PN-ABZ 419
92049

The Potential Role of Deposit Insurance in the Development of the Housing Finance Sector

A Report to the National Housing Bank

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March 1996

Prepared for
Indo-US Housing Finance Expansion Program

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USAID Project No. 386-0526-00-C-2295-00

The Potential Role of Deposit Insurance

In the Development of the Housing Finance Sector

(Revised DRAFT, 4 March 1996)

Introduction and Conclusion

Since 1990, the housing finance company (HFC) sector has grown relative to banks and other non-bank financial companies. It is still a small part of the financial universe in India, with HFC credit outstanding less than 4 percent of bank credit outstanding, but it is a key part of the reorientation of the financial sector towards market demands and private management. It seems to have also attained a relatively high visibility among the Indian middle class who seem to be the primary beneficiaries of economic reform.

But HFCs are facing some fallout from the reforms which could slow or reverse their growth. These include (1) a growing reliance on household deposits, (2) growing competition for those deposits, and (3) potential competition in housing lending with other types of financial intermediaries. Their future course will depend on many things, but one element which could eventually matter significantly is deposit insurance (DI). It is highly unlikely that the industry will be able to compete successfully for deposits and lending if other direct competitors have implicit or explicit deposit insurance, especially if the insurance costs less than an actuarially fair price.

These trends and perspectives are examined in this report, along with an analysis of the deposit insurance scheme currently in effect for other intermediaries. The conclusions are that (1) there will be an inexorable trend towards the overlapping of financial sub-sectors and (2) HFCs will be at a disadvantage if the same (not separate) DI coverage is not provided for the HFCs. The recommendation is that deposit insurance should be extended to HFCs on the same terms as to the scheduled banks currently, probably in advance of extension to other NBFCs.

However, this step should only be taken within the context of a forward-looking evolution in the regulation and supervision of the sector, preferably including the licensing and regulation by one institution for all competing entities.[1] Moreover, it cannot be said with certainty that this step will ensure the survival of HFCs in the coming competition for resources and customers. It is only a small but appropriate part in the process of "leveling the playing field" and in the longer-run development of housing finance in India.

The Roles of Deposit Insurance

"Deposit insurance" refers to a scheme of any type which assures a depositor in a financial institution the return of the principal of their deposit in

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[1] This is essentially the perspective of the Shah Working Group, which recommended that the question of DI for NBFCs be reconsidered after the sector is put on a completely "sound footing."

cases of the cessation of operation of the institution. The insurance may come with important limitations, including on the absolute amount insured, the share of the deposit covered, on the recovery of interest at the contracted-for rate, or on the timeliness of payment. It may be explicit or implicit, free to the institution or costly, uniform across institutions or differentiated, and so on.

These many dimensions of DI will be explored below. The first task is to examine the purposes of DI as it has been employed in advanced financial systems and as it has existed in India.

It is usually stated that the most basic purpose of deposit insurance is to increase the stability of the payment mechanism in the economy. In simple financial systems, the payment mechanism is managed by the commercial banks, primarily through the offering of checking or other draft privileges. But the flow of payments will be disrupted if banks can not trust each other and recipients of checks or other sight drafts can not trust banks to honor them. If the payment mechanism fails to work absolutely reliably, economic transactions not based in cash or barter could be disrupted.

There are two basic reasons why banks may fail in their ability to manage the payment mechanism. The simplest is because they have taken losses on loans or other investments such that they can no longer honor all of the claims against them, now or ever. In this case, the bank is "insolvent" or bankrupt. The second case is that they simply can not honor all the claims at the moment, i.e., they are illiquid.

Unfortunately, these two conditions are closely related. Perceptions by depositors or other creditors that a bank is insolvent will trigger a "run," whereby each individual depositor attempts to avoid being the one left bearing the shortfall. Even if these perceptions are wrong, the need to raise cash quickly can disrupt the banks functioning and cause the forced sale of assets at lowers prices, creating insolvency.

In principle, the simplest method of dealing with illiquidity is for the central bank of the country to provide liquidity to the banks as needed to handle runs (the "lender of last resort" window). This step is not always easy to execute, especially without having inflationary consequences. But it does not involve the administrative costs or contingent liabilities of the creation of an insurance mechanism.

So why have deposit insurance? One reason is that the lender-of-last-resort window is ultimately not very effective in the absence of deposit insurance in convincing those depositors not participating in the run to leave their deposits.

There is still the question of who will be left bearing the shortfall if the institution turns out to be insolvent. In fact, neither is deposit insurance effective without the liquidity window, because there is often a period of illiquidity of a deposit after the closing of a bank. Assurance of eventually getting full compensation is not sufficient to stop a run a bank entirely or its spreading to other banks. As noted below, experience has shown that both deposit insurance and a liquidity window are needed to manage insolvent or illiquid banks.

There seem to be three other reasons why deposit insurance schemes are instituted. The first, and most important for developing countries, is to reassure relatively unsophisticated households that it is safe to trust the banking system for their payment transactions. Many studies have shown that the financial "deepening" of the economy is essential for economic growth, facilitating trade and investment. Such deepening requires individuals to move beyond cash and barter transactions to trusting banks, at least for their transaction funds.

The same logic applies to household savings. In addition to handling the transaction funds in the economy, banks and other deposit-taking institutions also act as the most convenient repositories of household cash savings. Since another key part of financial deepening is the increased intermediation of savings, away from self-investment in gold, houses, and other personal stores of wealth and towards third-party investment, it is important to society that trust in this process also be developed, both to encourage savings and the efficient intermediation of those savings.

Third, there is the practical and social reason that households with small holdings of wealth are the most likely to suffer the most seriously from the failure of a bank, both because they will be last to try to get out and because they can bear the loss the least well. This creates strong political incentives to protect such depositors, in the aftermath if not in advance.

Thus, there are four closely related roles of deposit insurance, (1) protecting the payment mechanism from stress, (2) encouraging the use of the banking system, (3) encouraging savings in financial forms, and (4) protecting the welfare of moderate wealth families. These can be boiled down to really two rationales, (1) encouraging and protecting the development of the financial system and (2) protecting the core financial wealth of households.

The History of Deposit Insurance

During the 19th century, as commerce grew radically in Western industrializing nations, there were financial crises, including failures of banks to

honor drafts, in country after country. These financial crises had severe consequences for trade and production, but there was only slow movement towards systems to prevent these events. Even if they had wanted to, governments did not have the technical means to monitor the banks closely enough to deter or manage pending failures. On the other hand, banks did face the necessity of building up their reputation carefully and assiduously avoiding activities that might endanger that reputation.

The situation changed in a critical way with the establishment of "central banks" around the turn of the century. The banks became the ultimate source of money in the economy and thereby the regulators of the payment system. One of their key powers was to create money when needed by banks which faced unexpected demands for funds. This role came to be known as "lender of last resort" for commercial banks.[2]

The idea behind a lender of last resort was not to insure the creditors of a bank against loss, but to deal directly with the basic underlying tension involved in modern banking, term intermediation. "Term intermediation" refers to the funding of investments with liabilities that have planned or contingent cash flows which are sooner in time than the contractual or effective cash flows on the investments.

The most obvious example is the funding of 20 year housing loans with deposits of maturity of one year or less. But less obvious examples may contain significant term intermediation and even more risks of instability. For example, commercial banks fund overdraft loans or short-term trade credit from current accounts or liquid savings accounts on a seemingly matched basis.

But the effective term of the assets may be much longer in cases of economic crisis, with protracted recovery measures needed to collect outstandings. On the liability side, longer-term deposits usually offer an option of early withdrawal upon payment of a penalty, and thus can be subject to a very short-term contingent outflow.

In the absence of term intermediation, a financial intermediary could stop booking new business at any point in time without deleterious effect to the current book of business. Thus, sudden changes in the willingness of savers to channel funds into the institution will not disrupt current activities. In contrast, when longer term (or potentially illiquid) investments are being funded out of short-term funds, a sharp decline in the funding would require the abrupt termination of the investments or the default of the institution to the savers.

By the 1920s, commerce and trade had grown enormously, and the role of the banks was central not only to the payment system, but also for the flow of short-term credit to business. It was this increasing reliance on credit that came to the forefront in the Crash of 1929 and the ensuing Great Depression. The Federal Reserve failed not only to inject liquidity into sound banks facing escalating

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[2] For example, the Federal Reserve Bank was established in the U.S. in 1913 in direct response to a financial panic in 1907. It was envisioned that it would be in a position to provide liquidity on a timely basis to prevent future collapses of the monetary and credit system.

depositor demands and credit recovery problems, but had not prepared at all to deal with the snowballing effect of a loss of confidence of depositors in the banking system. The result was a steady shrinkage in the money supply (25 percent in 3 years) and a perhaps even more devastating decline in the availability of credit of all sorts (surviving banks became extremely adverse to extending credit, preferring to hold government securities or cash).

It was amidst the wreckage of the event that it was decided that the lender-of-last-resort window had to be complemented by a deposit-insurance scheme if households were to feel comfortable again trusting banking and savings institutions. The world's first deposit insurance scheme, the Federal Deposit Insurance Corporation (FDIC), was born in 1934. It was soon followed by a separate scheme, the Federal Savings and Loan Insurance Corporation (FSLIC), for the savings and loan institutions, which specialized in offering savings accounts and making housing loans. Since establishment of these schemes, there has not been a cumulating failure of the general financial system in the U.S., despite the failure of many individual institutions.

From the beginning of its deposit insurance system, the U.S. has embraced the full range of roles for deposit insurance noted above, choosing to protect both current and savings accounts in banks and savings deposits in the savings and loans, which did not play a role in the payments mechanism.[3] It is not clear which basic motivation was dominant though, the desire to protect the financial system or the small depositors. In any case, the experience of the Great Depression was that the economy had grown to rely on an efficient credit mechanism and that households had grown to rely on a safe depository system.

Still, this was a big step on the part of the government, because it now undertook to assure at least the smaller depositors that their deposits were safe, no matter what. This removed from the depositor the need to consider the reputation of the bank and from the bank to quite so zealously guard that reputation.

Such a step may have been obvious after the trauma of the Great Depression, but it is an interesting question as to why a government should do this in general. In principle, the risks of term intermediation are just a normal risk of financial intermediation, something to be managed by the institution for a fee which constitutes a return to the equity investors for bearing the risk. A well-

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[3] In fact, nearly all major forms of financial intermediation are both heavily regulated and insured today, including investment brokers, pension funds, credit unions, and others.

developed financial market will utilize those methods of financial intermediation which most efficiently manage this type of risk, including those that eliminate it entirely (i.e., provide for matched-funding). Investors or depositors would take into account the presence of this risk in determining the rate of return they are willing to accept, just as they take into account the credit risk involved. The government does not get involved in assuring other investors of the liquidity or the return on their asset (as in the stock market).

In the absence of government-sponsored DI, private institutions may wish to purchase some kind of investor insurance, because investors can not judge the low risk of the investment as well as the insurance company. In this case, if the assurance of the insurance company is better recognized, the company's guarantee may be worth more than the premium required to be paid to obtain it.

Alternatively, a group of private banks might agree among themselves to cover the losses to depositors of any one bank if they anticipate that these losses will arise from random, uncontrollable causes, much as households buy health insurance. A related extension is for the group to act because each member of the group can be hurt by losses suffered by depositors with any other member of the group, because depositors assume that such losses indicate that other banks will also impose losses on them.

Some countries have also pursued other paths towards system-wide stability. As noted above, some systems, notably in Germany, have attempted to minimize the degree of term intermediation. Other economies, including the U.S., have moved in that direction by developing mechanisms such as mortgage-backed securities, contract-savings schemes, commercial paper markets, and so on that better match assets and liabilities. Other governments have chosen to show by their action that they will step in forcefully when needed to stabilize the system, including compensating depositors in banks. Still others have "encouraged" formation of private DI schemes.

In addition, all countries have moved towards greater regulation and supervision of the banking sector. This trend has culminated in the world-wide implementation of the Basle standards for capital adequacy and prudential norms.

The use of the Basle norms substantially reduces the need for DI, for two reasons. The increased level of capital required for many institutions provides greater protection of depositors from losses suffered by the institution and also assures the depositor that the owners of the bank have a clear incentive not to consciously take unreasonable risks. Second, the enforcement of prudential and accounting standards provides greater transparency in the operation of the institution and in the calculation and enforcement of the measures of capital

adequacy. These steps will not eliminate the failure of institutions, but will make them rarer and more often the result of random events that do not indicate weakness throughout the system.[4]

The usefulness of DI has been diminished by the Basle process but not eliminated. Basle did not regulate term intermediation or interest rate risk or credit risk and thus, depending on the specifics of a financial system in these regards, the system may still be subject to sudden instability. In this regard, it is of particular interest that some countries, including India, are experimenting with the requirement of credit ratings for most, if not all, debt-type financial instruments. Credit rating can go beyond the Basle standards to include the other risks involved in the debt issuer. In principle, it facilitates the market reflection of all risk elements.

Despite all of these alternative mechanisms and risk reducing practices, most countries offer an explicit or implicit government backing to deposits, for the simple reason that at the time of a banking crisis, the public and the politicians are not interested in anything less than open-ended coverage. All private insurance, any credit rating scheme, any theoretically sound capitalization norms, will not translate into sufficient confidence in the financial system as a whole, much less for any weakened institution, no matter how large.

Deposit Insurance Systems in Other Countries

Although most countries provide depositors in the nation's banks a degree of protection from losses in cases of insolvency, the range of terms and coverage is enormous, at least on paper. As a matter of practice, however, the coverage is far more homogeneous, with few countries willing to leave the small depositor to their own wits in evaluating the risks of failure (and their banking systems exposed to a loss of confidence).

The largest single variation across countries is whether the insurance is explicit and formalized or implicit and ad hoc. A typical example of an ad hoc system is that in Jordan. In 1991, Jordan's second largest bank failed, primarily as a result of fraud. The losses would have impacted many households and businesses and, worse, potentially ended Amman's position as a relatively safe resting place for funds from the diaspora of Palestinians and from others throughout the Middle East. Jordan has no explicit deposit insurance scheme, but

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[4] Examples of this include the difficulties of Barings and Daiwa in the aftermath of frauds.

the government stepped in to take over the bank and compensate all of the depositors.

Despite the simplicity of an implicit system, with no insurance fund to operate, it is probably the worst of all the alternatives. It is one thing if a country can truly tell itself that under no circumstances it will bail out depositors. But if it knows it will have to intervene, it is preferable to tax the banks to build up a reserve fund, to have administrators prepared to take rapid action, and to set regulation and supervision practices from the perspective that the government will have to pay ultimately for mistakes in this area.

Many developing countries operate under implicit systems, often because the banks are either government-owned or foreign-owned. Among the members of the European Union, only Greece operates in this manner. However, nearly all countries maintain some degree of implicitness in their systems.

For example, France, Italy, Holland, and Switzerland all operate their insurance funds with ex post, as-needed funding from the healthy banks. Thus, as small banks fail, the other banks pay into a pool to compensate depositors. In several cases, the insurance system is actually operated on a private basis by associations of banks, often with the urging of the government. The advantage of such a system is that banks are free to ignore their contingent liability in this regard and thus report higher profits and reserves than those paying into funded systems. This advantage is also a disadvantage, in case there is a sudden call on the resources of the healthy banks.

There is an on-going effort within the EU to force the formalization of deposit insurance in all of the member countries. There are two forces behind this. The opening of member countries to cross-border competition in banking requires that all banks face similar regulatory and insurance burdens and that all depositors receive similar protection.

The events in Europe have brought to the fore an essential point about deposit insurance in most countries. The European public has been largely disinterested in the deposit insurance "equalization" process because it has always assumed that deposits were ultimately backed up by the relevant government. Even the banks implicitly presume it; the banks belonging to the "private" insurance systems can not and do not expect to cover extensive losses (and thus there exists an implicit public guarantee backing up the supposed private system). Some observers in the EU actually see this as an effort to bring some degree of discipline to the deposit market, because banks would be required to advertise the fact that the formal deposit coverage is not unlimited, unlike under the unspoken assurance in practice previously.

This situation raises another of the important "unspoken" aspects of deposit insurance. The largest banks in most countries hold deposits from most of the key entities in the economic system, including from other banks. Any illiquidity or substantial loss being borne by those entities could cause costly disruptions to economic activity. The potential for such disruption is the premise behind the "too-big-to-fail" assumption, that the bigger banks in a system are too important to the fabric of the financial system to let them falter even for a moment. The implicit guarantee they carry can in turn tilt large depositors towards them, to the detriment of the smaller banks, unless all depositors feel they are insured, despite formal policies limiting insurance coverage. Thus, the "too-big-to-fail" quandary has led to complete coverage of deposits in most cases, often through the expedient of merging all the depositors of the failed bank into a healthy bank.

The tendency to cover all deposits, not just insured ones, has undermined the disciplining effect of the formal limitations on coverage, but has not eliminated it. It is still the large depositors that are the first to leave a threatened institution. Unfortunately, the departure of these depositors alone can often cause severe liquidity problems for a bank, which can create a larger run on the bank (but not necessarily the whole system) due to another aspect of deposit insurance which is often not noted. In the absence of a merger, the process whereby a bank is taken over and claims paid often means a period of illiquidity for the insured depositors. Unless there are very large costs to premature withdrawal of a deposit, there remains an incentive for all depositors to flee a failing bank.

Deposit Insurance in the United States

As noted above, the United States was the first country to establish a formal deposit insurance scheme. Moreover, it has probably made more use of it than any other country. There have been well over a thousand institutions, large and small, that have failed and been liquidated or merged. The large number partly reflects the unusually large number of depository institutions in the U.S. due to limitations on branching and interstate banking. The failure rate itself is partly due to the same regulatory restrictions (which have only recently been reduced) because institutions were not able to diversify their credit risks over larger geographic areas.

The history of DI in the U.S. is a long and very complicated story, reflecting the high degree of politicization of every aspect of the development of the banking sector (not unlike in India). As of the beginning of the 1980s, the depository sector included a huge number of institutions offering similar services, but under many different regulators and with a wide variety of powers and restrictions, all designed to advantage one sector or type of institution relative to the others. The

great majority of institutions offered some kind of deposit insurance, with backing from either the Federal or state government. And this insurance had achieved its primary goal of preventing system-wide runs.

Several recent incidents in the history of deposit insurance in the U.S. are of interest as illustrating well certain aspects of DI. For example, in early 1991, a large bank in the Northeast region failed because of the sharp decline in real estate values in the previous two years. It was only the thirty-third largest bank in the country, but it was one of the largest in the region and an important part of the local financial sector. Using the discretion allowed it, the FDIC announced that all depositors would be protected, whatever the amount of their deposit. The total loss was about 10 percent of assets. However, just two months previously, a small bank in New York had failed and the large depositors were not protected from a loss of 50 percent.

This was a situation where the "too-big-to-fail" doctrine was applied. It illustrates how the DI system gives a competitive advantage to a large bank and also how the restrictions on interstate banking creates banks that are relatively more exposed to regional real estate cycles. Not coincidentally, since then, there has been a massive move towards consolidation of the banking industry into large scale nationwide banks.

A major part of the U.S. deposit insurance system itself failed in the 1980s and had to be bailed out by the government (confirming the implicit expectation that the government itself stood behind the DI fund). The roots of this failure lay in the pattern of geographical and business segmentation in the sector. This created the potential for major losses being imposed on the separate insurance system set up for the savings and loans institutions (also called thrifts). The situation came to a head in the early 1980s, when the thrifts, which had been given various advantages in return for specializing in offering fixed-rate mortgages, were finding their deposit base eroded by money-market funds (which had worked around the barriers erected to deter competition) and their profits destroyed by the dramatic rise in deposit rates due to higher inflation, followed by tight money.

The evolution of the money-market funds and the new variability of interest rates made a liberalization of the financial sector mandatory. This meant giving all institutions a greater range of permitted investments and greater freedom in raising funds. Obviously, these freedoms entailed greater risk as well, but few in the political system (which essentially included the regulators) wanted to face the implications of that.

Those implications included the need for more capital and more stringent supervision. Instead, the regulators were in the process of bending the rules to

avoid recognizing the de-capitalization of the industry that was rapidly unfolding (as a result of losses arising from mis-guided regulations previously deterring variable rate lending). And more stringent supervision would work against the implicit hope of many that plunging into higher risk lending would generate the extra profits needed to recapitalize the thrifts.

Part of the problem was that the deposit insurance fund was already too depleted to begin to handle the institutions already actually insolvent (despite this, the Congress raised the coverage per account from $40,000 to $100,000). This created strong incentives for all involved to try to hide the problem rather than act on it. (Exactly the same economic and political dynamic has been unfolding in Japan, where losses and insolvencies have been deferred as long as possible to avoid the political heat of a taxpayer bailout.) The experience argues strongly for a deposit insurance scheme with sufficient ex ante funding to permit the administrator to proceed against insolvent institutions without seeking additional funding.

The experience also well illustrates the ultimate nemesis of deposit insurance, moral hazard. Moral hazard can be defined as an incentive for one party to engage in activities detrimental to another party. In this case, the moral hazard was the incentive of thrifts or banks with severely diminished capital to take on as much risk as possible, to increase the chance that they would win "big" enough to recapitalize their institution. Such a "go for broke" mentality is always hazardous to the DI fund since it symmetrically increases the chance of the fund taking a larger loss. Moreover, it was a self-fulfilling process in this case, because of the large number of institutions simultaneously crowding into the same riskier areas of business (primarily commercial real estate) and funding this effort by competing deposits away from those institutions not being as aggressive.

The thrift disaster was an extreme case of moral hazard. But an increase in moral hazard always accompanies the offering of DI, since the DI reduces the cost to a manager of taking on risk (i.e., otherwise would have to pay depositors more), without reducing the reward (higher risk usually comes with a higher reward on average, but with a greater chance of a big loss). That is why any DI program must be accompanied in a calculated manner with a program of supervision and regulation designed to monitor and control risk-taking.

The difficulties of the 1980s and early 1990s has resulted in some rationalization of the DI system. The premium now varies according to certain measures of risk, although most institutions pay the minimum rate. The rate for banks, which had been raised from 0.21 percent to a range of 0.23 to 0.31 percent to rebuild the DI fund, has been cut to only 0.04 percent as long as the DI fund stays above 1.25 percent of insured deposits. The rate for thrifts has stayed

high, despite concern about the competitive disadvantage they then suffer. Instead, it appears likely that the thrifts will finally be fully integrated into the banking sector and the DI funds will be merged. The banking sector itself is rapidly being rationalized through a series of mergers which should tend to create stronger, more regionally diversified banks.

History of Deposit Insurance in India

The history of deposit insurance in India starts in a manner similar to the experience in the U.S. India did not move towards deposit insurance immediately after Independence, presumably partly because of weak finances and partly because deposit insurance did not exist at that time in Britain. However, there were a series of bank failures in the early 1950s that undermined confidence in the banking system, which at that time was totally private. Apparently, though, it was a major failure in 1961, by the Palai Central Bank, that caused the government to establish the Deposit Insurance Corporation in 1962.

It is notable that for the next eight years, through to the nationalization of the major banks, there were no further major failures. However, there were twelve small banks which came under the purview of the DIC, all of which were merged with other banks with the DIC bearing only small net losses.

After the 1969 nationalization of all the major banks, the DIC lost most of its purpose. Once the Central government became the equity investor in a bank, it was hard to imagine that it would not inject capital into it as needed to protect the depositors. However, such protection would not apply to depositors in the private banks. By providing them DI, the DIC helped the private banks to survive in the presence of an implicit blanket government guarantee of the public sector banks. But the role of these banks in the financial fabric of the country was not essential.[5]

As the economy has grown, the role of banks in the payment mechanism and the credit intermediation mechanism has grown. But there has not been the issue that had loomed large for the United States of maintaining confidence in the

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[5] Partially in response to this situation, the DIC was renamed the Deposit Insurance and Credit Guarantee Corporation (DICGC) and given the additional responsibility of operating a credit guarantee window for bank loans to priority sectors. This was a convenient arrangement whereby the accumulating surplus of insurance premiums could be used to pay the growing claims against the under-priced guarantee fund.

system, because the government controlled and implicitly guaranteed it.[6]

As the financial system evolved, a number of other institutions were also established. These included institutions such as the co-operative banks and the regional rural banks (RRBs) which faced the same sort of term intermediation problem of the commercial banks. It also included institutions that intermediated funds for the longer term (e.g., ICICI, UTI), either government-directed credit or funds raised from the charitable trusts or even individuals.

The co-ops and RRBs were brought under the DIC scheme and most of the longer-term intermediaries were government sponsored and thus presumably government-guaranteed. The only significant forms of intermediation left outside the implicit or explicit coverage of a government guarantee were the equity markets, the small market in corporate bonds, the large deposits in the private commercial banks, and the deposits in the Non-Bank Companies (NBCs).

The NBCs are an important part of the picture today, both because they are a substantial part of the financial market and because they are the sector in which the HFCs have taken root. There are three major types of NBC's currently, the Non-Bank Non-Financial Companies (NBNFCs), the Non-Bank Financial Companies (NBFCs), and the HFCs. The NBNFCs are usually ordinary operating companies which have opened up a deposit-taking window in the company in order to raise funds additional to what they were being allocated under the directed credit schemes of the government. The NBFCs exist for the same reason, and act as financial intermediaries serving those smaller companies and individuals who can not gather deposits directly. The HFCs are technically NBFCs with a separate regulatory structure (the NHB).

The NBCs have grown steadily since the imposition of directed credit, so that by 1993 their deposits were one-fourth as large as the total deposits of the banking system. Of these, over half were deposits with NBNFCs. In fact, only 18 percent of NBC deposits were held by entities where the deposits exceeded 40 percent of the company's net owned-funds, i.e., where there was any substantial leveraging. Only these institutions are regulated to any degree by the Reserve Bank of India. Even though there are a large pool of deposits outside of the protective gaze of the banking regulators and coverage of DI, most of these are buffered by substantial equity protection. On net, the really "at-risk" deposits in

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[6] Only gradually did a new type of financial intermediary, the non-bank financial institutions, grow outside of an implicit or explicit government guarantee. Presumably, this conduit for credit was considered non-essential to the good functioning of the economy.

NBCs totaled about 3 percent of total bank and non-bank deposits.[7] In theory, these deposits are not covered by DI and, in practice, some NBFCs have failed and cased losses.[8]

Starting in 1991, the national government has moved ahead more seriously with the overall "commercialization" if not privatization of the financial sector. This has brought the issue of government regulation and supervision, as well as guarantees and insurance, to a new level of prominence. For example, eleven new private banks have been licensed and these banks intend to aggressively compete with the state-owned and existing private banks. This and other steps are intended to pressure the public sector banks to perform on more of a commercial basis.

These steps mean that there will be an expanding share of deposits and credit origination that is effectively covered by the formal deposit insurance scheme, rather than by the ad hoc protection derived from the government owning the bank. Not only will the share of the public sector banks decline, but even the public-sector banks may face the possibility of "failure" under the strict new accounting and supervision rules, which rule out the sort of "creative accounting" that permitted banks to ignore losses in the past. In such a case, presumably the bank will be wound down or amalgamated under the auspices of the DICGC, not simply recapitalized by the government.

Equally importantly, there appears to be a growing recognition that the financial sector will eventually become more integrated and competitive, both within and across sub-sectors. This integration is generally complete in the U.S. and Europe. The non-bank corporate debt markets, both short-term and long-term, compete with banks on the lending side and money market and other mutual funds compete with banks on the fund-raising side. Depository institutions may interface with the consumer with respect to a wide range of credit and investment activities, but may compete with specialist institutions drawing funds from the general capital markets through asset-backed securities. Overall, there remain specialized institutions on both the asset and liability sides, but all compete for funds and credit customers in a relatively level playing field.

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[7] Another formal "deposit" arrangement exists in the form of partnerships of up to ten participants who pool funds together and make loans or investments. These partnerships are not included in any of these data.

[8] It is notable that some of the NBFCs have been sponsored by banks and that these banks in practice guarantee the deposits of their NBFCs.

India may not achieve this degree of integration and sophistication in the near future, but it is seemingly moving in that direction. Capital requirements, uniform regulation, and serious supervision are appearing in all sub-sectors of the financial market, including public and private banks, housing finance companies, other non-bank financial institutions, insurance, provident funds, mutual funds, and the stock brokerage firms.

Of particular importance, the NBFC sector, which has always been seen by the public and government alike as being relatively unregulated and higher risk, is being targeted for increased capital requirements, regulation and supervision. The HFCs are a sub-sector that has been recognized as special since before the establishment of NHB in 1988 and are already being treated largely as banks with respect to capital adequacy and supervision. Both the HFCs and the other NBFCs are being required to achieve a satisfactory credit rating in order to operate on a leveraged basis, a step that will narrow sharply the number of entities that the government will need to apply rigorous supervision to.

In this context, certain issues related to deposit insurance may be resurfacing in India after being dormant for the last 25 years. It is still too early to anticipate what will happen if the larger public sector banks were to need recapitalization again, but it is timely to ask (1) how effectively will the DICGC handle a major bank failure, (2) to what extent does DI tilt the financial playing field towards the commercial banks, (3) to what extent is it likely that the commercial bank sector will subsume the non-bank sector, with or without deposit insurance, and (4), if not, how will the RBI extend its control into the NBFC sector, through licensing (and therefore the power to take over and liquidate, and thus insure) or some other approach.

The first two of those questions can be addressed here. The effectiveness of the DICGC is open to question for two reasons. It has not handled a major bank failure in its entire history, and thus its administrative capabilities are probably limited. More importantly, as of March 1995, the DI fund was equal to only 0.50 percent of insured deposits and most of this was actually being used to pay claims against the Credit Guarantee fund. In contrast, the DI fund for banks in the U.S. is expected to be 1.25 percent of insured deposits. Moreover, the deposits in India are more concentrated in the hands of a relatively few banks than in the U.S., so that the failure of any major bank would impose a greater strain on the DI fund. (Of course, the real implication is that the large public sector banks will remain implicitly guaranteed by the government directly for the foreseeable future.)

As for the level playing field, there are still a large number of tilts and bumps that are much larger than the question of uniform access to DI. But one issue that

will need to be addressed eventually is what is an appropriate premium for DI. This is especially important if DI is not extended soon to qualifying NBFCs. For both the purpose of expanding the fund to cover its risks properly and for the purpose of leveling the playing field by not so subsidizing the DI coverage for banks, the premium for DI should probably be raised substantially from its current level of 0.05 percent.

History of HFCs in India

Why is there a HFC sector in India and why it has taken on a special status within the non-bank financial sector? The brief answer is that market-rate finance for the construction, purchase or improvement of housing was not generally available in India before the HFCs. Subsidized financing was available in limited amounts to special groups through the commercial banks, HUDCO, and the Life Insurance Company (LIC). In other words, special channels existed for special groups at special rates, but an ordinary middle-class household with plans to buy or build a house or flat had nowhere to turn.

Given that most of the financial sector was composed of similar special channels for limited amounts for specific purposes, the demand for housing finance could have been met by tinkering with the existing system or by going outside the system to create open-ended market rate lenders. The latter route was pursued by HDFC with the encouragement of the government, USAID, and the World Bank.

HDFC was founded in 1977 in the legal context of a NBFC. While HDFC was different from most existing NBFCs by virtue of its focus on a socially priority sector and its official sponsorship, it operated within the same relatively low-regulation, low-supervision environment as the NBFCs. The one regulation that all NBFCs found most constraining was the inability of raising deposits with terms less than 24 months. In HDFC's case, this meant relying on a changing mix of 2-4 year deposits raised from major institutional sources (especially charitable trusts, which had some discretion over a portion of their assets); term loans from banks, LIC, or other government-sponsored intermediaries; loans from the World Bank, USAID, and other donor agencies; and an attempted contract savings scheme. Household deposits were not a significant part of HDFC's funding.

It is generally viewed that HDFC was able to raise funds from these many sources because of the endorsements it had received from government and foreign agencies. The author is not aware of any discussion of an implicit or explicit guarantee arising in this regard, but the effect appears to have been the same. This allowed HDFC to get off the ground and prove through experience that its

premise was correct, that market-rate housing finance could be a sound and profitable business. HDFC's track record only reinforced the perception of it being a low-risk repository of funds.

HDFC having shown the way, and in the absence of regulatory obstacles, other HFCs followed by the mid-1980s. This was also the period of the first round of economic reform under Rajiv Ghandi and thus coincided with a period of rising middle-class incomes and renewed interest in private-sector entrepreneurialism. It appears that these early HFCs planned to raise funds from the same types of sources as had HDFC, including foreign sources. Most such funding was no longer on offer, since it was intended for pilot purposes, not to fund an industry. Thus, the new HFCs initially had to piece together funding from charitable trusts, sponsoring institutions, and some household deposits, a strategy that severely limited their growth in the early years.

The government took note of the growing interest in housing finance, and, with the assistance of USAID, set about creating an official support mechanism for the fledgling industry. In 1987-88, the National Housing Bank (NHB) was developed to regulate and financially support the sector. The effect was dramatic. Loan originations nearly doubled in the ensuing fiscal year and doubled again in the following two years.

Most of this rapid growth in market-oriented lending was funded out of the older-style directed credit mechanisms, but channeled through the NHB in the form of refinance for loans of specific limited characteristics. (Another important source of this growth was the decision by the LIC to switch most of its on-going lending for housing to a separate housing finance entity, LIC Housing Finance Limited.) The resources raised by NHB rose rapidly in the first three years, peaking in 1991-92 at Rs. 688 crores, a level equal to more than half of the lending originated by NHB-recognized HFCs in that year. In this context, NHB, an arm of the RBI, was shouldering much of the credit risk of funding the new entrants.

By 1992, it was clear that the HFC sector, along with the rest of the entire financial sector, was going to be substantially liberalized. As envisioned by the Narasimham Committee and the Shah Working Group, the financial sector has been steadily undergoing a truly massive makeover, with the goal of converting it from a passive conduit for government-directed funding decisions to being an active risk-attuned, profit motivated fund-raiser and funds allocator.

At the leading edge of this reform has been the steady closing of windows of below-market wholesale directed credit. The implication for NHB has been a steady decline in the pool of funds it can offer for refinance and a steady relaxation of NHB's restrictions on the interest rates the HFCs can charge. An

implication for HFCs is that they must compete with banks and other NBFCs for funds, particularly for deposits, the arena where price and service competition can be most effective.

The deposit market has always been a key source of HFC funding. Even HDFC derived almost 40 percent of its total resources in 1989-90 from deposits. However, at that time, the deposit market being tapped by HDFC was not one of household savers choosing between a bank and a NBFC, but rather composed of charitable trusts and other institutional repositories of funds seeking to get a market rate of return on the small part of their portfolio on which the government permitted any discretion in its disposition. The larger part of even this deposit market was off-limits to the HFCs, being directed towards being lodged at below-market rates with the commercial bank sector (which in turn labored under directives as to where to allocate funds and at what rate).

The available evidence suggests that less than 20 percent of total deposits in HFCs as late as March 1992 were placed by households. This was probably because the HFCs felt that this source of funds would be too expensive, once the higher administrative costs and competition with the other NBFCs was factored in. However, this view has changed radically the last few years. Either because of limited ability to coax more funds from the institutional sector or because of innovation in marketing to households (e.g., the use of agents), the household share of HFC deposits has risen steadily to an estimated 40 percent in March 1995. Given that during the same period the share of deposits in total HFC resources also doubled, the growth rate of household deposit taking was about 70 percent a year, far exceeding the 33 percent growth in sector assets.

This shift was predictable. The HFCs were experiencing the liberalization movement, losing their directed sources of credit on the one hand and being freed in setting terms on their lending on the other hand. Their natural source of funds is deposits (at least in the absence of a debt market and a legal environment capable of supporting mortgage-backed securities). At this point, HFCs are generally too risky for longer-term bond issuance. Moreover, they have to have a branch system anyway to originate and service loans. They also benefit from lower required liquidity reserves against deposits than banks.

These advantages of funding mortgages by raising deposits from households are certainly not conclusive. There are a number of approaches which are potentially competitive, especially if the NHB chose to take on some of the credit risks by raising funds for refinance under an implicit government guarantee. But at this stage in the development of the sub-sector and the reform of the larger financial sector, household deposits are the most likely target.

This would be even more strongly indicated if the RBI removes remaining limitations on the marketplace for deposits, not only with respect to interest rates, but also the ability to differentiate rates by size of deposit and location of depositor (i.e., pay large depositors in large cities more).

A key step in this regard was the relaxation in June 1993 of the restriction on the minimum term of deposits to 12 months from 24 months. In this manner, the RBI has signaled that it foresees greater overlap in the future in the fund-raising activities of banks and the NBFCs. Other key changes pending are the equal treatment of taxation of interest at source and, of course, extension of deposit insurance.

The Need for Deposit Insurance

Part of the reason for considering the extension of deposit insurance to the HFCs is simply that it may be necessary to assure a level playing field with the banks. Aside from that reason, however, the HFCs would be likely candidates for a deposit insurance scheme anyway. If in fact they are going to rely significantly on household deposits for funding long-term loans, their continuing viability will depend on a high level of public trust in their liquidity and solvency. The failure of even one major HFC may make the operation of the remaining ones very difficult.

At the moment, the depositors in HFCs have no real protection from either illiquidity or insolvency. There is no formal procedure for an HFC facing a loss of confidence, and thus deposits, to have access to a liquidity window. To some extent, HFCs can use NHB refinance as such a liquidity mechanism, but only with a longer-term horizon. There are no provisions for overnight processing of a request for refinance and the existing refinance window is for the remaining period of the refinanced loan, not for a short-term liquidity crunch.

Moreover, there are not any mechanisms in place to prevent HFCs to become insolvent due to interest rate movements. The interest rates on housing loans are legally flexible in the face of shifts in the cost of funds, but this flexibility has yet to be utilized in practice, despite significant swings in market interest rates. Until a formal variable rate loan program is widely adopted by HFCs or NHB regulation and supervision in this regard is strengthened, there is a significant risk of failure of an HFC over the course of a major interest rate cycle. Such cycles have not existed in the past under a regulated rate structure, but will surely arise in the future.

Thus, the stage is set for a chain reaction of failure and illiquidity in the HFC industry, of the sort that only a credible deposit insurance scheme can deter.

What is missing is a necessary complement of any DI scheme, that is, a stringent system of regulation and supervision to limit the risks to which the DI is exposed. The NHB is moving in that direction from an initial position of simply monitoring the sector. But it seems that scope and specificity of regulation is still too limited and that the quality of the supervision too low to prevent the exposure of an HFC to significant losses.

As noted above, the HFC industry, along with the rest of the NBFC sector, are in the process of being evaluated by credit rating agencies. It is possible that the credit rating process could substitute for the sort of regulation and supervision that is normally needed to maintain the integrity of a DI fund. However, it is beyond the scope of this analysis to assess whether the stress models applied by the credit rating agencies are designed in such a way that the risks of illiquidity and insolvency will be minimal among the well-rated institutions. Moreover, it is unlikely that the credit rating agencies will be as timely in detecting increasing risk as a well-functioning supervision process.

Another caveat that should be noted is that most of the major new HFCs are promoted by public-sector entities, often with secunded management. These entities could reasonably be expected to provide liquidity and equity capital if needed and thus provide a substantial degree of protection for the HFC sector. However, this situation only strengthens the argument for providing DI explicitly to all qualified HFCs, rather than rely on implicit DI to only those sponsored by public-sector entities. The public sector is already bearing most of the risk, without the benefits of open entry to new private sector entrants.

Future development of HFCs

To some extent, the success of the HFC sector has been due to opportunities left open to it by the restrictions previously imposed on the banking sector. As these restrictions are removed, the overlap and competition between sectors will increase, on both the funding and lending sides. On the funding side, banks have been restricted in the interest rates they could pay on term deposits to a level lower than that permitted NBFCs. At the same time, the NBFCs were restricted to offering a minimum term of 2 years. Both of these differentials have been narrowed in the last two years, and the expectation is that at least the interest rate restrictions will be lifted entirely soon. (There seems to be more uncertainty as to whether the banks will soon relinquish their monopoly on shorter-term deposits.)

At the same time, the banks have received gradual relaxation of the tight restrictions on rates and amounts of lending for housing. At this point, there is no

evidence of increased interest on the part of banks in consumer lending, including housing. In fact, there is some indication of a divergent trend. HDFC, a proverbially forward-looking company, has established new entities to enter commercial banking and non-housing consumer finance, without any suggestion that all these activities could be done within the context of a single institution, the HDFC Bank. However, HDFC has enunciated in its 1994-95 annual report the view that "an era of multi-product competition on both resource mobilization as well as lending" is in prospect. It appears that it simply views the best method of preparing for that era is to develop its expertise in each area separately, at least initially.

However, to better perceive the future in this regard, one can look to the Western advanced countries or to the Asian "advancing" countries. Europe and the U.S. have been undergoing a rather painful and uneven process of eliminating segmentation in their financial marketplace, complicated by the presence of deeply vested interests and a maze of segmented regulation and privileges. The end result, however, has been either the gradual elimination of boundaries between segments or the conjunction of the different segments into affiliated networks.[9]

In the newly developed Asian countries, the trend is towards the commercial banks acting as universal banks, with interests in all segments of finance. In the process, previous channels of housing finance have been superseded and new channels for funding, such as secondary markets or refinance facilities, have been developed.

These trends were recognized by the Shah Working Group and were part of their motivation for seeking rapid movement towards the uniform regulation and supervision of the NBFCs. Since their report in September, 1992, the development in his direction has been nearly as rapid as, and in some ways more rapid than, they recommended. Recent pronouncements by the Governor and Deputy Governor of the RBI further confirm the RBI's intentions in this regard.

Conclusions and Recommendations

Where does this discussion leave the question of deposit insurance? This question is currently resting where it was left by the Shah Group, essentially to be addressed once the reforms in the NBFC sector were complete. To a great extent,

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[9] At the same time, there has been a shift towards specialization according to the various functions of finance, e.g., funding, loan servicing, credit evaluation, instead of following the end purpose of the finance.

that conclusion still holds; it is not advisable to extend any kind of government guarantee to institutions that are not essentially of very low risk and under careful scrutiny. The big difference between now and 1992 is that it is almost four years later; the sector reforms have progressed as planned; there is a growing reliance on household deposits for the funding of HFCs; and the necessary administrative preconditions are in sight, at least for the HFCs. The moment for further consideration of DI should also not be far in the future.

How should DI be extended to HFCs? It is not desirable to have two or more different deposit insurance systems for a supposedly integrated financial system. The drift of regulatory developments has been to bring the risks associated with each type of institution to a common and low level. Moreover, with each type of institution (bank, HFC, and other NBFC) likely to eventually operate in each other's segments of the market, the presumptive view is that there should be no differences in regulation, supervision, or deposit insurance.[10]

These statements raise more general issues that will have to be sorted out in the next few years. For example, in the future, is there a role for stand-alone institutions specialized in housing finance, as opposed to perhaps subsidiaries of banks or large NBFCs? The specialization of skills and marketing are not a reason for legal and regulatory segmentation.

If there are reasons for such segmentation, e.g., as a method of channelling some sorts of subsidy to housing finance (as in the case of the 40 percent provisioning rule for HFCs), what logical implications does that have for regulation, supervision, and deposit insurance? The experience in the U.S. is that, once the decision has been made to largely integrate the financial sector, it is essential that the regulation and supervision process also be integrated. Within that single regulatory body, special rules for different segments can be provided as appropriate.

Are there any circumstances under which a separate deposit insurance system should be set up? It seems unlikely for such to be the case. In fact, there are strong arguments for building on the current DICGC. First, any new system would take several years to build up enough reserves to be credible. Second, the current members have no particular claim to the current reserves of the DICGC, since they exist only because of the direct government bailout of the public sector banks, organized in place of a liquidation through using the DI reserves. Now that

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[10] This presumably implies that the legal basis for HFCs and the other NBFCs will need to be changed from the Companies Act to the Banking Act or their own Act.

the public sector banks have been bailed out, they and all other institutions competing on the new level laying field should enjoy the benefits of a credible DI system, one with funds on hand for rapid action and with the implicit backing of the government.

As noted above, some may see logical grounds for differentiation between sectors with respect to specific aspects of regulation, taxation, or supervision. This could imply differences in these regards, but not necessarily in the institutions governing the sectors. Similarly, if there are differences in the risk exposure of HFCs relative to banks or other NBFCs, that would be an argument for a different premium for different institutions, but not for a different fund. In this regard, the DI should operate the same as any private sector insurance company, charging according to risk and pooling its resources to pay claims.[11]

When should DI be extended to the HFCs? In principle, this should happen as soon as possible and certainly in advance of the removal of the remaining barriers to open competition for deposits and in lending. However, there are certain prerequisites that have to be met as well. As noted, it would be desirable for the systems of regulation and supervision to be integrated in advance. Short of that, the regulation and supervision of the HFCs by the NHB has to be brought up to a level sufficient to prevent abuse of the privilege of DI by HFCs taking excessive risks.[12]

Actions need to be taken with respect to the major risks in the sector, including establishing the widespread use of variable-rate mortgages, improving foreclosure powers, and perhaps introducing some minimum geographic diversification of lending. In addition, the sector needs a more formal and appropriate liquidity facility. There does not seem to be any reason why the NHB could not set up such a short-term liquidity facility, since the NHB could probably access liquidity from the RBI as needed and mark up the funds for short-term loans to HFCs against overcollateralized packages of mortgages.

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[11] The argument can be made that the kind of lending that banks do is more risky than that for housing. However, that only considers credit risk, whereas the interest rate risk and liquidity risk of HFCs may be higher. It is hard to say how the premiums should differ without a lot more analysis.

[12] In this regard, the setting of a requirement that an investment grade credit rating be obtained will screen out some potentially risky participants. Unfortunately this is only useful initially. If there is a downgrade of the credit rating, DI probably can not be removed without causing the destruction of the institution.

Another prerequisite for DI is that the NHB or RBI must have more than the power to stop an HFC from taking additional deposits, but be able to essentially take over and, if necessary, liquidate the institution. As James Croft observed in his 1990 review of the regulation of HFCs, banning deposit-taking is a very crude enforcement mechanism and NHB needs "the ability to effectuate a timely and efficient winding up process" for insolvent HFCs. There can be no access to deposit insurance without such authority, because the DICGC must be able to take over the management of the assets of a failed institution to protect itself since it is the one bearing the additional losses.

Can the credit rating system now in place substitute for DI? In principle, an appropriate system of stress tests can do an even better job of detecting weaknesses in an institution than RBI supervision and thus monitoring the likelihood of failure. But when weakness starts to grow and the rating is reduced, credit rating by itself can do nothing about stabilizing the situation to permit the orderly disposition of the institution's affairs. Moreover, it is unlikely that Indian depositors are sophisticated enough at this point to accept assurances by a private-sector entity that institutions retaining a high rating can be trusted despite the failure of another seemingly similar institution. Thus, it seems unlikely that a credit rating system can substitute for DI, although it may be a very useful prerequisite for gaining access to the DI system initially and perhaps for setting differential premiums.

Clearly, there are many things to do before DI can be extended to HFCs. Unfortunately, it seems that, until DI is made available to HFCs, there will remain the possibility that a failure by one HFC could undermine confidence in others enough to at least slow the sector's growth.[13] The playing field within the HFC sector will also remain tilted towards institutions sponsored by public-sector entities. These negative impacts will be enlarged if the banks are simultaneously in the process of becoming serious competitors on the full range of deposit-raising and lending activities.

An important caveat to this perspective is the possibility that the funding for home loans will start coming from some sort of secondary market mechanism, rather than from deposits. Some such mechanisms, such as the German mortgage

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[13] Despite this, there are reasons for expecting that some of the existing HFCs will be opposed to coming under the DICGC. Many HFCs are in the competitively comfortable position of sponsorship by a financial institution that is covered by the DICGC or otherwise securely positioned and do not wish to extend an automatic "AAA" rating to deposits in new HFCs, no matter how qualified they may be with respect to stringent regulatory guidelines.

bond system, rely on the existence of specialized institutions not involved in deposit-taking. But if such a mechanism was equally accessible by any mortgage originator, not just specialist institutions, the existence of a secondary market would not change the general proposition that all institutions should be treated equally, including DI coverage, but it would reduce the urgency of extending DI to the HFCs.