# Deposit Insurance

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THE failure of the Palai Central Bank has focussed public attention once again on Deposit Insurance. American experience in restoring confidence of the people in banks which was shaken during the Great Depression and the stability imparted to the banking structure of the U S through the Federal Deposit Insurance Corporation arc being discussed in various quarters. The Corporation is held up as a model to be followed in India. A brief study of the constitution and functions of this Corporation in the light of the suggestions put forward for setting up such an institution in India may, therefore, be of some interest at this stage.

The Federal Deposit Insurance Corporation was established in 1933 with a capital of $289 million, of which $150 million was contributed by the Federal Government and $139 million by the Federal Reserve Banks. In addition to its capital, the Corporation was given a line of credit of $3 billion from the US Treasury. The capital stock of the Corporation: has already been repaid in terms of the Act of 1947. The Board of Directors consists of 3 members, of whom two are nominated by the President for six years and the third is the Comptroller of Currency in his ex-officio capacity. One of the nominated members is the Chairman of the Board.

The Indian Banks Association has suggested that a similar Corporation should be set up in India with a paid up capital of Rs 5 crores and with borrowing power for a similar amount. The capital of the Corporation may be subscribed by the Reserve Bank. Life Insurance Corporation and the Scheduled Banks and its Board of Directors should represent all the contributors to the capital-stock.

### INDEPENDENCE OF F D I C

In order to give full independence to the F D I C from political influences, statutory provision was made to the effect that not more than two directors of the Board should be members of the same political party. In view of the precaution taken in America to keep the Corporation free even from political influences, the wisdom of giving representation to scheduled banks on the Board of Directors of the proposed institution in India may be doubted. An advisory committee consisting of members representing various business and financial interests could be set up to give expert advice regarding various problems. The Board will be able to discharge its duties efficiently and honestly only if it is free from influences from all quarters.

If representation is given to the scheduled banks, the Board will not have that sense of independence which the F D I C enjoys. In 1948, the F D I C even asked for independent inspection of member banks. Such inspection, it was held at that time, would lead to duplication of what had already been carried out by the Federal Reserve Banks. That such a question should have cropped up shows that, at times the proposed Deposit Insurance Corporation in India may come in conflict even with the Reserve Bank, not to speak of the insured banks. The Board should, therefore, be composed entirely of the nominees of Government and its members should hold office for 5 to 6 years, as in the F D I C.

### MEMBERSHIP

A controversy may arise as to whether the membership of the proposed institution should be voluntary or compulsory. In the U S. all banks which are members of the Federal Reserve System automatically become members of F D I C. They do not even have to apply for membership. The non-member banks have to apply through their supervising authorities. There is no reason why the same procedure should not be adopted in India. All scheduled banks should be required by statute to become members of the insurance scheme—in return for the facilities enjoyed by them at the Reserve Bank. It could be argued that the State Bank of India and its subsidiaries may be treated as a separate category and be allowed to stay out of the scheme. Purely from the banking point of view, deposits with the State Bank and its subsidiaries do not enjoy any better security than those with other big banks. Their public ownership cannot be a valid reason for their exclusion from the scheme. By staying out of the scheme, the State Bank and its subsidiaries will, moreover, enjoy an advantage over other banks in that they will not have to bear the burden of premium which other banks will have to pay for deposit insurance.

By the end of 1957, the number of insured banks in America had risen to 13,404 constituting 95 per cent of the total member of banks in the country. Insured banks held total deposits of about $226 billion, of which $127 billion were insured. Approximately 98 per cent of all accounts had balances of less than $10,000 and were, therefore, fully secured.

### PREMIUM

Premium of the F D I C was assessed at 1/12 of I per cent of total deposits plus trust funds less cash items on collection. The rate was based on the losses suffered by the depositors of the closed or suspended banks in the non-crisis years during the period 1863-1933. 'With the increase in the Insurance Fund, the rate of premium has been progressively reduced by giving the insured banks refund to the extent of 60 per cent of the premium collection.

No statistical data arc readily available regarding losses incurred by depositors through bank failures in India over a period of years for working out an actuarial basis for insurance premium. The Indian Banks Association has, however, estimated that premium at 1/16 of per cent will he adequate.

In the U S, the insurance limit is fixed at $10,000 per depositor, but insurance premium is assessed on total deposits of the insured banks. A suggestion has been made in some quarters that assessment in India should be based on the deposit insured and not on the total deposits of banks in order to reduce the premium burden on big banks which carry larger accounts. In this connection, the following excerpt from the Staff Study on "Assessments and Coverage for Deposit Insurance" from the *Federal Reserve Bulletin,* February, 1949 will be of interest:

"The base was selected despite the fact that many banks would have essentially full coverage out of the common fund whereas others, mainly the larger banks, a large portion of whose, deposits would represent large accounts, would have considerably smaller proportion of their deposits in sured. It was thought that the indirect benefits from deposit insurance for larger banks fully justified their more than proportionate assessment contribution.'

The larger banks enjoy another type of insurance which is not provided by insurance corporations. In no country can Government afford to allow any big bank to face serious difficulties. Failure of a big bank causes very serious repercussions on the economic conditions of the country and in time of difficulties. Government invariably comes to their rescue even to an extent which is beyond the limit warranted by the assets offered by the banks as security. This is a type of 'insurance' for which the big banks do not pay any premium. Hence, any suggestion for reducing premium levy on them appears to be inequitable and should be deprecated.

### FOREGIN BANKS

F D I C does not extend insurance cover to deposits with foreign batiks operating in the U S. The foreign banks are not allowed to accept deposits from the public. except some special types of deposits and that too under certain conditions. They depend entirely on foreign exchange business and their place in the world of American finance and business is hardly of any importance.

The Indian Banks Association cites the American example in support of its proposal to exclude be reign exchange banks operating in India from the coverage of the proposed Insurance institution. While advocating such exclusion, the Association makes an astonishing; state meat. It states that "the majority of foreign banks operating in India arc independent of the *internal* economy of the country" (italics mine). In June 1960. deposits of the exchange banks formed 12 per cent of the total deposits of scheduled banks and their advances accounted for 18 per cent of total scheduled bank advances. Again, advances of the exchange banks formed 86 per cent of their total deposits as against 51 per cent in the case of Indian scheduled banks. In view of the above, it is rather difficult to understand what the Association meant by the words "independent of the internal economy of the country". The foreign exchange banks in India now depend relatively more on internal advances than foreign exchange business for utilisation of their resources. If they are excluded from the coverage of the proposed insurance scheme, they may lose a part of their deposits to other banks which offer the security of insurance. But on the other hand, if they are excluded from the Insurance scheme, they will be relieved of the burden of insurance premium which will fall more heavily on Indian banks. The proposal for discrimination against the exchange banks may. therefore, be opposed by the Indian banks them selves in their own interest !

### POWERS OF THE CORPORATION

The powers granted to the Deposit Insurance Corporation in America permit loans on and purchase of assets for the purpose of amalgamating distressed banks with stronger banks. "These powers have provided the Corporation with a very effective alternate procedure for dealing with banks in difficulty. This alternate procedure' has resulted in much smaller losses than would have come from outright liquidation proceedings and consequently required less recourse to the Insurance funds". The power- granted to the Reserve Bank of In dia to secure banking stability do not directly deal with one of the causes of instability among the banks, viz. panic among the depositors. The liquidation of bank- which is due to panic withdrawal of funds can be prevented through deposit insurance. The American Corporation is allowed to give loans to enable a closed bank to reopen or to lend to insured banks or to purchase their assets to enable them to avert such dangers. The power- enjoyed by the F D I C are much wider than those entrusted to central banking institutions and the F D I C. does not suffer from the statutory disabilities of the latter.

The Reserve Bank of India has taken the initiative in some cases to bring about the merger of banks. But such instances arc very lew. Amendments have been pot forward to the Banking Companies Act to allow the State Bank, along with the Reserve Bank, to preside over the liquidation of hanks. The problem is not to determine who will preside over bank liquidation but how to prevent such liquidation. In the U S, between 1934-57. 251 banks were placed under receivership and FDIC paid insurance claim to the extent of $95.3 million. During this period, the Corporation also made loans to or purchased assets from 181 banks who were in serious financial difficulties, in order to facilitate the absorption of their deposits by sound insured banks. Such disbursements amounted to $197.8 million. This shows that a Deposit Insurance Corporation can press the move for merger with much greater vigour than the Central Bank of the country.

### ACIEVEMENT

The achievements of the FDIC will be evident from the fact that in the 251 deposit pay oil cases, it paid out 89 per cent of the deposits. Another 10 per cent of the deposits were paid through offsetting of liabilities and only I per cent of the deposits df these 251 banks were no! recovered by the depositors. The deposits received by the depositors in cases of pay off amounted to 98 per cent of total deposits. In 181 deposit assumption eases, the depositors received full disbursement of $197.8 million and this involved the Corporation in recoverable loss of $13 million.

It is. however, remarkable that in spite of its spectacular achievements. the FDIC stated in its report for 1957, that the contribution of Federal aid towards stability of banks should not he ignored. During 1934-56. the Reconstruction Finance Corporation. the Home Owners Loan Corporation and the farm credit it Administrations disbursed upwards of $2 billion to aid open or closed banks.

> "These disbursements contributed significantly to restoring the strength of the banking system. and had these agencies .not been in existence, the federal Deposit Insurance Corporation undoubted-Is would have been called upon for a much larger expenditure of funds '.

It is revealing that in the land of free enterprise, more than $2 billion of Federal aid should be necessary to restore the strength of the banking system. Setting up of a Deposit In surance Corporation is. therefore. only the first step towards building up of a strong banking structure in India, but this step must be taken without the least delay.