For a private market in deposit insurance

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Depositors' claims can be settled faster if the DICGC acted only as a re-insurer and private/public sector players offer protection

It is nearly four weeks since the RBI froze the banking operations of Punjab and Maharashtra Cooperative Bank (PMC) Bank including restrictions on the quantum of withdrawal by depositors of monies deposited in that bank. The RBI has claimed that with the hike in the quantum of withdrawal to ₹40,000 announced on October 14, around 77 per cent of the depositors would be able to withdraw their entire savings in the bank. But there still remains a question mark over the fate of the monies held by the balance 23 per cent of the customers of the bank. They are left to agitate in front of the RBI premises on Mint Street in Mumbai or pour their tale of woe before 24/7 television news channels. Yet it need not have been reduced to all this.

Think of an alternative scenario. The RBI issues a direction under Section 35A of the Banking Regulation Act against a particular bank which puts a question mark over the safety of a customer's deposit in that bank. Far from rushing the next day morning to the bank branch, the customer leisurely walks up to the nearest branch of an ICICI Lombard or a HDFC ERGO from whom he/she has taken out a policy deposit insurance against the defaulting bank and lodge a claim for the sum assured on the ground that a direction by the RBI under Section 35A constitutes a claim event.

The case for a private market in deposit insurance stems primarily from the fact that the present system of settling deposit insurance claims under the Deposit Insurance and Credit Guarantee Corporation Act is slow and cumbersome as this newspaper had argued in a recent article on the subject (*BusinessLine*, October 19). The structural reason as to why the settlement process is so time consuming is that the RBI does not segregate the process of settlement of deposit insurance claims from the process of preserving the value of the troubled bank's assets. That the insurance liability falls on its wholly-owned subsidiary, the Deposit Insurance and Credit Corporation (DICGC), doesn't help matters either.

Ideally, the banking regulator (RBI) should not also be in the business of deposit insurance protection.

Also, the DICGC bundles the role of primary insurance protection and reinsurance operation into a composite whole. This goes against the fundamental principle of risk mitigation in the insurance industry where the functions of insurance and reinsurance are usually separate depending on the size of risk exposure in individual policyholder or types of policies. If the DICGC were to act only as a re-insurer with a large number of private and public sector insurance companies offering deposit insurance protection, the process of settlement of insurance claims would be inherently faster.

There is another problem which is even more serious. The vast army of private savers in the country's banking system simply do not enjoy total insurance protection for their bank deposits. The deposit insurance which is currently pegged at ₹1 lakh is substantially below the average size of deposits in the banking system which as of March 2019, stood at roughly ₹5 lakh. In absolute terms, around ₹85 lakh crore worth of public savings in the Indian banking system is currently uninsured. This is spread over 17.4 crore bank accounts (DICGC Annual Report 2018-19). Granted that many savers typically tend to bank with more than one institution, the number of individuals/corporates or unincorporated entities whose deposits are marginally or substantially bereft of any insurance cover is bound to be a large portion of the 17.4 crore number mentioned above.

Hike insurance cover?

The obvious solution is to hike the insurance cover. But this is something that the government is unable to do. The government's reasoning goes something like this. The banking system in most market-driven economies is highly interlinked with one another. A crisis in one institution willy-nilly ends up becoming the crisis of the entire banking industry as a whole. Should the banking industry be integrated in a greater measure with financial institutions across the globe, a distress in one with its 'contagion' effect of consequences becomes even global in nature.

In such a situation, it is beyond the capacity of any insurance institution or for that matter, even the sovereign to bail out banks across the world. The only way things can be brought back on an even keel is for the community of savers to forgo a portion of what these institutions owe to them — what the financial services industry calls a 'haircut'. The restructured institutions can then dust themselves up back to functioning as a lending institution and keep the wheels of the economy moving.

This is what the government tried to do with its Bill on Financial Resolution and Deposit Insurance of 2017. Since it would be politically suicidal to confess upfront, that there is no way out of forcing the depositors into taking a 'haircut' on the monies deposited, the legal draft on the issue was delightfully left vague while throwing in a crumb to the public in the form of a hike in deposit protection from ₹1 lakh to ₹3 lakh. But of course, the public were not fooled and the resultant furore led to the government withdrawing the Bill itself!

We thus have a situation where the government seems daunted by the prospect of having to underwrite a humongous sum of money on the implicit assumption that a failure in one bank will inevitably lead to a collapse of the entire banking industry. Since that price tag for that is currently put at ₹85 lakh crore, the government has come to the conclusion that it doesn't have the fiscal capacity for the same and has thus chosen the expedient way — kicking the can down the road to be confronted at a future date.

But the government is clearly misreading the lessons of the Global Financial Crisis of 2008. The crisis in the financial institutions of the West, back then, was due to non-ring-fencing of primary banking business from purely speculative bets on the value of financial assets whose connection to some real assets was so far removed as to make it almost illusory. This is not the case in India.

The use of derivative products by banks is not extensive and, in any case, can be ring-fenced from traditional activities of deposit taking and lending undertaken by a bank. A point to note in this context is that the extent of financial sector inter-coupling is so minimal as to be seen as practically non-existent. The inter-bank assets and liabilities taken together, account for a tiny fraction (around 4 per cent) of the banking system's assets (loans and investments) that lie outside the banking sector (*RBI Weekly Statistical Supplement*: September 27, 2019).

Uninsured deposits

The other misconception about uninsured deposits is that a claim against such deposits will materialise all at the same time. For such a contingency to happen, the entire economy of India would have to face a total collapse from an extreme man-made or natural disaster. How realistic is that? This is like asserting that all the 'Life' policies underwritten by LIC would result in death claims against the insurance company at one instantaneous point of time.

The phenomenon of uninsured deposits in the banking system is not without an element of irony. Both the RBI and the insurance industry regulator (IRDAI) currently permit regulated institutions to cover their assets against risk of default through the mechanism of Credit Default Swaps. But ordinary investors have no protection for the entirety of their savings in the banking system because the public agency tasked with offering such protection is either incapable of or otherwise unwilling to secure them in its entirety. Need one say more?

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