Chapter IV
Modifying Deposit Insurance System in India

Chapter II has detailed some of the best practices in deposit insurance in the world. Chapter III has documented the deposit taking activities by various institutions in India. In this Chapter we have examined the present institutional structure of the deposit insurance system in India and suggested changes in it. This chapter is divided into three sections. The first part provides an historical review of the deposit insurance system and the credit guarantee system in India. The second part examines the various facets of the deposit insurance system in India and suggests modifications therein. The third part examines the credit guarantee scheme in India.

Section 1.
Origin of Deposit Insurance in India
4.2. The concept of insuring deposits kept with banks received attention first time in the year 1948 after the banking crises in Bengal. The question came up for reconsideration in the year 1949, but it was decided to hold it in abeyance till the Reserve Bank ensured adequate arrangements for inspection of banks. Subsequently, in the year 1950, the Rural Banking Enquiry Committee also supported the concept. Serious thought to the concept was, however, given by the Reserve Bank and the Central Government after the crash of the Palai Central Bank Ltd., and the Laxmi Bank Ltd. The Deposit Insurance Corporation (DIC) Bill was introduced in the Parliament on August 21, 1961. After it was passed by the Parliament, the Bill got the assent of the President on December 7, 1961 and the Deposit Insurance Act, 1961 came into force on January 1, 1962. With the integration of the Credit Guarantee Corporation of India Ltd., in July 1978, the title of the Act was changed as the Deposit Insurance and Credit Guarantee Corporation Act, 1961.

4.3. The Deposit Insurance Scheme was initially extended to functioning commercial banks only. This included the State Bank of India and its subsidiaries, other commercial banks and the branches of the foreign banks operating in India.

4.4. Since 1968, with the enactment of the Deposit Insurance Corporation (Amendment) Act, 1968, the Corporation was required to register all the 'eligible co-operative banks' as insured banks under Section 13 A of the Act. An eligible co-operative bank means a co-operative bank (whether it is a State Co-operative Bank, Central Co-operative Bank or Primary Co-operative Bank) in a State which has passed the enabling legislation amending its Co-operative Societies Act, requiring the State Government to vest power in the Reserve Bank to order the Registrar of Co-operative Societies of a State to liquidate, amalgamate or reconstruct a co-operative bank and to supersede its Committee of Management and to require the Registrar not to take any action for liquidation, amalgamation or reconstruction of a co-operative bank without prior sanction in writing from the Reserve Bank .

4.5. In the year 1976, the Parliament passed the Regional Rural Banks (RRBs) Act, 1976 and with the enactment of this Act, the RRBs automatically came under the purview of the Deposit Insurance Scheme. In terms of the provisions of the DICGC Act, 1961, it is obligatory on the part of the Corporation to register all the existing as well as new banks coming up after the enactment. In other words, the Deposit Insurance Scheme is a compulsory scheme and no bank can remain unregistered with the Corporation except those co-operative banks where the State Governments are yet to pass the required legislation. As on the 31st March 1999, all the States/Union Territories except four States *viz*., Arunachal Pradesh, Meghalaya, Mizoram and Nagaland and three Union Territories, *viz*., Andaman Nicobar, Chandigarh and Lakshadweep have carried out the required amendments in their respective Co-operative Societies Acts.

4.6. The introduction of Credit Guarantee Schemes by the erstwhile Credit Guarantee Corporation of India Ltd., was part of the measures taken in the late 1960's aimed at encouraging banks to extend credit to priority sector. In July 1978, DIC assumed also the function of credit guarantee and hence was renamed as Deposit Insurance and Credit Guarantee Corporation (DICGC). Thus, unlike its counterpart in other countries, the deposit insurance agency in India provides insurance to deposits and guarantee to bank credits to risky but socially important borrowers like small borrowers and small-scale industries.

Section 2.
Deposit Insurance Scheme - Current Status and Modifications Proposed

4.7. This section examines the following aspects of the Deposit Insurance System in India: (a) Coverage of deposits under deposit insurance, (b) Premium system, (c) Deposit Insurance Fund and (d) Organisational issues.

Coverage of Deposits
4.8. The Group examined four issues relating to the coverage of deposits under the deposit insurance scheme: (1) Types of deposits covered, (2) Level of deposit insurance coverage, (3) Types of institutions whose deposits are covered and (4) Assessment Base.

Types of Deposits Covered
4.9. In India, at present, all deposits *except* the (i) Deposits of foreign Governments, (ii) Deposits of State/Central Governments, (iii) Inter-bank deposits, and (iv) Deposits held abroad, are insured by DICGC. Consequent upon the amendment to Section 2(g) of the DICGC Act, empowering the Corporation to exclude any amount due on account of any deposit with any insured bank with the previous approval of Reserve Bank of India, from the 1st May 1986 deposits of the State Land Development Banks with the State Co-operative Banks are also excluded from the purview of the Deposit Insurance Scheme. Thus, the Deposit Insurance Scheme, by and large, covers the Household Sectors, which commands nearly two-third of the total bank deposits in the country (See Table 4.1). However, simultaneously, the scheme covers the Certificates of Deposits (CDs) as also the foreign currency deposits, i.e., the FCNR(B) deposits, both of which are high value deposits and subscribed to by those who cannot be considered as naïve or unsophisticated. The use of insurance coverage for (a) cash collaterals levied on deposits, and (b) deposits which are created by transferring subordinated liabilities prior to a bank failure was also discussed in the deliberations.

Table 4.1: Ownership of Bank Deposits By Type and Economic Sector
(As on End March 1998)

(Amount in Rs. Crore)

	Current		Savings		Term		Total	
	Amt	% to total	Amt	% to total	Amt	% to total	Amt	% to total
1	2	3	4	5	6	7	8(2+4+6)	9
1.Government Sector	14,430	17.5	11,556	8.4	34,146	8.9	60,132	9.9
2. Private Corporate Sector (Non-Financial)	11,265	13.7	343	0.2	13,101	3.4	24,711	4.1
3. Financial Sector	15,950	19.4	1,868	1.3	26,935	7.0	44,753	7.4
4. Household Sector	38,425	46.6	1,17,259	84.8	2,47,074	64.3	4,02,758	66.6
5. Foreign Sector	2,300	2.8	7,267	5.2	62,891	16.4	72,457	12.0
6. Total (1 to 5)	82,370	100	1,38,293	100	3,84,147	100	6,04,811	100.0

Source: Reserve Bank of India, (1999) 'Composition and Ownership Pattern of Bank Deposits-March 1998', *RBI Bulletin*, June, pp.823-844.

4.10. As regards CDs, these are not on par with deposits and are basically tradable instruments. These are also subordinated to deposits in the event of a bank liquidation. Hence, it is not appropriate to extend insurance cover to CDs. Since the minimum amount of a CD is Rs. 5 lakh, there is also no specific advantage in extending the cover to CDs. **The Group, therefore, recommends exclusion of CDs from the deposit insurance coverage. Similarly, the Group recommends that deposit insurance cover should not be extended to deposits taken as cash collaterals as also to deposits which are created by transferring subordinated liabilities, at least 6 months prior to a bank failure/moratorium, whichever is earlier**.

4.11. As regards foreign currency deposits, the international evidence is mixed with a number of developed countries not covering foreign currency deposits to protect the Deposit Insurance Agency (DIA) from foreign exchange risk. But in the wake of financial crisis in East Asia, many developing countries have brought foreign currency deposits under the deposit insurance cover. Although the inclusion of foreign currency deposits would involve foreign exchange rate risk, including these deposits for insurance cover and the fact that these deposits are quite sizeable for many banks, we recommend the continuation of deposit insurance cover to these deposits**.**

Level of Deposit Insurance Coverage

4.12. Initially, the insurance cover was limited to Rs.1,500 only per depositor for deposits held by him in the " same right and capacity " in all the branches of a bank. This insurance limit was enhanced from time to time as follows:

Rs.5,000 with effect from 1 January 1968
Rs.10,000 with effect from 1 April 1970
Rs.20,000 with effect from 1 January 1976
Rs.30,000 with effect from 1 July 1980
Rs.1,00,000 with effect from 1 May 1993 onwards

The substantial increase in deposit coverage from Rs.30,000 in May 1993 to Rs.1 lakh was the outcome of the review of the scheme in the background of security scam in 1992 and the subsequent liquidation of Bank of Karad.

4.13. Table 4.2 presents the extent of deposit insurance coverage in India; nearly 98 per cent of deposit accounts (up from 79 per cent in 1961) and 72 per cent of assessable deposits (up from 23 per cent in 1961) are protected by deposit insurance scheme in India.

Table 4.2: Extent of Deposit Insurance Coverage in India: 1961-99

Year	No. of fully protected accounts @	Total no. of accounts	Percentage of (2) to (3)	Insured deposits@ (Rs. crore)	Total assessable deposits (Rs. crore)	Percentage of (5) to (6)
1	2	3	4	5	6	7
1961	55.42	70.58	78.5	392.32	1,693.74	23.1
1981	1,364.62	1,377.07	99.1	25,859.20	35,004.43	73.9
1989-90	3,059.11	3,141.68	97.4	1,01,681.96	1,40,745.95	72.2
1990-91	2,982.52	3,089.12	96.5	1,09,315.52	1,56,891.90	69.7
1994-95	4,956.05	4,993.99	99.2	2,66,746.65	3,64,057.60	73.3
1995-96	4,818.63	4,868.07	99.0	2,95,574.97	3,92,071.69	75.4
1996-97	4,273.23	4,351.26	98.2	3,37,671.00	4,50,674.17	74.9
1997-98	3,713.02	4,108.73	90.4	3,70,531.21	4,92,379.86	75.2
1998-99	4,544.33	4,641.93	97. 9	4,39,609.10	6,09,962.07	72.1

Notes : @Number of accounts with balance not exceeding Rs.1,500 till the end of 1967, Rs.30,000 from 1981 onwards till 1992-93 and Rs.1,00,000 from 1993-94 onwards.
Source: Deposit Insurance and Credit Guarantee Corporation, *Annual Report* (Various Issues).

4.14. The level of deposit insurance cover depends indirectly on the level of development and the extent of inequalities in income and wealth. The lower per capita income and pronounced income and wealth inequalities indicate co-existence of poverty and high living standards. These conditions dictate that the level of insurance coverage should be such as to bring almost 90 per cent of the deposit accounts under its coverage. This coverage can be adjusted based on movements in GDP and inflation rates. The IMF typically offers one or two times per capita GDP as a rough rule of thumb for limiting the coverage. In India, the ratio of deposit coverage is 6.1 times which is one of the highest in the world (See Annexure II.2). But given the fact that a substantial portion of GDP is coming from the unorganized sector, we recommend **no change in the deposit insurance coverage for deposits. We also recommend that co-insurance, to a limited extent, be introduced so as to promote market discipline, particularly, among the relatively bigger depositors. In this regard, co-insurance is recommended for deposits between Rs.90,000 and Rs.1 lakh with 90 per cent cover which could be fine-tuned in future; deposits up to Rs.90,000 will, however, continue to have 100 per cent cover.**

4.15. The Group also examined the aspect of holding deposits in the "same right and capacity" which has resulted in numerous separately insured accounts ("pyramid structure") within a single bank through separate insured rights and capacities like joint accounts, etc. Even wealthier depositors can acquire unlimited amount of deposit insurance by opening separate insured accounts in different banks. The IMF best practices recommend a shift from "per deposit" to "per depositor" coverage. However, the problem is how to monitor and enforce this. In the current state of technology it will not be feasible. **The Group does not, therefore, recommend migration to the "per depositor" concept.**

Types of Institutions Covered

4.16. As discussed in Chapter III, besides banks, a number of entities like financial institutions, NBFCs, etc., have been taking public deposits. The moot question is whether deposit insurance should cover liabilities of these entities as well. This issue is interrelated with the issue of the goal of deposit insurance. In the literature, there are three visions of what deposit insurance should do, *viz.*, (i) protect banks from failure, (ii) protect some or all depositors; particularly the small and unsophisticated depositors who cannot be expected to monitor the soundness of their banks' assets portfolios, and (iii) to promote savings and better exploit the benefits of large scale payment system. From an economic perspective, the third is clearly the most important. The retail and wholesale payment system is the fundamental lubricant of the modern economy. In an environment, where several banks fail, the payment system would be disrupted, and monetary aggregates could be subjected to shocks. Besides, the level playing considerations are also cited in favour of explicit deposit insurance scheme. Where such a scheme does not exist, depositors may uncritically avoid smaller financial institutions in favour of State-owned banks (which enjoy implicit protection) and/or large banks. Secondly, one has also to see whether the deposit taking entities are properly regulated, lest partly regulated and poorly supervised entities could pose moral hazard problem, as evident from the experiences of the East Asian countries. Thirdly, there should be admission norms for entry into Deposit Insurance Scheme (as in many countries), as unrestricted entry into the scheme can amplify the moral hazard issues.

4.17. Table 4.3 presents the structure of insured deposits by DICGC during 1996-97, 1997-98 and 1998-99. The scheduled commercial banks accounted for 86 per cent of the insured deposits, the Regional Rural Banks (RRBs) 3 per cent and the Co-operative banks 11 per cent in 1998-99. In terms of deposit insurance premium collected also, the picture is somewhat similar (Table 4.4).

Table 4.3: Insured Deposits in India According to Banking Group - 1997-99.

Category of Banks	1996-97		1997-98		1998-99	
	Total Insured Deposits (Rs. Crore)	% to total	Total Insured Deposits (Rs. Crore)	% to Total	Total Insured Deposits (Rs. Crore)	% to Total
a) SBI Group	86694.48	25.67	97216.42	26.24	113803.01	25.89
b) Nationalised Banks	181227.77	53.67	183773.71	49.60	209332.71	47.62
i) Public Sector Banks (a+b)	267922.25	79.34	280990.13	75.83	323135.72	73.51
ii) Foreign Banks	5719.22	1.69	6755.56	1.82	7899.18	1.80
iii) Indian Private Sector Banks (i.+ii)	18466.46	5.47	27493.12	7.42	46733.40	10.63
A.Scheduled Commercial Banks	292107.93	86.5	315238.86	85.1	377768.30	85.9
B. Non-Scheduled Commercial Banks	1.27	-	N.A	N.A.	N.A	N.A
I. Commercial Banks (A+B)	**292109.20**	**86.51**	**315238.81**	**85.08**	**377768.30**	**85.93**
II. Reg. Rural Banks	**9805.29**	**2.90**	**12965.62**	**3.50**	**14399.46**	**3.28**
III. Co-op Banks	**35756.51**	**10.59**	**42326.78**	**11.42**	**47441.34**	**10.79**
Total (I+II+III)	**337671.00**	**100.00**	**370531.21**	**100.00**	**439609.10**	**100.00**

N.A.- Not Available

Source: Same as in Table 4.2.

Table 4.4: Category-Wise Break-up of Deposit Insurance Premium[20] Collected from Insured Banks by DICGC-1998-99

(Amount in Rs. Crore)

<table>
<tr><th>Year</th><th>Commercial Banks</th><th>Regional Rural Banks</th><th>Co-operative Banks</th><th>Total</th></tr>
<tr><td>1997-98</td><td colspan="2">284.96</td><td>34.31</td><td>319.27</td></tr>
<tr><td>% to total</td><td colspan="2">89.2</td><td>10.8</td><td>100.0</td></tr>
<tr><td>1998-99</td><td colspan="2">326.90</td><td>43.79</td><td>370.69</td></tr>
<tr><td>% to total</td><td colspan="2">88.2</td><td>11.8</td><td>100.0</td></tr>
</table>

Source: Same as in Table 4.2.

4.18. As detailed in paragraphs 4.3 ,4.4, 4.5, at present, deposit insurance cover is compulsory for the commercial banks, the RRBs and the co-operative banks. The Group recommends that **the deposit insurance be continued to be compulsory for the banks, but it need not be obligatory for the Corporation to extend the coverage to *any* bank**. The banks, which come under the umbrella of deposit insurance, must observe certain discipline prescribed by the regulators/supervisors so as to keep themselves fit, because their failure would ultimately erode the precious Deposit Insurance Fund of the Corporation. The specific concern arises from the fact that the open-endedness and compulsory nature of deposit insurance have accentuated the moral hazard issues, with the weak banks enjoying benefits of deposit insurance cover at the expense of the strong ones. Many banks in these segments have negative net worth and still continue to enjoy deposit insurance cover.

4.19. Of immediate concern is the co-operative banking segment, the dual control of which makes the control of the Reserve Bank and the insuring agency less effective as most of the co-operative entities have been established by the respective State Government enactments. It is also observed that substantial number of co-operative banks, especially in the urban banking segment, has been weak and could make a serious dent on the deposit insurance fund. In fact, the Narasimham Committee on Banking Sector Reforms (1998) had recommended that the dual control of the co-operative banks should be dispensed with and brought under the unified regulatory and supervisory control of the Reserve Bank. In fact, this has not fructified, as many State Governments are unwilling to surrender their powers.

4.20. Against this backdrop, **it is recommended that those banks, which currently enjoy the deposit insurance cover but do not meet the following criteria, be given a maximum period of 3 years (inclusive of the time span given by the supervisor) to attain these norms, failing which actions will be initiated by the Corporation to withdraw the deposit insurance cover.**

1. **Non-compliance with CRAR prescriptions (not mandatory for RRBs and co-operative banks).**

2. **Entities with CAMELS rating of "C" or below consistently for 3 years.**

Besides, if the Corporation notices any deterioration in the financial position of the weak banks within the stipulated three years, it shall initiate action to withdraw the deposit insurance cover.

Banks shall disclose in their Annual Reports their compliance or non-compliance with the above mentioned norms as additional disclosures.

4.21. Deposits of DFIs currently do not constitute a major source of funds for these institutions due to the umbrella cap prescribed for mobilization of funds by them. The deposits mobilized by them are not significant. Further, the DFIs are not under the same regulatory regime as that of banks. But as the process of functional diversification of DFIs continues, deposits could emerge as a cheaper source of funds for them. However, by then, the DFIs would be transforming themselves into either banks or NBFCs, as envisaged by the Khan Working Group[21], and would in the former case be covered under Deposit Insurance.

4.22. Similarly, funds mobilized by mutual funds do not exactly qualify under the term 'deposits'. Since these funds do not come under the category of retail deposits and that of unsophisticated depositors, it is prudent to keep deposit liabilities of these institutions out of deposit insurance as has been the practice elsewhere (e.g., FDIC).

NBFCs

4.23. The issue of extending deposit insurance to NBFCs was addressed by a number of committees in recent times. The Working Group (1997) headed by Smt. K.S. Shere, which had examined the issue in detail, had observed that in the existing milieu, the introduction of Deposit Insurance Scheme for depositors of NBFCs might not be advisable. The Committee on Banking Sector Reforms (1998) had also observed

> "..deposit insurance for NBFCs could blur the distinction between banks, which are more closely regulated, and the non banks as far as safety of deposit is concerned and consequently lead to a serious moral hazard problem and adverse portfolio selection. The Committee would advise against any insurance of deposits with NBFCs" (p.viii).

4.24. This issue was again examined by the Vasudev Committee (1998[22]) which observed "it would not be judicious to introduce a deposit insurance scheme for the depositors in NBFCs because of the moral hazard issues, likelihood of asset stripping and the likely negative impact on the growth of a healthy NBFC Sector" (p.37)

We also had a re-look at the international experience with regard to extending deposit insurance for non-banks. The U.K. experience of Building Societies (as detailed in Chapter II) is more in the form of mutual liability insurance. The recently introduced deposit insurance system in Thailand does cover finance companies; but that is more as a reaction to bank panics.

4.25. The argument for inclusion of NBFCs into deposit insurance fold has to be examined in terms of whether their liabilities fall under monetary aggregates, its potency to create shocks in the system and whether they are adequately regulated and supervised. Although deposits of NBFCs do not strictly come under any of the monetary aggregates, they come under the new liquidity aggregates. The Working Group on Money Supply (Chairman: Dr. Y.V. Reddy[23]) had recommended that deposits of non-banking financial companies should be included in the liquidity aggregates. Secondly, although the deposits of NBFCs in relation to deposits of scheduled commercial banks are not considerable (about 5 per cent), the systemic impact of failure of NBFCs on the banking system would be considerable. Thirdly, only in January 1998, NBFCs have been brought under a more comprehensive regulatory and supervisory ambit of the Reserve Bank. The process of registration is still on, and the regulatory and supervisory system in place is yet to stabilize. A new enactment is also being contemplated. We believe that deposit insurance is not a substitute for supervision. **It is premature to extend deposit insurance cover to NBFC immediately. But denying them deposit insurance cover indefinitely may not be prudent, once these entities are adequately regulated and supervised and there is some degree of regulatory parity vis-à-vis banks. The Group, as a practical measure, therefore, recommends that extending deposit insurance could be considered after the regulatory and supervisory system is stabilized. Hence, a review may be made after 2 years and deposit insurance be thought of only for those NBFCs which meet the registration and supervisory norms.**

Assessment Base for Deposit Insurance

4.26. At present, the premium is charged on the "assessable deposits" and not on the "insured deposits". There is a view that since the Corporation makes good only the insured amounts of deposits in the case of a bank failure, the premium should be charged only on the insured deposits and not on the assessable deposits. Given the administrative complexities involved at the branch level to compute insured deposits, it would be appropriate to continue with the present arrangement of charging insurance premium on the basis of "assessable deposits".

Premium System

4.27. Two issues have been examined here. One relates to the shift from the flat rate to the risk related premium rates and the other to the method of charging the premium.

Premium Rates

4.28. At present, the DICGC charges a flat rate of 5 paise for Rs. 100 of assessable deposits. The rates of premium as fixed by the Corporation from 1962 to the present are given in Table 4.5.

Table 4.5: Deposit Insurance Premium Rates in India:1962-99.

Period	Premium
1	2
Upto 30th September 1971	Re. 0.05 or 1/20th of 1 per cent p.a.
Upto 30th June 1993	Re. 0.04 or 1/25th of 1 per cent p.a.
From 1st July 1993	Re. 0.05 or 1/20th of 1 per cent p.a.

4.29. As per the existing provisions of the Act, the Corporation can levy a maximum premium of up to Rs.0.15 per Rs.100 per annum. The premium is required to be paid on the total assessable deposits and not merely on the deposits insured by the Corporation. The premium is payable half-yearly and is charged on total assessable deposits of an insured bank as on the last Friday of the half year and is payable in advance within one month from the commencement of that half year. In the case of delayed payments banks are required to pay penal interest at the rate of 8 per cent above the Bank Rate. The premium paid by the insured banks is required to be absorbed by the banks themselves so that the insurance protection to depositors is made available free of cost.

4.30. The Narasimham Committee on Banking Sector Reforms (1998) had recommended that

> "…there is….need to shift away from the 'flat' rate premiums to 'risk based' or 'variable rate' premiums., Under the risk based premium system all banks would not be charged a uniform premium. While there can be minimum flat rate which will have to be paid by all banks on all their customer deposits, institutions which have riskier portfolios or which have lower rating should pay higher premium. There would thus be graded premium. As the Reserve Bank is now awarding CAMELS ratings to banks, these rating could form the basis for charging deposit insurance premium" (Chapter V, para 5.42)

4.31. In fact, the introduction of risk-based premium pricing could minimize moral hazard. Hence the introduction of risk-based pricing of deposit insurance should

- Be set high enough to cover the expected reimbursement that would be needed in the event of one or more bank failures and

- Vary with the riskiness of the individual bank- with weak or poorly capitalized banks being forced to pay more.

4.32. In practice, it is very difficult to attain both the goals. Given the difficulties in forecasting the timing, depth and spread of financial crisis, it may be virtually impossible for insurance fund to quantify the expected cost of a banking crisis. This is more difficult in a country like India dominated by public sector banks (including RRBs), which have an implicit guarantee from the Government. A crude estimate of the likely impact of vulnerability of public sector banks alone on the DICGC funds can be gauged from the ratio of net NPAs to insured deposits of public sector banks which is around 7 per cent (in 1998-99).

4.33. Risk-based premiums should be determined objectively and the criteria should be simple for the banks to understand. We have examined a number of methodologies including the use of option pricing models and we feel the CAMELS model could be adopted in the Indian context. The CAMELS rating has been introduced in India for banks only one year back and only one round of exercise has been completed. Hence, it would be desirable to base pricing of risk based on the latest available CAMELS rating generated by Department of Banking Supervision of the Reserve Bank. **In the case of entities, which do not have a reliable CAMELS rating (like the co-operative banks and the RRBs), one may have to opt for flat-fee based deposit insurance till the CAMELS database becomes available. However, the flat fee based premium will be higher than the lowest/best premium rate for the scheduled commercial banks.** A detailed exercise using data obtained through (a) CAMELS model and (b) Option Pricing model is presented in Annexure IV.1. In this endeavour, **it is recommended that those entities, which do not report data to the insurance agency in time and thereby increase the asymmetry of information, may be levied a penalty of 50 to 100 basis points more deposit insurance premium.** The Group recommends that the CAMELS model discussed in Annexure IV.1 may be used for pricing of deposit insurance. As per the exercise conducted by the Group based on CAMELS model by varying the premium rates between 5 to 24 paise per Rs. 100 the Deposit Insurance Fund would attain the targeted level of 2 per cent of insured deposits (as recommended in para 4.38) within next 4 years .

Method of Charging Deposit Insurance Premium

4.34. At present, the deposit insurance premium is charged (on advance basis) on a half-yearly basis based on deposit balances as on end-June and end-December basis. The premium for half years ending June and December is required to be remitted by July-/January-end respectively. Since all the banks have already changed their balance sheet dates from end-December to end-March basis, **it is appropriate that premium be also determined semi-annually on the basis of balance sheet figures, i.e., end-March/September. Banks would be given a period of one month's time to pay the advance premium amount, as is the present practice.**

Deposit Insurance Fund

4.35. The deposit insurance fund[24] as a percentage of insured deposits in India works out to 0.70 in 1998-99 (See Table 4.6) and compares unfavourably with the figure of 1.25 mandated by FDIC in U.S and the figures in other countries. We calibrated the effect of vulnerability in the banking system on deposit insurance fund by looking at two scenarios:

(a) what would be the impact of failure of two weak scheduled commercial banks on deposit insurance fund?

(b) If the entire liability on account of NPAs (Gross) of scheduled commercial banks devolves on the deposit insurance fund, what would be the impact.

4.36. As regards (a), we calibrated the impact of failure of two of the weakest banks in the system on the deposit insurance fund for end-March 1999. The result showed that the existing Deposit Insurance Fund would be wiped out entirely and the Deposit Insurance Fund would be in a deficit of Rs.16,600 crore. As regards scenario (b), the deficit worked out to Rs.43,000 crore.

Table 4.6: Deposit Insurance Fund of DICGC: 1962-1999

(Amount in Rs. Crore)

Year	Deposit Insurance Fund (DIF)	Insured Deposits	DIF as a % of Insured Deposits
	2	3	4
1961	1	392	0.22
1972	25	4,656	0.53
1982	154	31,774	0.48
1990-91	337	1,09,316	0.31
1995-96	205	2,95,575	0.07
1996-97	299	3,37,671	0.01
1997-98	2,022	3,70,531	0.54
1998-99	3,107	4,39,609	0.70

Source: Same as in Table 4.2.

4.37. In order to make deposit insurance fund sound and sustainable, **the creation of two deposit insurance funds is recommended, one for the commercial banks (including RRBs) and the other for the co-operative banks.** In fact, the IMF Survey[25] on best practices has observed that

> "…some types of depository institutions….. may be more risky than commercial banks; be subject to different laws and regulations; and may be overseen by a less effective system of supervision. In this situation, creating separate insurance schemes….. may be the answer.."(p.11).

4.38. It is also recommended that we introduce the concept of a deposit insurance fund of 2 per cent of the insured deposits in the beginning for the commercial banks (including RRBs) and the co-operative banks which could be altered depending on the vulnerability of the banking sector. The 2 per cent minimum DIF has been arrived at on the basis of the impact of likelihood of default of one of the weak banks on the deposit insurance fund. As in the case of FDIC, whenever a particular fund falls below the threshold level, the premium for that segment will have to be altered in tune with the change in the risk profile. In the case of DIF exceeding the target level, insurance premium will have to be adjusted downwards.

Re-Insurance

4.39. The Group also recommends that with a view to knowing whether the premium rates prescribed by the Corporation are market driven or not, and if not, by how much the rates are away from the market-related rates, re-insurance possibilities, in a very limited way, be explored. **It is recommended that 2.5 per cent of the insured deposits may be re-insured. The possibility of re-insurance with insurance agencies may be explored.**

Organisational Issues

Capital structure of the Corporation

4.40. The DICGC is functioning as a wholly-owned subsidiary of the Reserve Bank. Its initial capital was Rs.1 crore which was subsequently enhanced to Rs.50 crore from the 1st May 1984, and it is fully subscribed by the Reserve Bank of India. It has been meeting the operational expenses out of the investments made from the capital. In some years, this income was found to be inadequate to meet operating expenses, which forced it to seek grant from the Reserve Bank.

4.41. The DICGC, under the reformed set-up, should function as a professional entity. Hence, it should also have adequate capital. Capital serves as the buffer against potential losses. It should have at least more capital than the entry-level capital prescribed for a new private sector bank and hence, **it is recommended that the capital of the Corporation be fixed at Rs.500 crore and contributed fully by the Reserve Bank**. **The capital increase should be in a phased manner and be done only after securing the income-tax exemption. Besides, it should also**

have a lender of last resort facility from the central bank or the Government. Ideally, it can have collateralised liquidity support from the Reserve Bank and financial support (to meet any contingencies) from the Government.

Investment

4.42. At present, the investment of the Corporation is in central government securities. The weighted average return on these investments is 11.52 per cent as at end-July 1999. In order to maximize the yield on investments, **the Corporation should be empowered by a suitable amendment to its Act to invest in instruments other than the central government securities. Then, the Corporation should have an "investment policy" with the approval of its Board.**

Tax Concession

4.43. Keeping in view the social obligations served by the Corporation and also the position that the Corporation is not a company within the meaning of the Companies Act, 1956, the Corporation **should be exempted from payment of corporate tax,** as was the practice before December 1986. In fact, the FDIC and the Deposit Protection Board, U.K[26] are exempt from corporation tax.

Board

4.44. The Management of the Corporation vests in a separate Board of the Corporation constituted as per the provisions of DICGC Act 1961. The Governor, Reserve Bank or any Deputy Governor nominated by him functions as Chairman of the Corporation. **The Group recommends that the representatives of the supervisors of the commercial banks and co-operative banks of fairly senior rank should be in the Corporation's Board**. In addition to the above, **five directors** having special knowledge/experience in banking, accountancy, co-operation, commerce, industry, insurance, etc., **may be nominated by the Reserve Bank of India.** From the point of view of prudent management, **it is advisable not to have any nominee from the insured entities on the Board of the Corporation.**

Inspection and Supervision

4.45. Although in terms of the provisions of the DICGC Act, 1961, the Corporation is empowered to have free access to records of the insured banks, it is not having its own inspection machinery, but depends on the inspection reports of the Reserve Bank in the case of commercial banks and urban banks and NABARD for the RRBs and other co-operative banks. This policy is being followed in the interest of administrative and financial expediency and to avoid the dual inspection machinery and duplication of staff. In order to enable the insurer to monitor information about insured entities, the supervisor will have to provide regularly information obtained through inspection or otherwise to the Corporation on a timely and frequent basis. We had examined the role of the Corporation and recommend that it should be on the model of FDIC sans supervision. **The Group recommends that a well-defined platform be statutorily mandated where periodical exchange of information between the Corporation and the Reserve Bank shall take place. The Corporation shall have access to inspection reports, post-inspection discussions, and to be actively involved in action plans for banks and in compliance with action plans.** Since the Corporation's stake is involved in a bank on the brink of failure, it shall have the authority to suggest to the regulator the future course of action for the banks, which may include revoking the licence of the bank.

Human Resources

4.46. The Corporation has to function as a highly professionalised agency having core competence in the arena of insurance, liquidation, mergers and related fields. In this endeavour, **the Corporation may have to re-look at the human resource requirements in the future. The reformed Corporation should be lean and have officer oriented staff of its own with a strong information technology base. In this endeavour, the Corporation should have the option to recruit its personnel from the market and also have the authority to screen officers who wish to be deputed to the Corporation from the Reserve Bank.** If the Corporation has to perform specialized task in order to discharge its envisaged function, the salary structure of its staff should be in line with the market expectations so that it will have adequate response to its recruitment from the market.

Section 3.

Credit Guarantee Schemes

4.47. The credit guarantee schemes, which were formulated by the Credit Guarantee Corporation (CGC) of India Ltd., and continued by DICGC, were intended to provide the necessary incentive to banks for extending credit to small borrowers (including farmers) engaged in the non-industrial activities. A credit guarantee scheme for small-scale industries sponsored and formulated by the Government of India and administered by the Credit Guarantee Corporation (Reserve Bank of India) had been in operation since July 1960. In pursuance of the recommendations of the Working Group constituted by the Government in 1979, all credit guarantee schemes were integrated under one organisation.

4.48. Based on the recommendations of an Expert Committee, the scope of the credit guarantee schemes was enlarged effective from April 1, 1989 to cover the entire gamut of priority sector advances. However, at the request of some credit institutions, DICGC has allowed exclusion of certain categories of advances guaranteed by Central/State Governments, ECGC, etc., from total priority sector advances for the purpose of payment of guarantee fee and consequently, these advances do not get DICGC guarantee cover. The schemes covered under the credit guarantee scheme are: (i) Small Loans Guarantee Scheme 1971;[27] (ii) Small Loans (Financial Corporations) Guarantee Scheme, 1971; (iii) Service Co-operative Societies Guarantee Scheme, 1971; (iv) Small Loans (Small Scale Industries) Guarantee Scheme, 1981;[28] (v) Small Loans (Co-operative Credit Societies) Guarantee Scheme, 1982; (vi) Small Loans (Co-operative Banks) Guarantee Scheme, 1984.[29] With effect from April 1, 1992 with the termination of the schemes (ii), (iii) and (v), the Corporation presently operates only schemes (i), (iv) and (vi). Initially, the guarantee was extended upto 90 per cent of the total outstanding loan (including interest), which was reduced over time to 50 per cent of the principal amount.

4.49. The consideration for extension of the guarantee cover is the payment of guarantee fee at the stipulated rates calculated on the balances outstanding under the priority sector advances (except certain specified categories) and paid yearly in advance by the credit institutions. The fee rate is 2.50 per cent per annum for the Small Loans Guarantee Scheme, 1971 only. The guarantee fee rate for each of the two other schemes viz. Small Loans (Co-operative Banks) Guarantee Scheme, 1984 and Small Loans (SSI) Guarantee Scheme, 1981 is 1.50 per cent per annum. The Regional Rural Banks were, however, allowed to pay the fee at half the normal rate for first five years from the date of their joining the Scheme. The fee is required to be paid regularly on an annual basis in order to keep the guarantee in force. Penal interest @ 8 per cent above the Bank Rate is charged on overdue guarantee fee.

4.50. The credit guarantee schemes of DICGC have not been viable. The credit guarantee fund has been in deficit except for the year 1989-90, resulting in huge deficit for the DICGC as a whole (Table 4.7). A major attraction of credit guarantee schemes for banks, apart from the guarantee, was that the guarantee fee paid to DICGC was tax-deductible. The DICGC has been forced to fund the credit guarantee fund by borrowing from the deposit insurance fund. To overcome deficits in guarantee funds, the guarantee fee was enhanced in April 1989. Then in 1995, the guarantee claims were confined to principal loan rather than outstanding loan, as was the practice earlier. These changes made the credit guarantee schemes an unattractive proposition for the banks. Consequently, most of the banks have opted out of the schemes. At present, only two RRBs are participating in Small Loans Guarantee Scheme 1971, whereas in Small Loans (Small Scale Industries) Guarantee Scheme 1981 two RRBs and 17 co-operative banks are members. Only one co-operative bank is participating in small Loans (Co-operative Banks) Scheme 1984.

Table 4.7: Surplus/Deficit of Credit Guarantee Schemes in India - 1990-99

(Amt.in Rs.Crore)

Year	Guarantee fee receipts	Guarantee claims receipts	Claims paid	Gap (2) - (3)	Gap (2) - (4)
1	2	3	4	5	6
1989-90	598.83	548.33	508.54	(+) 45.50	(+) 85.29
1990-91	524.72	748.76	547.16	(-) 224.04	(-) 22.44
1991-92	565.88	627.23	462.29	(-) 61.35	(+) 103.59
1992-93	702.78	1143.27	633.55	(-) 440.49	(+) 69.23
1993-94	846.09	1490.76	889.99	(-) 644.67	(-) 43.90
1994-95	829.13	1726.82	1179.01	(-) 897.69	(-) 349.88
1995-96	704.64	2365.23	1042.27	(-) 1660.59	(-) 337.63
1996-97	564.02	2112.37	378.64	(-) 1548.35	(+) 185.38
1997-98	164.91	303.96	371.40	(-) 139.05	(-) 206.49
1998-99	123.21	252.30	601.91	(-) 128.96	(-) 478.68

Source: Same as in Table 4.2.

4.51. The banks feel that with an in-house corpus (Fund created out of credit guarantee fee paid to DICGC) they can manage the overdues problem of the priority sector loans. **Given the fact the credit guarantee operations of the DICGC have been less attractive for the user and the fact that extension of loans and managing risks associated with it are the prerogatives of the lender and the fact that the deposit insurance fund has been cross-subsidising the credit guarantee fund, the Group recommend that the credit guarantee on loans may be withdrawn and the Corporation could be renamed as "Deposit Insurance Corporation".**

Moreover, it is not desirable to combine deposit insurance and credit guarantee functions from the moral hazard point of view. After the withdrawal of the Credit guarantee function, the "credit guarantee fund" on account of any past transactions or claims should be separated out and maintained by the Reserve Bank.

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20 These are inclusive of interest on overdue premium.

21 Report of the Working Group for Harmonising the Role and Operations of DFI's and Banks (Chairman: S.H. Khan).

22 Government of India (1998) *Report of the Task Force on Non-Banking Finance Companies* (Chairman: C.M. Vasudev), October.

23 Reserve Bank of India (1998) *Money Supply: Analytics and Methodology of Compilation- Report of the Working Group* (Chairman: Dr.Y.V. Reddy), June, Mumbai.

24 Deposit insurance fund has two components, viz., (a) Balance in Deposit Insurance Fund and (b) surplus from revenue account.

25 Garcia (1999) Op. cit.p.11.

26 In U.K. the contributions received by the Deposit Protection Board under FSA are not subject to corporation tax but no relief is available for any revenue expenditure. The Board is liable to corporation tax on investment income or other income received. Deferred taxation is provided in full, using the liability method, on all timing differences, which arise from differences between the treatment of investment income for accounting and fiscal purposes.

27 The Small Loans Guarantee Scheme, 1971, which came into force on 1 April 1971, covers credit facilities granted by commercial banks including regional rural banks to the priority sector (other than small scale industries) as defined by Reserve Bank and this includes farmers and agriculturists, small road and water transport operators, retail traders, small business enterprises, professional and self-employed persons and educational, housing and consumption loans.

28 The Small Loans (Small-Scale Industries) Guarantee Scheme, 1981 was introduced from 1 April 1981 and it covers credit facilities granted by commercial banks including regional rural banks, co-operative banks, State Financial Corporations and State Development Agencies to small-scale industries units for acquisition of or repairs to or replacement of fixed assets or equipment and for working capital requirements for production and marketing of products.

29 The Small Loans (Co-operative Banks) Guarantee Scheme, 1984 covers credit facilities granted by eligible primary (urban) co-operative banks to the priority sector as defined by Reserve Bank, including activities allied to agriculture, road and water transport operators, retail traders, small business enterprises, professional and self-employed persons and educational, housing and consumption loans. All eligible licensed primary (urban) co-operative banks as defined in clause (gg) of Section 2 of the DICGC Act, 1961 as well as eligible unlicensed primary (urban) co-operative banks recommended by the Reserve Bank of India as eligible, can participate in the Scheme.