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TIME FOR A HIKE IN DEPOSIT INSURANCE AND A RESOLUTION PLATFORM FOR NBFCS?

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The recent PMC bank crisis has raised questions about the current problems in the India's financial sector. Let us however emphasize that Indian banks are sound and are largely protected from the global vagaries given the very nature of regulation. For example, money markets in India are shielded from global spillovers by statutory liquidity ratio (SLR) requirements, allowing banks to get access to central bank liquidity as well as to secured markets, thus obviating a collateral constraint. Furthermore, banks largely fund themselves through retail deposits rather than wholesale funding, a source of vulnerability to external contagion.

Leaving aside such, we believe time is now appropriate for some changes in the financial market architecture. Studies suggest that since 1993, there has been a paradigm shift in the profile of customers and the conduct of business by banks. In particular, over the years, the level of insured deposits as a percentage of assessable deposits has declined from a high of 75% in FY82 to 28% in FY18. Given this backdrop, we believe, there is a dire need to revisit the insurance coverage of the bank deposits. In particular, the current upper limit of Rs 1 lakh per depositor, we believe, has outlived its shelf life and there is a need to revisit it. Further, over the years, the composition of the Bank deposits has undergone massive changes in India. In this backdrop, the DICGC coverage should be revised and bi-furcated into 2 categories: 1) Desirable coverage of at least Rs 1 lakh for SB deposits (around 90% of the total SB accounts) and 2) desirable coverage of at least Rs 2 lakh for Term Deposits (around 70% of the total TD accounts). There should also be a separate provision for senior citizens. This revision in DICGC coverage becomes all the more desirable in the Indian context, where senior citizens / retired people have no social security in place and mostly keep fixed deposits for earning interest income. Apart from this, it is also suggested that depositors should get an incentive to spare a part of their total deposits to buy Bank Bonds that provide guaranteed coupon rates on a half yearly basis and are tax free. This will herald a new paradigm in the Indian deposit banking sphere, since tax free and guaranteed payments of a certain income will do much to encourage depositors to come forward with offers to provide a part of their savings in exchange for the shares in the banks.

As far as the currently persisting problems in the NBFC sector are concerned, time has now come to think of an NCLT like framework to enhance the investor confidence and thereby provide the much required fillip to the lending to the NBFCs. However, this must be done in conjunction with identifying NBFCs with a weak balance sheet and working on a quick resolution. This could be say, facilitating an ownership change or bringing in a financially strong promoter. In 2017, Government introduced "The Financial Resolution and Deposit Insurance (FRDI) Bill" in the Parliament but has withdrawn it in 2018 due to the bail-in clause and mass protest across the country. We believe that Government should again promulgate the FRDI bill without the "bail-in" clause since, in India, the average income of a vast majority of depositors is modest.

BANKING CRISIS, NATIONALISATION & DEPOSIT INSURANCE : HISTORICAL BACKGROUND

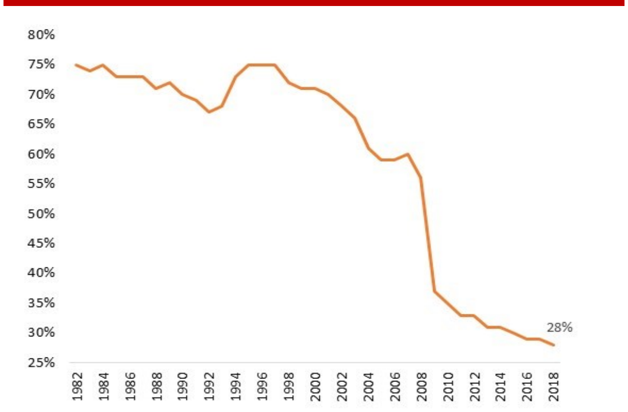
- Prior to nationalization of banks in 1969, nearly 900 banks failed between 1935 and 1947, followed by 665 banks in the period from 1947 to 1969. After 1969, RBI became highly conservative and no new bank licences were issued till 1994. The Banking Regulation Act 1949 empowered the RBI to regulate the banking sector. Exercising this power, the RBI introduced statutory liquidity ratio to build reserves for safety. However, the collapse of Palai Central Bank in August 1960 hit the panic button, and large-scale closures were enforced. That failure led to the formulation of deposit insurance rules in 1962, thus enhancing stability in the banking system. Thereafter, the RBI has tried to respond to all these crises by tightening and adding more regulations and cases of bank failures have been very rare in India. Following the global financial crisis of 2008, Indian banks are now governed both by the international Basel norms and the domestic regulations. RBI has also extensive powers to inspect banks and intervene in their operations.
- The recent PMC bank crisis has again raised the question of deposit insurance in India. Since 1993, there has been a paradigm shift in the profile of customers and the conduct of business by banks. In particular, over the years, the level of insured deposits as a percentage of assessable deposits has declined from a high of 75% in FY82 to 28% in FY18. Given this backdrop, we believe, there is a dire need to revisit the insurance coverage of the bank deposits.
- Currently, the Deposit Insurance and Credit Guarantee Corporation (DICGC) provides for cover of Rs 1 lakh per depositor (since May 1993) for deposits of Commercial Banks, RRBs, Local Area Banks (LABs) and Co-operative Banks and rest of the deposit amount is forfeited in the rare event of a bank failure. At the end of FY19, the number of registered insured banks stood at 2098, comprising 157 commercial banks and 1941 cooperative banks.

Cross Country Deposit Insurance Coverage & Per capita Income (in USD)

Country	Deposit Insurance Coverage	Percapita Income (PCI)	Coverage as times of PCI
Australia	182,650	49,928	3.7
Brazil	64,025	8,650	7.4
Canada	72,254	42,158	1.7
France	108,870	36,855	3.0
Germany	108,870	41,936	2.6
India	**1,508**	**1,709**	**0.9**
Italy	108,870	30,527	3.6
Japan	88,746	38,894	2.3
Russia	19,210	8,748	2.2
UK	111,143	39,899	2.8
US	250,000	57,467	4.4

Source: IADI, World Bank, SBI Research

Total amount of insured deposits: % assessable deposits of ASCB



Source: SBI Research

- In 2017, Government has introduced “The Financial Resolution and Deposit Insurance (FRDI) Bill” in the Parliament but has withdrawn it in 2018 due to the bail-in clause and mass protest across the country. The FRDI bill contemplated a mechanism of deposit insurance up to a specified limit (at least Rs 1 lakh) for not only banks but also for the NBFCs, insurance companies, pension funds, stock exchanges, and depositories. However, contrary to DICGC act of 1961, the FRDI bill was supposed to examine whether the amount of money exceeding Rs 1 lakh that was supposed to be forfeited in DICGC could be effectively used by a bank in distress by the “bail-in” clause.
- Data on Cross Country Deposit insurance Coverage limit shows that Deposit insurance coverage in India is one of the lowest at Rs 1 lakh / $1508 / 0.9 times India’s per capital income. Furthermore, if we compare India with BRICS group of countries like Brazil & Russia, the comparative insurance figure rises to Rs 42 lakhs & Rs 12 lakhs respectively! If we compare the deposit insurance limit in India with countries having similar per capita income, we find that the insurance cover is even unlimited in some countries.
- An analysis of deposit base of banking system shows two divergent trends. First, in terms of the number of accounts, 61% of the total accounts are less than Rs 1 lakh, around 70% are less than Rs 2 lakh, and 98.2% are less than Rs 15 lakh. So clearly, it seems on paper that the number of small depositors are adequately covered in terms of insurance cover. However, in terms of quantum of deposits, we observe that percentage of deposits less than Rs 1 lakh is only 7.8% of the deposit base. 20.4% of the deposits are contributed by customers having deposits of more than Rs 15 lakh but less than Rs 1 crore with average deposits of Rs 35 lakh.
- Even though 32.5% of deposits are more than Rs 1 crore, with an average deposit of Rs 4.48 crore, we believe most of such may be categorised as bulk deposits and may not be strictly relevant for our discussion. Effectively, the customers (with balance between Rs 15 lakh and Rs 1 crore) get protection only to the extent of 2.8% of their deposits though the premium is paid on the entire value of deposits held by them. **Is it not unfair?**

RESOLUTION MOST IMPORTANT

- **1. FRDI bill without “bail-in” clause:** We believe that Government should again promulgate the FRDI bill without the “bail-in” clause. As per bail-in clause the financial firms/companies issue securities in lieu of the money deposited. It means, in case the firm’s financial situation deteriorates, deposits could be converted into securities such as shares in the bank.
- Whether the concept of bail-in is justified in Indian context was a matter of debate. This is similar to the strategies adopted by EU countries like Cyprus. Interestingly, the bail-in provision was used in Cyprus in 2013 where deposits above €100 000 were classified as “disposable or frozen” as the number of accounts above €100 000 mostly belonged to the affluent class. **In contrast, the use of concept 'bail in' should be avoided in the Indian case where the average income of a vast majority of depositors is modest.**
- **2. Increase the limit of Deposit Insurance to Rs 2 lakh:** The current upper limit of Rs 1 lakh per depositor , we believe, has outlived its shelf life and there is a need to revisit it. Further, over the years, the composition of the Bank deposits has undergone massive changes in India. In this backdrop, the DICGC coverage should be revised and bi-furcated into 2 categories:1) Desirable coverage of at least Rs 1 lakh for SB deposits (around 90% of the total accounts) and 2) desirable coverage of at least Rs 2 lakh for Term Deposits (around 70% of the total accounts). There should also be a separate provision for senior citizens. This revision in DICGC coverage becomes all the more desirable in the Indian context, where senior citizens / retired people have no social security in place and mostly keep fixed deposits for earning interest income which in many cases becomes a part of their current income for regular upkeep. There are also many small savers who have fixed deposits with the same intent. In extreme event of a bank failure, it is unfair if such hard earned money is forfeited.

Deposit Insurance in Countries with Similar Percapita Income

Country	Percapita Income (in Rs Lakh)	Deposit Insurance Coverage (in Rs Lakh)
India	1.04	1.00
Honduras	1.53	6.11
Laos	1.53	2.23
Ukraine	1.42	5.46
Uzbekistan	1.37	Unlimited

Source: IADI, World Bank, MOSPI, SBI Research

Per Account Deposit as per Type of Deposits (Mar'18)

	No. of Accounts (in Million)	Amount (in Billion)	Average Balance per account (in Rs)
Current	76	10753	1,40,936
Savings	1596	37654	23,590
Term	239	65938	2,75,908
Total	1912	114345	59,819

Source: RBI; SBI Research

Term Deposits - Number of Account and Amount

Size of Term Deposits	Number of Accounts		Amount (in Rs Billion)		Average Amount per Account (in Rs)
	Million	% of Total	Rs Billion	% of Total	
Less than 25,000	68	28.3	791	1.2	11699
25,000 and above but less than 1 Lakh	78	32.8	4352	6.6	55518
1 Lakh and above but less than 15 Lakh	89	37.1	25913	39.3	2.92 lakh
15 Lakh and above but less than 1 Crore	4	1.6	13451	20.4	35.18 lakh
1 Crore and above	0.5	0.2	21430	32.5	4.48 crore
Total	**239.0**	**100.0**	**65938**	**100.0**	**2.76 lakh**

Source: RBI, SBI Research; For Mar'18

- **3. Incentivize Depositors:** We believe that depositors must get an incentive to spare a part of their total deposits to buy bank bonds that provide guaranteed coupon rates on a half yearly basis and is tax free. Simultaneously, any distressed banks could be encouraged to improve their management strategies with a tenure-based plan for recovery and viability. Tax free and guaranteed payments of a certain income will do much to encourage people to come forward with offers to provide a part of their savings in exchange for the shares in the banks. The bonds may be allowed to be traded after 3 years or 5 years. The time period for tradability clause may be fixed with reference to the banks' recovery and viability strategy plans.
- In the end, a comprehensive social security plan is a sine-qua-non for any “bail-in” that is still not available to 97% of India’s population! There is one more point that needs to be dealt with. Banks are required to pay premium on the entire assessable deposits whereas strangely the liability of the corporation to limited to only Rs 1 lakh / $1500. No wonder, such level of deposit insurance is significantly inadequate and must be increased.

NBFC CRISIS: CURRENT STATUS & POSSIBLE SOLUTIONS

- Tight Liquidity condition post IL&FS default has accentuated by issues at other systemically large HFCs. This is translating into high borrowing costs for most NBFCs and is resulting in decline in wholesale lending, adversely affecting Construction Activity and SMEs engaged in allied activities.
- A spate of incomplete projects could eventually lead to default by both developer as well as individual mortgage borrowers, creating a systemic asset quality issue. Approximately 2 lakh crore of CPs and 2.75 lakh crore of bonds issued by NBFCs are coming for rollover.

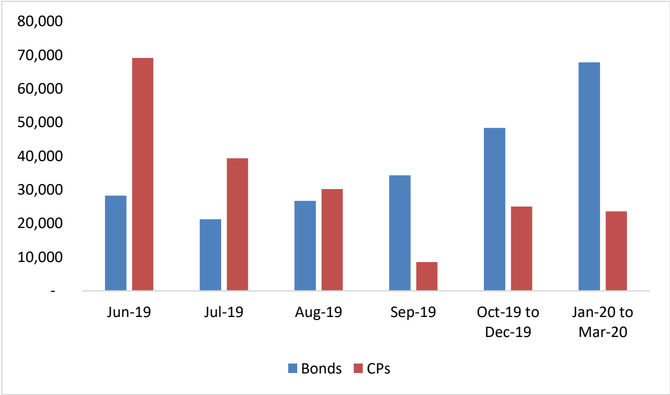
RESOLUTION OF NBFCS MOST IMPORTANT

- There should be a clear process of Identifying systemically large entities with a weak balance sheet and work on a quick resolution, facilitating an ownership change or bringing in a financially strong promoter. If needed, there could be requirement of additional indemnity from the existing promoters to cover potential losses. This will substantially reduce the risk of a disorderly exit from the market and spill-over effect on the other entities.
- Ownership change/capital infusion will clearly ensure that entities continue to be going-concern. This would lead to an immediate rating upgrade and improve the viability of the company's operations. This measure would also stem outflows from Mutual Funds having exposures to such NBFCs.

IN CONJUNCTION, CREATION OF AN IBC-LIKE FRAMEWORK FOR NBFCS

- Lack of an NCLT-like framework dissuades the lenders from lending to NBFCs during periods of stress. Currently, risk pricing is difficult as 'Loss Given Default' is unknown. While there have been defaults by NBFCs, there is a complete lack of a redressal mechanism.
- Having a robust IBC structure within a revised FRDI bill would enhance investor confidence in lending to the NBFCs. A well laid down process should kick in from regulators immediately after a systemically important entity falls below Investment grade (eg. Appointment of Nominee Director, forensic audit, PCA like framework).

Large amount of NBFC debt up for maturity (Rs crore)



Source: AIMin, Prime; CP & Bond outstanding up to Jun 2020 (CPs till May 2020)

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