Is deposit insurance working as it should?

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Bank depositors often have to endure long waits in limbo before they are able to get their hands on the insurance money

The Indian saver's enduring faith in bank deposits has taken hard knocks lately. First there was the string of disclosures from public sector banks on legacy bad loans that they had evergreened. Then came the revelation that many private sector banks had also chronically under-reported dodgy loans. Recently, the RBI's directions against Punjab and Maharashtra Co-operative (PMC) Bank have opened a Pandora's box on funds diversion and weak supervision at urban co-operative banks.

The immediate reaction from most commentators to these events has been to demand that the RBI raise the deposit insurance cover for banks from the current limit of ₹1 lakh per depositor, to a more liberal limit of say ₹2 lakh or ₹5 lakh. Some campaigners are even demanding 100 per cent insurance coverage.

A revision in India's bank deposit insurance cover, which is way below global averages, is long overdue. But if the campaigners believe that a bigger cover will be enough to provide succour to hapless depositors who've trusted their life savings with dubious banks, they're far off the mark.

Directions limbo

History shows that in India, depositors in troubled banks often endure multi-year waits and surmount many hurdles before they get their hands on the insurance money.

Bank deposit insurance payouts in India kick in only after the RBI cancels a bank's license and appoints a liquidator for winding up of its matters.

For depositors in co-operative banks, troubles usually start with the RBI unearthing some evidence of mismanagement or misreporting by the bank and passing directions on it. These include curbs on the bank's lending, investing and deposit-taking activities accompanied by stringent limits on depositors withdrawing their money.

But several years can elapse between the RBI passing its first set of directions on a bank and finally making up its mind to cancel its license. In the meantime, depositors are usually stuck in limbo — neither able to access to their deposits nor file insurance claims.

It was in March 2001 that the RBI issued its first set of directions restricting withdrawals from Madhavpura Mercantile Co-operative Bank, which went belly up after lending to the infamous Ketan Parekh. It took 11 years for RBI to finally cancel the bank's license in June 2012, paving the way for depositors to get their insurance payout. In these 11 years, the bank came up with multiple proposals to restructure its operations, all of which failed spectacularly.

For over two lakh depositors in the Bengaluru-based Amanath Co-operative Bank, under RBI directions since April 2013, it has been a wait without end. After initially freezing withdrawals at ₹1,000 per account for six months, the RBI tried to cobble together a merger of the ailing bank with Canara Bank in 2014. After the merger fell through, depositors have been left high and dry with the RBI extending its restrictions dozens of times without assigning any reasons.

There are literally thousands of depositors in co-operative banks currently under the RBI's watch, who have been frozen out of their bank accounts for years.

While the RBI's keenness to explore every option to revive an ailing bank is understandable, the unending wait that its directions impose on depositors is unfair. The RBI must set fixed timelines for revival efforts at troubled banks, failing which liquidation will automatically proceed. It also owes depositors regular updates on the status of resolution efforts.

Liquidation troubles

Even after a bank's license is officially cancelled by the RBI and its liquidation is set in motion, depositors of failed banks may face interminable waits for their insurance pay-outs.

According to the rulebook, when the RBI cancels a bank's license, it must immediately direct the Registrar to appoint a liquidator. Within three months of his appointment, the liquidator is supposed to hand over a claims list of all eligible depositors to the Deposit Insurance and Credit Guarantee Corporation (DICGC). The DICGC is required to pay the insured amounts to the liquidator within two months of receiving this list.

While these rules envisage depositors receiving their claims within five months, the real-life experience tends to be vastly different. Data from the DICGC suggests that on an average in the last five years, deregistered banks took anywhere from eight months to eight years to settle their first set of claims to their depositors. While the DICGC seems to adhere to timelines, the claim settlement process often runs into roadblocks at the liquidators' end.

In some cases, the claims process is stalled by poor maintenance of depositor records or their seizure by investigators. In others, rogue managements do their utmost to scuttle resolution by filing suits against merger or liquidation plans. Some liquidators also present half-baked records to the DICGC, requiring much toing and froing.

These factors could explain why despite dozens of co-operative banks failing over the years, the DICGC has been paying out only modest sums by way of insurance claims. From the time of its inception until March 31, 2019, the DICGC has paid out a cumulative ₹296 crore to depositors of 27 failed commercial banks and ₹4,822 crore to depositors of 351 failed co-operative banks. That's less than ₹15 crore in average payouts per bank.

Clearly, it is time to hold bank liquidators accountable to fixed timelines on the liquidation process, similar to those specified under the IBC.

Is the fund enough?

So far, given the modest demands that have been made on it, the DICGC has faced no challenges in meeting demands for insurance claims from failing banks. With annual claims often undershooting its premium collections of ₹11000-12000 crore from member banks, its Deposit Insurance Fund has steadily grown to stand at ₹97,319 crore by March-end 2019. There has also been no reason to revise the flat rate of premium levied on member banks, set at 10 paise for every ₹100 of assessable deposits.

But the question really is if the Deposit Insurance Fund would be up to the task, if it was faced with more frequent claims, or hit by multiple large co-operative or commercial bank failures in the same year.

In developed countries such as the US, this problem has been solved by regulators assigning comprehensive risk ratings for banks covered by deposit insurance and levying differential premia based on each bank's risk rating. In case of default, premia for the entire class of banks are immediately hiked to disincentivise risk-taking. Drawdowns from the insurance fund are promptly refilled through higher premia or contributions from the central bank. There's also regular stress-testing on the ability of the fund to weather systemic failures in the banking system.

It is not as if Indian regulators aren't aware of these developments. Several RBI-appointed committees — from the Narasimham committee on reforms in 1998 to the Jasbir Singh committee on differential risk premiums in 2015 — have thoroughly gone into these aspects to suggest drastic reforms to India's archaic system of deposit insurance. But apart from a half-hearted attempt to introduce some of these ideas in the (shelved) FRDI Bill in 2017, these proposals have not seen the light of the day.

Reforms on all these counts need to accompany an increase in the deposit insurance cover, to make sure that the Indian savers' faith in the banking system isn't lost for good.

Published on October 18, 2019

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