
ROLE OF DEPOSIT INSURANCE IN PROTECTING THE ECONOMY OF INDIA

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ABSTRACT

Irregularities and deficiencies in the banking systems, if not checked timely, could lead to financial crisis which may bear a substantial cost to the economy. Recent examples of such crisis are sub-prime lending crisis of USA in 2009 and the current European crisis where many countries have been given bail-out packages multiple times to stabilize their economies. Since the world today is globalized, the emergence of cross-border banking and stability of the banking sector in an economy is of utmost importance for the domestic economy as well as the foreign economies. In order to limit the contagion of the failure of Bank(s), the countries have evolved safety nets to meet the emergencies in the banks partially or wholly. Safety nets are of two types: **Lender at the Last resort** and **Deposit Insurance**. In Lender at the last resort, whenever banks facing liquidity crunch are unable to raise their funds from other sources to meet their obligations, the Central bank lends them funds at the last. However the banks may not prefer this solution as it may affect the reputation of the banks. As a result, the only solution left is the Deposit Insurance. This paper focuses on analyzing How the Deposit Insurance scheme plays a vital role in a big economy like India and the major issues related to this scheme.

Key Words: Financial crisis, Economy, Lender at the last resort, Liquidity crunch, Central bank, Deposit Insurance, Obligation.

Introduction

The concept of insuring deposits kept with banks received attention for the first time in the year 1948 after the banking crises in Bengal. The question came up for reconsideration in the year 1949, but it was decided to hold it in abeyance till the Reserve Bank of India ensured adequate arrangements for inspection of banks. Subsequently, in the year 1950, the Rural Banking Enquiry Committee also supported the concept. Serious thought to the concept was, however, given by the Reserve Bank of India and the Central Government after the crash of the Palai Central Bank Ltd., and the Laxmi Bank Ltd. in 1960. The Deposit Insurance Corporation (DIC) Bill was introduced in the Parliament on August 21, 1961. After it was passed by the Parliament, the Bill got the assent of the President on December 7, 1961 and the Deposit Insurance Act, 1961 came into force on January 1, 1962. The Deposit Insurance Scheme was initially extended to functioning commercial banks only. This included the State Bank of India and its subsidiaries, other commercial banks and the branches of the foreign banks operating in India. Since 1968, with the enactment of the Deposit Insurance Corporation (Amendment) Act, 1968, the Corporation was required to register the 'eligible co-operative banks' as insured banks under the provisions of Section 13 A of the Act. An eligible co-operative bank means a co-operative bank (whether it is a State co-operative bank, a Central co-operative bank or a Primary co-operative bank) in a State which has passed the enabling legislation amending its Co-operative Societies Act, requiring the State Government to vest power in the

Reserve Bank to order the Registrar of Co-operative Societies of a State to wind up a co-operative bank or to supersede its Committee of Management and to require the Registrar not to take any action for winding up, amalgamation or reconstruction of a co-operative bank without prior sanction in writing from the Reserve Bank of India. Further, the Government of India, in consultation with the Reserve Bank of India, introduced a Credit Guarantee Scheme in July 1960. The Reserve Bank of India was entrusted with the administration of the Scheme, as an agent of the Central Government, under Section 17 (11 A)(a) of the Reserve Bank of India Act, 1934 and was designated as the Credit Guarantee Organization (CGO) for guaranteeing the advances granted by banks and other Credit Institutions to small scale industries. The Reserve Bank of India operated the scheme up to March 31, 1981. The Reserve Bank of India also promoted a public limited company on January 14, 1971, named the Credit Guarantee Corporation of India Ltd. (CGCI). The main thrust of the Credit Guarantee Schemes, introduced by the Credit Guarantee Corporation of India Ltd., was aimed at encouraging the commercial banks to cater to the credit needs of the hitherto neglected sectors, particularly the weaker sections of the society engaged in non-industrial activities, by providing guarantee cover to the loans and advances granted by the credit institutions to small and needy borrowers covered under the priority sector. With a view to integrating the functions of deposit insurance and credit guarantee, the above two organizations (DIC & CGCI) were merged and the present Deposit Insurance and Credit Guarantee Corporation (DICGC) came into existence on July 15, 1978. Consequently, the title of Deposit Insurance Act, 1961 was changed to 'The Deposit Insurance and Credit Guarantee Corporation Act, 1961. Effective from April 1, 1981, the Corporation extended its guarantee support to credit granted to small scale industries also, after the cancellation of the Government of India's credit guarantee scheme. With effect from April 1, 1989, guarantee cover was extended to the entire priority sector advances, as per the definition of the Reserve Bank of India. However, effective from April 1, 1995, all housing loans have been excluded from the purview of guarantee cover by the Corporation.

Literature Review

FSF (2001) Banks and financial institutions are in the business of assuming and managing risks. They are allowed and encouraged to lend and invest money kept with them by the depositors instead of safekeeping it in full amount. They are prone to liquidity and solvency problems as they transform short term deposits into long term less liquid loans and investments. They lend to a wide variety of borrowers whose risk characteristics are not always apparent. **Pennacchi (2009)** If most of the bank's borrowers are not able to repay their loans at time its depositors are at the risk of loss. Banks rely on deposits of their customers that can be withdrawn on little or no notice. So banks are prone to Bank run where depositors seek to withdraw funds quickly ahead of banks insolvency. **Diamond DW (2007)** A **bank run** (also known as a **run on the bank**) occurs in a fractional reserve banking system when a large number of customers withdraw their deposits from a financial institution at the same time and either demand cash or transfer those funds into government bonds, precious metals or stones, or a safer institution because they believe that the financial institution is, or might become, insolvent. As a bank run progresses, it generates its own momentum, in a kind of self-fulfilling prophecy (or positive feedback loop) – as more people withdraw their deposits, the likelihood of default increases, thus triggering further withdrawals. This can destabilize

the bank to the point where it runs out of cash and thus faces sudden bankruptcy. **FSF (2001)** Banks that accept deposits are important to the economy because of their payments system, their role as intermediaries between depositors and borrowers and their functions as agents of transmission of monetary policy of the central bank. **Schich (2008)** The importance of banks in the economy, the loss of depositors when banks fail and the need to prevent the risk of this contagion led to establishment of financial safety nets in most of the countries. Policy makers maintain Deposit Insurance schemes to protect depositors and give them comfort that their deposits are not at risk. **Pennacchi (2009)** A bank's ability to create liquid transactions deposits can break down if its capital reduces and default risk rises. In this circumstance, deposit insurance restores deposit liquidity by making deposits default free. **Choi (1999)** Deposit Insurance is of two types: Explicit Deposit Insurance and Implicit Deposit Insurance. Explicit Deposit Insurance is a measure implemented in many countries to protect bank depositors in full or in part from losses caused by banks' inability to pay its obligations when due. In an Implicit deposit insurance scheme, losses arising from the insolvency of the financial institution are borne by the general public, regardless of income, size of the individual depositor, or size of the financial institution. Thus such a deposit insurance scheme cannot be seen as fair.

Diamond-Dybvig Model

The model, published in 1983 by Douglas W. Diamond of the University of Chicago and Philip H. Dybvig, then of Yale University and now of Washington University in St. Louis, provides a mathematical statement of the idea that an institution with long-maturity assets and short-maturity liabilities may be unstable. The **Diamond–Dybvig model** is an influential model of bank runs and related financial crises. The model shows how banks' mix of illiquid assets (such as business or mortgage loans) and liquid liabilities (deposits which may be withdrawn at any time) may give rise to self-fulfilling panics among depositors

Structure of the Model

Diamond and Dybvig's paper points out that business investment often requires expenditures in the present to obtain returns in the future (for example, spending on machines and buildings now for production in future years). Therefore, when businesses need to borrow to finance their investments, they wish to do so on the understanding that the lender will not demand repayment(s) until some agreed upon time in the future, in other words prefer loans with a long maturity (that is, low liquidity). The same principle applies to individuals seeking financing to purchase large-ticket items such as housing or automobiles. On the other hand, individual savers (both households and firms) may have sudden, unpredictable needs for cash, due to unforeseen expenditures. So they demand liquid accounts which permit them immediate access to their deposits (that is, they value short maturity deposit accounts). The paper regards banks as intermediaries between savers who prefer to deposit in liquid accounts and borrowers who prefer to take out long-maturity loans. Under ordinary circumstances, banks can provide a valuable service by channelling funds from many individual deposits into loans for borrowers. Individual depositors might not be able to make these loans themselves, since they know they may suddenly need immediate access to their funds, whereas the businesses' investments will only pay off in the future (moreover, by aggregating funds

from many different depositors, banks help depositors save on the transaction costs they would have to pay in order to lend directly to businesses). Since banks provide a valuable service to both sides (providing the long-maturity loans businesses want and the liquid accounts depositors want), they can charge a higher interest rate on loans than they pay on deposits and thus profit from the difference. Diamond and Dybvig's crucial point about how banking works is that under ordinary circumstances, savers' unpredictable needs for cash are unlikely to occur at the same time. Therefore, since depositors' needs reflect their individual circumstances, by accepting deposits from many different sources the bank expects only a small fraction of withdrawals in the short term, even though all depositors have the right to take their deposits back at any time. Thus a bank can make loans over a long horizon, while keeping only relatively small amounts of cash on hand to pay any depositors that wish to make withdrawals. (That is, because individual expenditure needs are largely uncorrelated, by the law of large numbers banks expect few withdrawals on any one day.) . However, since banks have no way of knowing whether their depositors *really* need the money they withdraw, a different outcome is also possible. Since banks lend out at long maturity, they cannot quickly call in their loans. And even if they tried to call in their loans, borrowers would be unable to pay back quickly, since their loans were, by assumption, used to finance long-term investments. Therefore, if all depositors attempt to withdraw their funds simultaneously, a bank will run out of money long before it is able to pay all the depositors. The bank will be able to pay the first depositors who demand their money back, but if all others attempt to withdraw too, the bank will go bankrupt and the last depositors will be left with nothing. This means that even healthy banks are potentially vulnerable to panics, usually called bank runs. If a depositor expects all other depositors to withdraw their funds, then it is irrelevant whether the banks' long term loans are likely to be profitable; the only rational response for the depositor is to rush to take his or her deposits out before the other depositors remove theirs. In other words, the Diamond–Dybvig model views bank runs as a type of self-fulfilling prophecy: each depositor's incentive to withdraw funds depends on what they expect other depositors to do. If enough depositors expect other depositors to withdraw their funds, then they all have an incentive to rush to be the first in line to withdraw their funds. In theoretical terms, the Diamond–Dybvig model provides an example of a game with more than one Nash equilibrium. If depositors expect most other depositors to withdraw only when they have real expenditure needs, then it is rational for all depositors to withdraw only when they have real expenditure needs. But if depositors expect most other depositors to rush quickly to close their accounts, then it is rational for all depositors to rush quickly to close their accounts. Of course, the first equilibrium is better than the second (in the sense of Pareto efficiency). If depositors withdraw only when they have real expenditure needs, they all benefit from holding their savings in a liquid, interest-bearing account. If instead everyone rushes to close their accounts, then they all lose the interest they could have earned, and some of them lose all their savings. Nonetheless, it is not obvious what any one depositor could do to prevent this mutual loss.

Research Methodology

This research is based on the review of existing literature on Deposit Insurance system. This is a descriptive research paper based on secondary data. Data have been collected through the websites, research paper, Journals and magazines.

How Regulators handle Bank Failures

The most straight forward method to resolve a failed institution is to Payoff the insured deposit, take over the failed institution and liquidate the failed institution's assets. Under a Payoff and liquidate policy, if sufficient are not realized from the failed institution, the insured depositors would be paid in full only up to Rs.1,00,000 per account. After that the depositors would obtain only a partial settlement or no settlement at all, when the assets of the bank are liquidated. A partial settlement would often be necessary because an insolvent bank has total assets worth less than total value of its liabilities. In such a case, the authority would pay insured depositors in full, but the uninsured might receive less than in a rupee for the uninsured deposits. A bank may have more value as a going concern, with valuable customer relations, locations, staff knowledge and expertise, it may be more valuable if at least part of its operations are maintained than if it is totally liquidated. This has generated a number of alternative methods for resolving bank failures. Most commonly, various forms of Purchase and assumption transactions are used. Instead of liquidating a failed bank, the insurance fund can allow another bank to enter into a purchase and assumption agreement, in which it would purchase the failed bank and assume its liabilities. In that case, the authority might provide financial assistance to the acquirer and relieve the bank of some or all of the bad assets in order to induce the acquirer to assume the failed bank's liabilities. Because the failed bank might have more value as an going concern than as a failed bank, it would be less costly for the authority to provide financial assistance than to liquidate the bank. Furthermore, when all the liabilities are assumed, no depositor would lose a dime, regardless of how large or small the depositor's account was. Thus, the use of purchase and assumption technique would provide de facto 100 percent deposit insurance. In a clean bank purchase and assumption policy, the authority retains some of the failed bank's assets and provides the acquirer with a promissory note to cover the value of the retained assets. Alternatively the acquirer may acquire all the failed bank's assets but retain an option to "put" some of the assets back to the authority in exchange for a promissory note at some latter point in time. It may exercise the put after it has a chance to better evaluate the failed bank's loan portfolio. In such a case the authority is likely to receive all the failed bank's defaulted loans when the put is exercised. Finally the authority may retain the failed bank's assets and transfer the insured deposits of that bank to another financial institution. Because an acquiring institution may find it cheaper to obtain additional deposit liabilities by buying them from the authority rather than by advertising, it may be willing to pay the authority a small premium for being allowed to assume the failed bank's insured deposits obligations.

Issues relating to Deposit Insurance scheme

- 1. Moral Hazard:** A major problem resulting from the provision of the deposit insurance scheme is that it reduces the incentive of depositors to monitor the health of institutions in which they deposit their hard earned money. This is a moral hazard in that the insured individual is less careful and thus is more likely to incur a loss than would be the case if he or she were not insured. The DICGC has tried to ensure that uninsured depositors police more carefully the banks in which they deposit their money. It has done so by arranging insured deposit transfer in case of bank failure. In such cases only the insured deposits are transferred to another institution. The uninsured deposits are transferred to the old bank which is liquidated. Consequently because uninsured depositors may lose some or all of their funds, they have a greater incentive to monitor the safety of the bank than they would if they expected a purchase and assumption to occur in the event of the failure. Deposit insurance can also create a moral hazard for the managers of depository institutions. In particular even if a depository institution is risky if it is insured it can usually continue to issue deposits to obtain funds at much the same rate as less risky institutions. It can do so because most depositors do not share the risk of loss. Thus unlike corporation managers, managers of insured depository institutions can usually take greater risk without greatly increasing the price they must pay to obtain liabilities. If they do not bear the full cost of their risk taking, they may be encouraged to take more risk than they would if they could only issue uninsured liabilities.
- 2. Too big to fail problem:** Purchase and assumption policies provide 100 percent coverage for all depositors whose deposits are assumed. A second policy adopted by regulating authority that provided 100 percent deposit insurance was its Too big to Fail policy. The reason large institutions were not allowed to fail because the failure might lead to other failures based on the interdependent financial relationships these banks have with other financial institutions. Regulators are worried that the failure of these banks will cause a run on these banks, not by insured depositors but by uninsured creditors and other financial institutions. In response to these cases and concerns that the failure of one large institution might have a domino effect throughout the financial system. However Too big to Fail has criticism. It has created a two tiered banking system. All depositors at very large institution have de facto 100 percent deposit insurance. Depositors at small banks have deposit insurance only up to Rs.1,00,000 per account. A second criticism is that if the government stands behind all the big-bank liabilities, bank management may be tempted to make riskier loans in an effort to increase profits. This is because uninsured depositors, who are at risk, help monitor the bank's performance, and their willingness to purchase the bank's liabilities disciplines the bank to take prudent risks. With the Too big to Fail policy in place, large banks' uninsured depositors may now be indifferent to the risks that these banks take because of the willingness of the regulator to intervene and prevent the banks from suffering any loss. This creates a major moral hazard problem.

Deposit Insurance Premium

Choi (1999) It seems that banks are convinced that deposit insurance scheme is necessary and need to be implemented. Even based on sound financial management, policy makers could not step back from establishing deposit insurance scheme. However the major controversial issue is that of Deposit insurance premium. Insurance premium refer to the premium payments made by financial institutions according to probability of that institution becoming unable to meet its obligations. Insurance premium are based on a differential rate or a flat rate. Flat rate are those for which a fixed percentage of deposits is designated, are easier to estimate and less expensive to administer and is more prevalent among countries having explicit deposit insurance. A differential rate is more effective in preventing moral hazard and instituting prudential management. As differential rate are more complicated so its best to start with flat rate and shift to a differential rate.

The rate of insurance premium was initially fixed at .05 or 1/20th of 1 per cent per annum. It was reduced to .04 or 1/25th of 1 per cent per annum with effect from 1st October 1971. However, it was again raised to .05 or 1/20th of 1 per cent per annum with effect from 1st July 1993. Since 2001, the Corporation has had to settle claims for large amounts due to the failure of banks, particularly in the Co-operative Sector causing a drain on the Deposit Insurance Fund (DIF). While there is sufficient corpus in Deposit Insurance Fund for the present, it is necessary to build up a sound DIF in the long term to protect the interests of the banking system. With this objective the Corporation decided to enhance the deposit insurance premium from 5 paise per ₹100 of assessable deposits per annum to 10 paise per ₹100 of assessable deposits per annum in a phased manner over a period of two years. In the first phase, the premium was raised to 8 paise per ₹100 of assessable deposits from the financial year 2004-05 and later to 10 paise per ₹100 assessable deposits from the financial year 2005-06. The Corporation will continuously review the DIF and will consider revising the premium further from time to time with the objective of maintaining a strong DIF. The premium paid by the insured banks to the Corporation is required to be absorbed by the banks themselves so that the benefit of deposit insurance protection is made available to the depositors free of cost. In other words the financial burden on account of payment of premium should be borne by the banks themselves and should not be passed on to the depositors.

Essentials of a sound Deposit Insurance Scheme

Setting objectives

☐ Principle 1– Public policy objectives: The first step in adopting a deposit insurance system or reforming an existing system is to specify appropriate public policy objectives that it is expected to achieve. These objectives should be formally specified and well integrated into the design of the deposit insurance system.

☐ Principle 2– Mitigating moral hazard: Moral hazard should be mitigated by ensuring that the deposit insurance system contains appropriate design features and through other elements of the financial system safety net.

Mandates and powers

☐ Principle 3– Mandate: It is critical that the mandate selected for a deposit insurer be clear and formally specified and that there be consistency between the stated public policy objectives and the powers and responsibilities given to the deposit insurer.

☐ Principle 4– Powers: A deposit insurer should have all powers necessary to fulfil its mandate and these powers should be formally specified. All deposit insurers require the power to finance reimbursements, enter into contracts, set internal operating budgets and procedures, and access timely and accurate information to ensure that they can meet their obligations to depositors promptly.

Governance

☐ Principle 5– Governance: The deposit insurer should be operationally independent, transparent, accountable and insulated from undue political and industry influence.

Relationships with other safety-net participants and cross-border issues

☐ Principle 6– Relationships with other safety-net participants: A framework should be in place for the close coordination and information sharing, on a routine basis as well as in relation to particular banks, among the deposit insurer and other financial system safety-net participants.

☐ Principle 7– Cross-border issues: Provided confidentiality is ensured, all relevant information should be exchanged between deposit insurers in different jurisdictions and possibly between deposit insurers and other foreign safety-net participants when appropriate. In circumstances where more than one deposit insurer will be responsible for coverage, it is important to determine which deposit insurer or insurers will be responsible for the reimbursement process.

Membership and coverage

☐ Principle 8– Compulsory membership: Membership in the deposit insurance system should be compulsory for all financial institutions accepting deposits from those deemed most in need of protection (eg retail and small business depositors) to avoid adverse selection.

☐ Principle 9– Coverage: Policymakers should define clearly in law, prudential regulations or by-laws what an insurable deposit is. The level of coverage should be limited but credible and be capable of being quickly determined. It should cover adequately the large majority of depositors to meet the public policy objectives of the system and be internally consistent with other deposit insurance system design features.

☐ Principle 10– Transitioning from a blanket guarantee to a limited coverage deposit insurance system: When a country decides to transition from a blanket guarantee to a limited coverage deposit insurance system, or to change a given blanket guarantee, the transition should be as rapid as a country's circumstances permit. Blanket guarantees can have a number of adverse effects if retained too long, notably moral hazard. Policymakers should pay particular attention to public attitudes and expectations during the transition period.

Funding

☐ Principle 11– Funding: A deposit insurance system should have available all funding mechanisms necessary to ensure the prompt reimbursement of depositors' claims including a means of obtaining supplementary back-up funding for liquidity purposes when required. Primary responsibility for paying the cost of deposit insurance should be borne by banks since they and their clients directly benefit from having an effective deposit insurance system. For deposit insurance systems (whether ex-ante, ex-post or hybrid) utilising risk adjusted differential premium systems, the criteria used in the risk-adjusted differential premium system should be transparent to all participants.

Public awareness

☐ Principle 12– Public awareness: In order for a deposit insurance system to be effective it is essential that the public be informed on an ongoing basis about the benefits and limitations of the deposit insurance system.

Selected legal issues

☐ Principle 13– Legal protection: The deposit insurer and individuals working for the deposit insurer should be protected against lawsuits for their decisions and actions taken in “good faith” while discharging their mandates. However, individuals must be required to follow appropriate conflict-of-interest rules and codes of conduct to ensure they remain accountable. Legal protection should be defined in legislation and administrative procedures, and under appropriate circumstances, cover legal costs for those indemnified.

☐ Principle 14– Dealing with parties at fault in a bank failure: A deposit insurer, or other relevant authority, should be provided with the power to seek legal redress against those parties at fault in a bank failure.

Failure resolution

☐ Principle 15– Early detection and timely intervention and resolution: The deposit insurer should be part of a framework within the financial system safety net that provides for the early detection and timely intervention and resolution of troubled banks. The determination and recognition of when a bank is or is expected to be in serious financial difficulty should be made early and on the basis of well defined criteria by safety-net participants with the operational independence and power to act.

☐ Principle 16– Effective resolution processes: Effective failure-resolution processes should: facilitate the ability of the deposit insurer to meet its obligations including reimbursement of depositors promptly and accurately and on an equitable basis; minimise resolution costs and disruption of markets; maximise recoveries on assets; and, reinforce discipline through legal actions in cases of negligence or other wrongdoings. In addition, the deposit insurer or other relevant financial system safety-net participant should have the authority to establish a flexible mechanism to help preserve critical banking functions by facilitating the acquisition by an appropriate body of the assets and the assumption of the liabilities of a failed bank (eg providing depositors with continuous access to their funds and maintaining clearing and settlement activities).

Reimbursing depositors and recoveries

☐ Principle 17– Reimbursing depositors: The deposit insurance system should give depositors prompt access to their insured funds. Therefore, the deposit insurer should be notified or informed sufficiently in advance of the conditions under which a reimbursement may be required and be provided with access to depositor information in advance. Depositors should have a legal right to reimbursement up to the coverage limit and should know when and under what conditions the deposit insurer will start the payment process, the time frame over which payments will take place, whether any advance or interim payments will be made as well as the applicable coverage limits.

☐ Principle 18– Recoveries: The deposit insurer should share in the proceeds of recoveries from the estate of the failed bank. The management of the assets of the failed bank and the recovery process (by the deposit insurer or other party carrying out this role) should be guided by commercial considerations and their economic merits.

Conclusion

Banks are always prone to the risk of failures so the need for establishment of an effective system is a must. Deposit insurance is one the option to protect the interest of depositors and maintain financial stability in the economy. Financial safety net is *sine qua non* for addressing macro-financial risks. Deposit insurance, a major aspect of financial safety, plays a crucial role in both 'crisis prevention' and 'crisis management'. It is important that during a financial crisis, in general, and banking crisis, in particular, the "unsophisticated" depositors are assured that their money is safe, albeit to a certain extent. The US Federal Deposit Insurance Corporation (FDIC) is the oldest deposit insurer amongst all, having been established in the post-Great Depression time in 1933. India was the second country, after the US, to provide insurance cover to bank deposits. The Deposit Insurance Corporation Act, which was passed by Parliament after long debates and discussions, received Presidential assent towards the end of 1961. The Act came into force from January 1, 1962, when the Deposit Insurance Corporation (DIC) was established under the aegis of the RBI. However, it is surprising that many are unaware of the facility of deposit insurance. One reason for this could be that in India banks are perceived to be either too-big-to-fail or impossible-to-fail on account of Government or RBI backing. While this may be true for the public sector banks, it certainly is not true in the case of private banks, foreign banks operating in India and the large number of cooperative banks. The reforms are long-pending. It is time the RBI and the Government acted on these.

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