International Conference Funding of Deposit Insurance Systems Hosted by DICGC
Inaugural Address by Dr. D. Subbarao Governor, Reserve Bank of India
January 18, 2010

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

Evolution of Deposit Insurance

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

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

Historical Perspective on Deposit Insurance in India

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

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

Global Crisis and Deposit Insurance

Let me now turn to the recent financial crisis. Though the crisis impacted the entire world, it affected different countries in different ways. After the collapse of Lehman Brothers in mid-

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

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

Global Crisis and India's Response

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

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

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

Financial Stability

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

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

DICGC - Challenges for the Future

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

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

Deposit Insurance - Post Crisis

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

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

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

The Report further observed that

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

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

Deposit Insurance - Global Coordination

With increasing global financial integration, consistency in the basic principles that guide deposit insurance is essential to maintaining a level playing field internationally. In this context, information exchange among deposit insurers gains importance. Today there are a large and growing number of cross border financial institutions functioning across multiple deposit insurance jurisdictions. There is need for clarity regarding the obligation of each deposit insurer in respect of each cross-border institution.While the ‘Core Principles for Effective Deposit Insurance Systems’ state that the deposit insurance already provided by the home country system should be recognised in the determination of levies or premium, there is need for a firm and shared understanding on this.

Relevance and Value of the Conference

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

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

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

- In light of the recent experience which has challenged the concept of “too big to fail”, is there a need to review the manner of defining ‘risk’ for the purpose of determining risk-based premium? How do we go about it?

- How do we factor-in the risk associated with all the nonbanking business of a financial conglomerate on its banking business? How should risk based premium factor in this risk?
- Should the entire income or the surplus of a deposit insurance system or any part of it be subject to taxes?
- Is it possible to define an international benchmark or at least a standard methodology for determining a benchmark for the Reserve Ratio (Ratio of Deposit Insurance Fund to Insured Deposit), signifying the adequacy of Deposit Insurance Fund?
- What countercyclical measures should a deposit insurance system take to build up its funds for the rainy day?

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

I wish the Conference all success.