active participation of public agents like financial news media and investment analysts in disseminating information, and, very importantly, in monitoring by competitor banking institutions.

The Australian Experience

2.82 The authorities in Australia are not entirely convinced by the adequacy of market-based regulation to maintain stability in the financial system. They argue, instead, that the increasing complexity of the nature and type of banking business limits the extent to which a public disclosure regime can realistically substitute for official supervision. Even with improved provision of information about bank operations, the public cannot be expected to have the time or the expertise to make continuous informed assessment of banks. Moreover, it is naïve to expect that disclosure-based regimes will be able to alleviate the public perception that the Government will have to ultimately take a close interest in resolving any threats to the health of the banking system.

2.83 A new financial regulatory structure came into existence in July 1998, in response to the recommendations of the Financial System Inquiry, popularly known as the Wallis Committee, set up in May 1996. The new structure is based on functional lines rather than institutional lines, and consists of four regulatory bodies:

- The *Reserve Bank of Australia* to oversee systemic stability, in particular through its influence over monetary conditions and through its oversight of the payments system;
- The *Australian Prudential Regulation Authority (APRA)* to supervise banks, life and general insurance companies and superannuation funds;
- The *Australian Securities and Investments Commission (ASIC)* to regulate market integrity and consumer protection; and

- The *Australian Competition and Consumer Commission (ACCC)* to oversee competition in the financial system.

2.84 According to the regulatory philosophy in Australia, such a structure is required to ensure that only those financial institutions, which are under the purview of prudential regulation, offer products involving binding contracts in fixed value. This includes deposit-taking institutions like banks. Prudential regulation is largely about encouraging and promoting ‘prudent’ behaviour by these institutions so as to increase the probability of their financial contracts being honoured. However, the bank supervisory regime in Australia does not offer any explicit deposit insurance or guarantee for the financial promises of regulated institutions.

2.85 The Australian Prudential Regulation Authority (APRA) is the agency responsible for the prudential regulation and oversight of the deposit-taking institutions. However, given that no regime of such a regulation can be totally fail-proof, the Australian regulatory system has given power to the Reserve Bank of Australia to provide emergency liquidity support (either to the whole system or on a lender-of-last-resort basis to a particular bank faced with a liquidity crunch) in the event of any threat to the stability of the financial system, as can arise from susceptibility of these institutions to panic runs. The new regulatory structure envisages close and effective co-ordination between the Reserve Bank Australia and the APRA for the same.

2.86 By placing the onus on the Reserve Bank Australia to act as the lender-of-last-resort, the Australian regulatory regime seeks to limit panic amongst deposit holders about the liquidity potential of the banking system, thereby reducing the probability of runs on the system. However, this system does not provide for support to insolvent as against merely illiquid institutions. It is important to note that runs on the banking system take place mostly due to lack of information with the deposit holders about the solvency of their

banks, rather than on suspicions of liquidity problems. To the extent that the depositors are unsure of the health of their banks' balance sheets, they are also likely to be unsure about the support from the Reserve Bank Australia and, thus, the potential for a run on the system remains.

Section IV **Issues Relating to Deposit Insurance Reforms in India**

2.87 Deposit insurance reform is not an end in itself. It is a means to achieve the end of fostering safety and soundness of the banking system and enhance competitiveness of the industry so as to avoid costly runs – costly for the economy, the depositors as also the taxpayers. Deposit insurance is not much talked about in India, and this is perhaps due to the government ownership of the major banks, which has created a misconception in the minds of depositors that banks are fail-safe and in case they fail, depositors will get back, in full, their money from banks or the Government. However, the situation is fast changing. Between 1993 and 1999, 8 public sector banks went public¹⁹ and the share of government ownership reduced. With the trend definite to continue in the coming years and more and more private banks entering the marketplace, everyone will feel the urgent need of deposit insurance. Besides, the integration of the financial markets as well as the risk content of the decision making process in the Indian banks are on ascent which would contribute to the vulnerability of the banking system. This further reinforces the need for putting in place a strong safety net for the depositors, particularly the smaller ones. Therefore, it is high time that the subject of deposit insurance be addressed. In this context, the IMF Best Practices recommend beginning of an explicit deposit insurance system when the banking system is sound and the system should be

¹⁹ The public issues of the public sector banks are as follows: State Bank of India (Rs.326 crore), State Bank of Bikaner and Jaipur (Rs.14 crore) State Bank of Travancore (Rs.15 crore), Oriental Bank of Commerce (Rs.64 crore), Dena Bank (Rs.60 crore), Bank of Baroda (Rs.100 crore), Bank of India (Rs.150 crore) and Corporation Bank (Rs.38 crore).

made compulsory for the participating agencies (See Annexure II.1). Between 1995 and 1999, the number of compulsory deposit insurance systems increased from 26 to 55, as observed by the IMF Survey.

2.88 An attempt at reforming deposit insurance system should focus on the following prime issues:

- **Issue No. 1:** The scope and the coverage of deposit insurance in terms of institutions, category of deposits and the extent of coverage.
- **Issue No. 2:** The system of premium.
- **Issue No. 3:** Optimal size of the deposit insurance fund and methods of financing it.
- **Issue No. 4:** Methods of dealing with bank failures so that whatever amounts (normally such amounts are very large) the deposit insurance agency compensates to the insured depositors up-front is recovered quickly by it from the liquidation proceeds of the failed bank, thereby ensuring a solvent deposit insurance fund.
- **Issue No. 5:** Organizational aspects and the role of the reformed deposit insurance agency.
- **Issue No. 6:** The possibility of extending deposit insurance to the depositors of the NBFCs.

Each of the above-mentioned issues is discussed below.

Issue No.1 **Scope of Deposit Insurance**

2.89 Theoretically, deposit insurance is intended to protect small, unsophisticated depositors who cannot protect themselves. It is not intended to offer full protection to wealthier and sophisticated depositors. In case it is extended to all, it will hamper market discipline, which acts as a check against excessive risk taking behaviour of bankers.

2.90 The IMF Best Practices recommend that the coverage limit of an explicit deposit insurance system should be low enough to

encourage large depositors and sophisticated creditors to discipline their banks. Sophisticated depositors exert this discipline by demanding higher deposit rates from weaker banks in compensation for the higher risk of loss they are accepting; in other circumstances, depositors may withhold funds entirely from a particularly troubled bank.

2.91 The IMF uses twice per capita income as a rule of thumb to determine a ‘small’ depositor. In addition, the coverage, it suggests, can be adjusted upwards over time to reflect higher GDP and faster rates of inflation (See Annexure Table II.2). Other factors, such as, the distribution of deposits according to their size may also be considered while evaluating the coverage limit. The IMF also mentions that the coverage limit should encompass a relatively high percentage of number of accounts, but a smaller percentage of the total value of deposits in the system. According to the IMF Survey, countries typically cover 90 per cent or more of the number of accounts, but only 40 per cent of total deposits.

2.92 Conceptually, it might be appropriate to limit the coverage at any point in time to the sum of any individual depositor’s account regardless of the number of accounts held in any or all banks. According to the IMF Survey, 66 countries limit coverage by applying the limit to the sum of the deposits that a depositor holds at any or each failed bank. By 1999, only two deposit insurance systems covered each deposit account individually, even a depositor held several accounts at the failed bank. While there has been a shift from ‘per-deposit’ to ‘per-depositor’ coverage, over time, thereby reducing the effective coverage ratio, some countries also adopt a system of co-insurance. There has been a considerable increase in countries restricting the deposit insurance to household or non-profit organisations as against sophisticated depositors (financial institutions, governments and large corporations) and now such countries accounting for a quarter against 13 per cent in 1995. There has also been a large increase in the number of schemes that exclude

inter-bank deposits from coverage from 45 per cent in 1995 to 66 per cent in 1999. Another trend observed is the exclusion of foreign currency deposits from coverage with about 40 per cent of the countries now excluding all or some deposits denominated in foreign currency from insurance coverage. In most of the countries that cover foreign deposits, although the pay-out is in domestic currency, the insurance system is not free from the exchange risk.

2.93 As a corollary to the above, the IMF prescribes that although all deposit taking institutions should be considered for inclusion in the deposit insurance system, investment banks, merchant banks and wholesale finance companies that take only large deposits and make large investments should be kept outside the purview. Secondly, those institutions, which are subject to effective supervision and regulation, should be considered so that the vulnerability of the deposit insurance agency is precluded. The IMF Survey opines that the non-banking finance companies in many countries are more risky than the commercial banks because they are subject to a less effective system of supervision and, therefore, should be excluded from deposit insurance coverage. Several countries (e.g., France, Germany, Italy, Japan, Norway, Spain, and the US) have instituted separate systems for different institutions – different in terms of risk profile, and legal, regulatory and supervisory framework.

Issue No.2

Premium

2.94 The current flat-rate deposit insurance premium provides incentives for banks to take more risks without incurring any additional premium expense. Thus, the flat-rate premium system subsidizes high risk, poorly run institutions at the cost of well-run institutions and ultimately the tax-payer. This pricing system is perverse.

2.95 An ideal deposit insurance premium pricing system should embody (a) banks paying premium indexed to their own levels of

risks, (b) a premium level that ensures a continually solvent insurance fund and (c) a better allocation of resources to productive banks and productive investments. However, in practice, it is difficult to achieve this ideal result, even by a risk-based premium system. For one, it is difficult to price individual bank risk correctly before problems occur, and because bank failures are not evenly distributed over time, it is difficult to estimate long-run revenues to cover long-run costs. Secondly, the level of premiums cannot be so large as to threaten the viability of an otherwise sound institution. Therefore, there is always some degree of subsidy inherent in insurance. In short, risk-based premiums should be viewed as a complement to, rather than a substitute, for other methods of checking excessive risk taking, which includes risk-based capital requirements, direct market discipline, strong supervision and direct restraints on risky activities.

2.96 According to the IMF survey, capital adequacy and supervisory rating can be used for fairly precise calculation of the risk-based premia. The number of countries that risk-adjust their deposit insurance premiums has gone up from four in 1995 to 21 in 1999. Now, almost a third of the total of countries with explicit deposit insurance schemes calculate risk-adjusted premiums against less than a tenth, four years back. More countries are planning to shift to risk-adjusted premiums in the future (Canada and Colombia). It may be noted that Norway and Germany levy flat-rate premiums on risk-adjusted assets, resulting in low premiums for banks with less risky assets.

2.97 Premiums charged by different countries varied from a temporary zero percent of deposits for the strongest banks in the US to a low of 0.005 per cent in Bangladesh and a high of 2 per cent in Venezuela.

2.98 To begin with, the IMF Survey prefers maintenance of a fund to imposing ex post levies, as the former is more rule-based and offers less uncertainty. Ex post systems, which levy charges only in the event of a failure of a member institution, are often privately run, do not have well specified cost-sharing, lack back-stop funding from the Government, and have difficulty in getting information from the supervisor and the central bank. The IMF survey has identified 10 ex post systems of which all except one (Bahrain) are in Europe. While ex post system countries are not switching to funded schemes, the Survey notes a clear trend toward funded schemes with almost all newly created insurance systems being funded ones. Now funded schemes constitute about 85 per cent of all explicit insurance schemes worldwide.

2.99 The IMF Survey also shows that 17 countries maintain a target level for the insurance fund. The target ranges from a low of 0.4 per cent of total deposits in Italy to a high of 20 per cent insured deposits in Kenya. Out of these countries, only four (Hungary, Italy, Tanzania and the US) have either met or about to meet the target.

2.100 Determining the optimal size of bank insurance fund either in terms of an absolute amount or in relation to some measure of exposure is an arduous task because bank failures and insurance losses are difficult to predict. Simply and objectively speaking, the fund should have money enough to cover losses and meet the cash needs first. How much additional money it should have would depend on: (i) the type of contingencies the fund should be expected to manage and (ii) the perceptions of the public regarding the ability of the agency to protect deposits under different economic conditions. If the public attitude is favourable, the agency may not maintain a large fund and *vice versa*.

2.101 Nevertheless, the premium structure has to be essentially flexible to the varying loss situations over time. Such a system necessitates insurance assessments on banks to be high enough to

keep the fund reserve ratio at a desired level always. Moreover, the Government should have a back-up fund for a well-run deposit insurance system that is met by unexpected demands on its resources and is in need of additional funds in order to carry out its responsibilities.

2.102 In a country where the depository institutions are fundamentally different from each other in terms of their role, geographical and client coverage, exposure to risks, risk management practices, supervisory and regulatory mechanisms, etc., the deposit insurance agency needs to set up separate funds with firewalls among them so that the problem of *inter se* cross-subsidization is not encountered. However, the fund having surplus may give a line of credit to the deficit fund in case of emergency.

2.103 A second alternative to guarantee an optimal fund size which may be pursued in addition to increases in assessments could be some sort of recapitalization of the fund through banking industry deposits or capital contributions. Under this plan, banks may be asked to provide capital to the agency in the form of deposits amounting to a certain percentage of total deposits. A recapitalization reduces the probability of the incidence of the cost of bank failures on taxpayers. Secondly, without recapitalization the deposit insurance agency may face difficulties in raising assessments sufficient enough to pay for unforeseen excessive losses. Thirdly, the market discipline among the contributing banks may be strengthened as well. However, a recapitalization would involve significant costs to the banking industry, which may tell upon its profitability. It may, in turn, also dissuade investors from committing risk capital to the industry.

[Issue No. 4](#)

[Failure Resolution Methods](#)

2.104 The failure resolution methods should keep in view several key objectives, while deciding the most appropriate method. The first and foremost objective is the need to keep intact public confidence and stability in the banking system. One should seriously recognize

the possibility that the mode of handling failures may have adverse repercussions on other banks and should not implement failure resolution methods that unnecessarily jeopardize the stability of the banking system. Secondly, market discipline against risk taking needs to be maintained. The way bank failures are to be handled has implications for the level of discipline that market will exert against risk taking by other banks. Failure resolution policies determine the probability and extent of loss that claimants may incur. These factors, in turn, influence the degree to which any particular group of claimants will monitor and control a bank's risk profile. Thirdly, the failure resolution procedure should be cost-effective. Fourthly, the deposit insurance agency should try to be as equitable and consistent as possible in its failure resolution policies. The issue of equity is a much-debated issue in the context of dealing with depositors in large versus small banks (the so-called "too-big-to-fail" doctrine).

2.105 Apart from these primary objectives the deposit insurance agency has to serve at least two secondary objectives, while selecting the failure resolution methods. These comprise, minimizing: (i) disruption to the community and (ii) the Government's role in owning, financing and managing financial institutions and financial assets. While the former objective is sought to be achieved by a swift and smooth conduct of transactions under the selected methods, the latter by opting for private sector resolutions, whenever and wherever possible.

2.106 Because these objectives are not always mutually compatible, meeting them simultaneously is not an easy task. While taking decisions in any given situation, the deposit insurance agency must attempt to balance these trade-offs. In view of this, the selection of appropriate failure resolution method becomes an intricate process.

2.107 In sum, it can be said that the deposit insurance agency should have in its armoury alternative weapons for resolution of bank failures so that the cost to the Government and the depositors remain

low. Moreover, the endeavour should be to liquidate a problem bank when it is a 'going concern' rather than a 'gone concern', so that, given the market imperfections in the asset markets, the liquidation value of a bank's assets can be maximized, instead of resulting in 'fire sale'. Thirdly, an 'essentiality doctrine' needs to be adopted, particularly if a big bank, at all, faces liquidation. Otherwise, the failure of such big banks will precipitate systemic upheaval, which will prove costly.

Issue No. 5: Organizational Aspects and the Role

2.108 According to the IMF, the deposit insurance agency should be independent from political interference and industry domination. However, it should be accountable for its actions, especially its mistakes, through a proper degree of transparency. Nevertheless, the agency must be backed by the sovereignty or a near-sovereign institution like the central bank so as to exude necessary confidence among the public.

2.109 The IMF Best Practices also recommend against having bankers on the main board of the agency so that conflict of interest is avoided; instead, they can be in an advisory board. The IMF Survey has found that there is a shift towards public or joint administration of the deposit insurance with the former now constituting a half and the latter a third of all schemes.

2.110 The deposit insurance agency, as insurer, has the direct onus of maintaining a healthy bank insurance fund, protecting insured depositors and handling bank failures. Ideally, for this purpose, it is expected that the agency also supervises the insured banks directly. There arises a conflict of interests between the supervisor who may not wish to close a non-viable bank for fear of being it interpreted as a supervisory failure, and the insurance agency that is eager to shut down a failed bank in order to reduce the losses it imposes on the fund. There is also conflict of interests between these functions and the central bank as the guardian of monetary policy and the lender of

last resort. Therefore, there is a strong case for having separate agencies for these three different functions.

2.111 Some countries have tried to resolve this problem informally, while others have given the insurance agency statutory powers to be part of the on-site inspection of troubled banks and their closing. To get such back-up powers for the insurance agency requires it to be a public body, as vesting such powers to a private bankers' club would be difficult. The IMF Survey has reported the responses from 36 countries to a follow-up inquiry on the organisational structure of the deposit insurance agency. Seventeen of these 36 countries had a deposit insurance body, which is a separate, independent legal entity. However, in many instances, it was either legally or in practice, under the control of either the central bank or the Ministry of Finance.

2.112 One can conceptualise either a passive or an active role for the deposit insurance agency. As a passive body it simply manages the insurance fund and pays out the funds that are due to depositors. This is normally seen in the case of a privately run scheme. The insurance agency with a larger mandate also acts as a receiver of banks whose licences have been cancelled, determine the method of their resolution, undertake their recapitalisation, liquidation or sale, and disposal of the remaining bank assets. There is a trend toward giving the deposit insurance authority larger and wider responsibilities including bank liquidation and restructuring.

2.113 However, many countries do have separate, established banking supervisory bodies, which, on a regular basis, conduct on- and off-site surveillance of banks. In such cases, if the deposit insurance agency is also allowed to exercise its separate supervisory functions, it may lead to duplication of functions and overburdening of the insured banks in terms of examinations. Therefore, for effectively carrying out the work of supervision, the deposit insurance agency has to rely a lot on co-operation of the bank supervisor and the lender of last resort for sharing of quality information. If the

information on which deposit insurance agency or the supervisors rely while considering disciplining or closing a bank is insufficient, appropriate actions will not be taken. If the information that is released to the public is inadequate or misleading, market discipline is lost. Moreover, if the public does not know the condition of the banking industry, it cannot press the supervisor to close failed banks promptly in order to reduce the potential burden on the deposit insurance fund and ultimately the taxpayer. The agency that faces such problems is unlikely to strengthen the financial system and can contribute to weakening it. The matter of inter-agency co-operation for information flow, therefore, becomes an important concern for the deposit insurance agency.

2.114 This is again easier if the insurance agency is a government body. Twenty of the 36 countries that responded to the IMF inquiry reported information sharing among these parties.

Issue No. 6

Deposit Insurance for NBFCs

2.116 In India, various committees have gone into the role of the NBFCs and have looked at different facets of its functioning and made recommendations. The issue of extending deposit insurance to the NBFCs in India became more vocal with the ever increasing fatality of the NBFCs and the 1996 Supreme Court judgement (dated January 4) suggesting to the Reserve Bank to examine whether Deposit Protection Scheme on the lines of the U.K., could be implemented for the NBFCs in India. The Reserve Bank had constituted a Committee under the Chair-personship of Smt. K.S. Shere to look into this aspect.

2.117. Subsequently, the Task Force headed by Shri C.M. Vasudev, Special Secretary (Banking) in the Ministry of Finance also rejected the case for deposit insurance for NBFCs in its report (October 1998) on the grounds of moral hazard issues, likelihood of asset stripping and the likely negative impact on the growth of a healthy NBFC sector. The Task Force also found the global experience in this regard not instructive. The report added that since it had suggested that the

depositors would have a first *pro rata* charge on the SLR deposits of the NBFCs, an element of comfort would become available for such depositors. It also reiterated the Shere Working Group's prescription that the ultimate insurance must necessarily be a transparent system, better disclosures, better prudential norms, effective regulation and supervision and informed decision making by aware investors who are in position to balance risk and returns.

2.118. The IMF Survey strikes a caution against instituting deposit insurance systems for finance companies. It observes that instituting a deposit insurance system for such companies may be more risky than the commercial banks because these are subject to different laws and regulations and may be overseen by a less effective system of supervision. In this situation, creating a separate insurance scheme, possibly with different structures for premia, may be the answer, the Survey concludes.

2.119. Given the issues flagged above, it is necessary to look at all deposit taking activities in India, irrespective of the fact whether they are covered by deposit insurance or not. This is attempted in Chapter III.