Deposit insurance can't handle large bank failures

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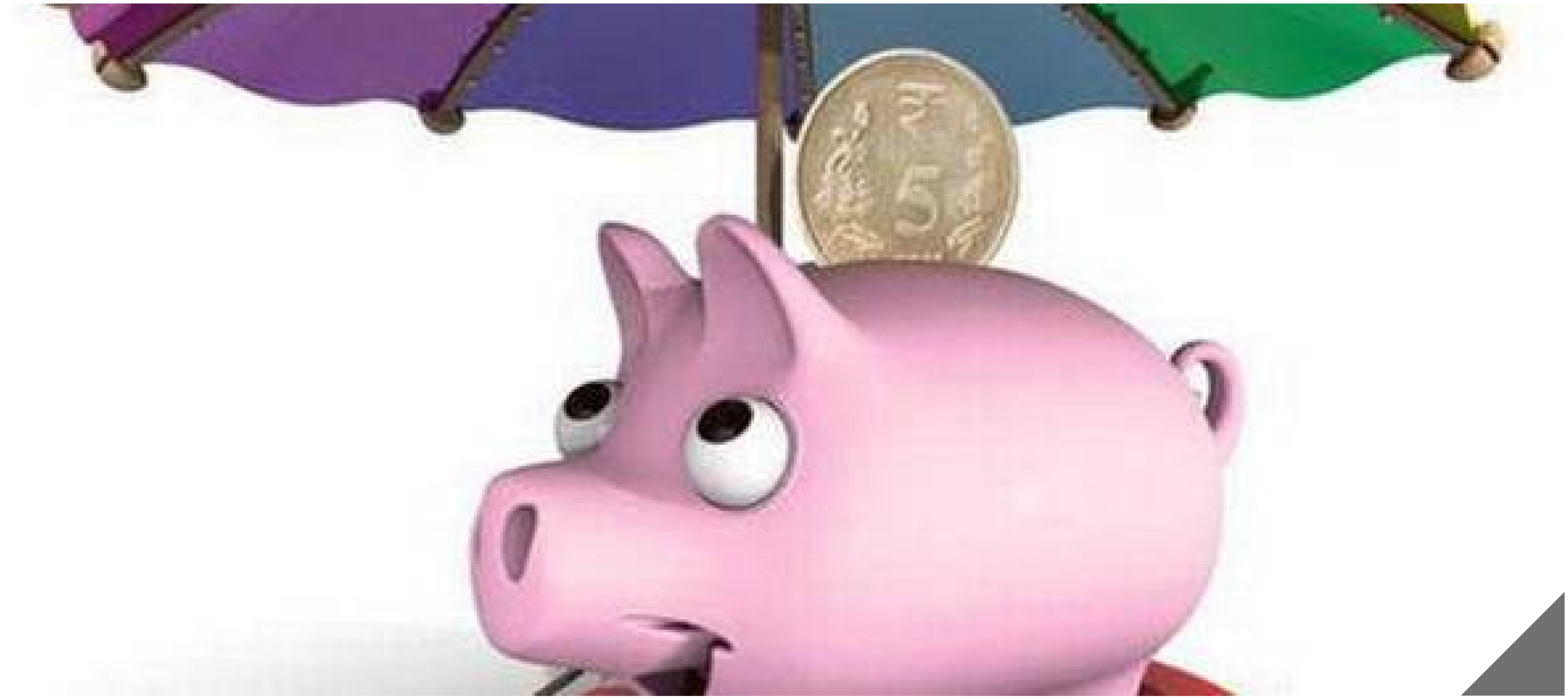

The DICGC has so far handled claims from small bank busts, but is it equipped for YES Bank-like troubles?

It may be just a coincidence that YES Bank, India's fourth largest private sector bank, should need a rescue package just a month after the RBI (Reserve Bank of India) announced a hike in the individual deposit insurance cover from ₹1 lakh to ₹5 lakh.

In YES Bank's case though, the insurance cover is unlikely to be used, with the RBI and the Centre cobbling together a takeover by SBI and other investors. Depositors have been assured that their interests will be fully protected.

Regulators have, over the years, taken a very different approach when dozens of co-operative banks have landed in financial hot water. In their case, the RBI stretched the moratorium until the banks came up with a resolution plan. If they failed, they were liquidated, with depositors taking a haircut. The Deposit Insurance and Credit Guarantee Corporation of India (DICGC) is called upon to pay insurance of ₹1 lakh per depositor. But commercial banks, particularly ones with a significant deposit base, have hardly ever been allowed to take this route. One reason for this could be that policymakers are worried about a system-wide loss of trust should a large bank flounder. A more pragmatic reason though, seems to lie in the balance sheet of the DICGC itself. It is well-funded to handle small bank busts, but has limited capacity to absorb claims arising from the failure of a large commercial bank.

Size constraint

This is evident from DICGC's latest annual report. In FY19, the corporation's total revenues stood at ₹19,288 crore with ₹12,043 crore earned from insurance premiums paid by banks and ₹7,245 crore from investment income. After settling claims and other expenses of ₹152 crore, the corporation reported a post-tax surplus of ₹11,931 crore. DICGC's annual surpluses go mainly into building up its Deposit Insurance Fund, which makes insurance payouts to depositors of de-licensed banks. At the end of FY19, this fund had investments worth ₹97,319 crore at market value (₹83,691 at book value). DICGC's claim payouts in recent years have not made much demands on either its revenues or its Fund. In FY19, it paid ₹37 crore in claims towards 15 failed co-operative banks. From its inception until March 31, 2019, the corporation has paid out ₹5,117 crore towards cumulative claims from 351 failed co-operative banks and 27 commercial banks. Effectively, claims on it have averaged about ₹120 crore a year.

But the very insignificance of those claim numbers go to show that DICGC's coffers are yet to be tested by the liquidation of any large commercial bank.

Burgeoning deposit base

According to RBI data, scheduled commercial banks in India handled aggregate deposits ₹129 lakh crore in December 2019, with 65 per cent of this with public sector banks and the rest with private banks. The average public sector bank now manages deposits of ₹4.24 lakh crore, while the average private sector bank has ₹1.71 lakh crore. YES Bank, for instance, held deposits of ₹2.1 lakh crore.

Now, given that only deposits up to a certain value (₹1 lakh until recently) are covered by insurance, only about 28 per cent of all bank deposits by value were covered by DICGC in FY19. Assuming similar coverage, if a private sector bank with a ₹2 lakh crore deposit base fails, claims worth ₹56,000 crore could theoretically be made on the DICGC. This is over ten times all the claims it has paid out since its inception and would significantly draw down its Deposit Insurance Fund of ₹97,319 crore. The recent fivefold increase in the deposit insurance cover aggravates this problem. The accompanying hike in deposit insurance premium from 10 paise per ₹100 of deposits to 12 paise, wouldn't really solve it as it adds only about ₹3,000 crore to DICGC's annual premium income.

Given that several RBI committees have gone into the workings of the DICGC, it is unlikely that policymakers are unaware of this issue. But they may need to take three explicit steps to shore up public confidence.

One, the mismatch between DICGC's balance sheet and the size of deposits it covers suggests that the RBI views the failure of large-sized entities such as YES Bank as low-probability events, which will rarely crop up. If this is the case, the RBI can reassure the public by providing data on, and stress-testing the impact of, big bank failures in its Financial Stability Reports.

Two, present deposit insurance premiums are clearly inadequate to build capacity in the DICGC to handle big bank failures. The RBI must make a strong pitch to the Centre to raise these premiums and to peg them to risks in each bank category.

Three, the RBI and the Centre must work out backstop arrangements for the DICGC, should it fall short of capital. This could be the contingency fund sitting in the RBI balance sheet or the Consolidated Fund of India but needs to be explicitly stated. Finally, if there is no intent to let a certain class of banks (say public sector banks) fail, it would also be fair to lighten their premium burden.

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