II. Banking and Deposit Insurance in Russia

The banking sector has been at the center of attention in Russia during 2004. The recovery, growth, and development of the Russian banking sector since the 1998 crisis has been quite impressive, despite the virtual absence of any major reform or restructuring measures. Growth in Russian banking has outpaced that of GDP. From 1998 to 2003, aggregate commercial bank assets increased from 31.5 to 42.2 per cent of GDP, bank capital from 4.8 to 6.1 percent, credit to the non-financial sector from 8.2 to 19.6 percent, and household deposits from 8 to 11.9 percent. But these positive trends were briefly interrupted in the first half of 2004 by a deterioration in liquidity and confidence that exposed remaining vulnerabilities in the banking system. Also in 2004, the Central Bank (CBR) and Russian government launched a major reform initiative that could fundamentally change the Russian banking sector and its structure over the next several years. A state insurance program for household deposits represents a primary element of this reform. Other key elements include new standards of accounting, disclosure requirements, bank monitoring, procedures for bank resolution, and the protection of creditor rights.

This note seeks to clarify a number of issues surrounding state deposit insurance that have resonated in recent debates within Russia. While deposit insurance has potential benefits for Russia, ensuring its success presents significant challenges to the Central Bank and Deposit Insurance Agency (DIA). These institutions must have the power to act in an independent, decisive, and impartial manner in (a) determining the eligibility of banks for participation in the program, (b) monitoring effectively participating banks, and (c) undertaking timely measures for resolving problems in individual banks. For this reason, the success of deposit insurance in Russia will be closely tied to other measures in the current Banking Sector Reform strategy, particularly those associated with improving accounting, monitoring, control, and procedures of bank resolution.

Empirical studies generally support an important relationship between financial intermediation and economic growth. The institutional environment of the transition countries of Eastern Europe and the CIS has favored bank-dominated financial systems. Even so, the banking sector has so far played a rather modest role in financing investment in these countries, and retained earnings have provided the lion's share of such financing. On the other hand, instability in the banking sector has been a common problem, even in Eastern European transition countries that achieved significant growth and investment at a relatively early stage (Hungary, Czech Republic, Latvia, Lithuania). Effective bank regulation and monetary policy can be critical in minimizing this instability, avoiding systemic risk, and providing the foundation for the significant growth of market-based financial intermediation. Some recent studies argue that primary factors responsible for relatively successful experiences in the development of commercial banking in transition countries are similar to those in the non-financial sector, and related to so-called *hard budget constraints*, i.e. financial discipline and a credible commitment not to bail out failing organizations.[2]

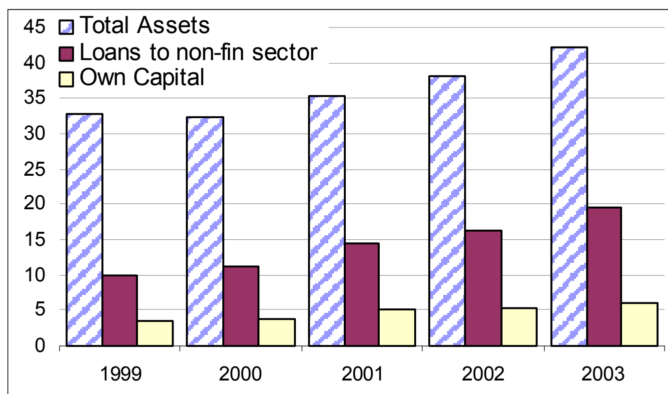
The development of commercial banking in Russia since the late 1980s has been difficult and complex. Many banks were formed in the early 1990s to exploit temporary opportunities that largely disappeared in the second half of the decade (servicing directed Central Bank credits to the non-financial sector, speculating on inflation and currency markets, currency exchange with high spreads). The latter half of the 1990s witnessed the rapid consolidation of a group of larger Moscow banks that were oriented primarily toward servicing the government sector (government bonds (GKO), becoming "authorized (upolnomochenye)" banks for federal and

[2] A strong such case is made in Berglof, Erik; Bolton, Patrick (2002) "The Great Divide and Beyond: Financial Architecture in Transition," *The Journal of Economic Perspectives*, vol. 16, No. 1, pp. 77--100

regional government accounts and programs). Extremely low liquidity and payment discipline in the enterprise sector, weak institutions for defending creditor rights, and high government bond yields kept commercial credit to the non-financial sector at very low levels. Macroeconomic instability and a mistrust of banks made paper dollars the preferred savings instrument for the population, and concentrated household deposits in the State Savings Bank, Sberbank.

The 1998 crisis brought the Russian banking sector to near collapse, yet the sector rebounded rather quickly even in the absence of major recapitalization or restructuring. (Figure 8). In fact, it can be argued that the primary positive contribution of the Central Bank and government to the development of Russian banking during this period is related more to what they *didn't* do than to what they did. There was no major bank recapitalization, no liberal allocation of refinance resources, far less opportunities for banks to profit from servicing the government, and no state deposit insurance. In these circumstances, banks were forced to fend for themselves in a tough competitive environment with limited profitable activities and low trust of the population. Banks in default to international creditors largely had to solve their own problems of credibility on international capital markets. At the same time, greater liquidity and profitability in the enterprise sector created opportunities for the development of loan portfolios with potential high returns. Thus, to avoid failure, Russian banks faced an immediate challenge of developing effective institutions for commercial lending to the non-financial sector. In other words, the Central Bank and Russia government made important progress in enforcing hard budget constraints for commercial banks, and bank incentives and institutions strengthened as a result. While the speed of asset and credit expansion in the banking sector in the still weak institutional environment of Russian financial markets may also raise some concerns, the overall trends since 1999 have been very positive.

Figure 8. Aggregate Commercial Bank Assets, Credit, and Capital (as % of GDP)



Source: CBR

Nevertheless, as acknowledged in the 2004 Strategy for the Development of the Banking Sector of the Government and Central Bank, Russian banking still suffers from a number of serious structural problems. In particular, the trust of the population in banks remains weak, bank liabilities typically consist of short-term and potentially volatile resources, the state-owned Sberbank occupies a monopoly position in the market for household deposits (over 60 percent), and state guarantees for household deposits in Sberbank impedes the development of competition on this market. In addition, the continued dominance of state-owned banks politicizes bank regulation in a manner that hinders the enforcement of hard budget constraints in an equal manner throughout the industry. The Strategy proposes major steps toward the resolution of these and other problems, including a deposit insurance program.

Deposit insurance exists in almost all developed economies. It has often proved an effective instrument for increasing the confidence of the public in banks, and in helping to prevent the self-reinforcing mass hysteria of bank runs. In addition, in the Russian context, a system of deposit insurance provides a potential key for creating a genuine competitive market for household deposits that would break the monopoly of Sberbank, also paving the way for its eventual privatization. Despite the de-dollarization of recent years, Russian households apparently continue to hold a huge share of their savings outside banks in foreign (paper) assets, which suggests a strong potential for additional financial intermediation if household confidence in banks can be improved.[3] Deposit insurance also appears to lower average interest rates at which banks can attract deposits, thereby potentially lowering the costs for borrowers as well.[4]

On the other hand, deposit insurance also has a negative side. The primary problem is that of *moral hazard*. The presence of deposit insurance can distort incentives in banks toward excessively risky investment strategies, and this particularly affects banks that operate with relatively little of their own capital. Under current circumstances, a poorly-capitalized bank without a strong reputation would typically have a very difficult time attracting household deposits due to a lack of trust. Thus, most banks of this type do not work much with household deposits, and might operate primarily with a select group of juridical persons on both sides of their balance sheets. If such a bank were to receive state insurance for household deposits, however, then it might suddenly be possible for this bank to attract household deposits, perhaps even through higher-than-market interest rates, and then use this money to engage in some very risky investments. If these investments pay off, the bank owners will become rich. If they fail, the bank will go bankrupt, lose only its own (small) capital, and the insurance fund or government (i.e. taxpayers) will compensate depositors. Fierce competition and declining interest spreads in the Russian banking industry can also increase the temptation for problem banks to resort to this sort of imprudent and destructive strategy.

Thus, ironically, deposit insurance does not necessarily decrease the risk of instability in the banking sector. While it generally has a positive impact on the confidence of depositors and can make bank runs less likely, it can also increase the riskiness of bank investment strategies, potentially leading to a larger number of bank failures. If these risks are correlated among banks, it becomes a system risk. Related problems have plagued even in some of the most developed economies. An often cited experience concerns US savings and loan organizations, many of which took advantage of deposit insurance and a deregulated environment in the 1980s to make speculative investments in the real estate market. Sharp increases in real estate prices turned many owners of savings and loan organizations into millionaires. But this speculative bubble eventually burst, and subsequent declines in real estate prices triggered large scale insolvencies that, due to deposit insurance, imposed costs of an estimated $124 billion on US taxpayers.[5] More generally, recent empirical studies across many countries raise doubts that the presence of deposit insurance decreases the probability of a financial or banking crisis.[6] Depositor confidence in commercial banks is a positive phenomenon only in the event that this is not false confidence.

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[3] The recent OECD Economic Survey of the Russian Federation (2004) reports estimates of “mattress money” in Russia ranging from USD 40-80 billion, as compared to USD 48 billion in household deposits in commercial banks. OECD (2004) pp. 227.

[4] See Demirgüc-Kunt, Asli; Huizinga, Harry (2004), “Market Discipline and Deposit Insurance,” *Journal of Monetary Economics*, vol. 51, pp. 375-399.

[5] Curry, Timothy and Shibut, Lynn (2000), “The Cost of the Savings and Loan Crisis: Truth and Consequences,” *FDIC Banking Review* vol. 13, no. 2

[6] See Demirgüc-Kunt, Asli; Detragiache, E. (2002), “Does Deposit Insurance Increase Banking System Stability? An Empirical Investigation.” Journal of Monetary Economics vol. 49, pp. 1373-1406

In light of these concerns, the degree of success from the introduction of deposit insurance in Russia will be conditional on exactly how it is implemented. The moral hazard problem can be alleviated and controlled both through selectivity in admission to the deposit insurance program and by regular effective monitoring of the risk position of participating banks. A bank that is well-capitalized will have less incentive to take excessive risks, as it would stand to lose a substantial amount of its own resources in the event of bankruptcy. Second, the Central Bank can enforce regulations that directly limit the risk components in the portfolios of commercial banks. Thus:

- ***State deposit insurance should be limited to banks that are well-capitalized and can be monitored effectively by the Central Bank***. Poorly-capitalized banks or banks that lack financial transparency should not receive state deposit insurance, and this creates too great a distortion in incentives toward excessively risky investment strategies.

- ***State deposit insurance places a greater regulatory burden on the Central Bank (and Deposit Insurance Agency***) to monitor effectively the risk positions of commercial banks who participate in this program, continually verify their capital adequacy, assess the overall quality of management and financial control systems, and take immediate action to correct what could be abusive behavior.

Given the above considerations, the basic logic of the current Strategy for the Development of the Banking Sector of the Russian Federation is understandable. On the one hand, the goal is to create a more level playing field for the development of a market for household deposits that could break the monopoly of Sberbank and give a major boost to the development of private banking and financial intermediation. On the other hand, the right to work with household deposits, and purchase state deposit insurance, will be limited only to banks that are well capitalized and can be monitored effectively by the Central Bank. The Strategy also contains additional measures for improving the monitoring of commercial banks and the ability of the Central Bank to resolve problems in a quicker and more effective manner.[7] The absolute level of deposit insurance is quite modest by international standards (100,000 rubles), although it will be possible for households to increase this sum by holding accounts simultaneously in a number of banks, or for a larger number of household members to open accounts. This seems to have been the case in Ukraine, where the recent introduction of deposit insurance led to a very rapid expansion of household accounts equal to exactly the specified insured limit.

The effective monitoring of bank capital and capital adequacy presents a particularly important challenge to the Central Bank. As emphasized above, the distortion in incentives from moral hazard becomes more serious to the degree that a bank has little of its own capital to lose in the event of bankruptcy. In the past, Russian banks have been able to manipulate artificially the book value of their capital through various schemes involving loans or purchases of equity with their affiliates. Thus, to monitor effectively the capital position of Russian banks, the Central Bank will need to obtain detailed information on bank owners their affiliates, and the consolidated accounts of the entire group. It is exceedingly difficult to monitor the actual capital position of a commercial bank in the absence of consolidated supervision.

[7] This latter goal has been addressed in *Changes to the Federal Law on the Insolvency (Bankruptcy) of Financial Organizations* of 31 July 2004 (N121-F3).

To meet the new challenges, the Central Bank has been introducing a qualitatively new type of monitoring that places less emphasis on the fulfillment of specific prudential norms (which can often be manipulated), and involves a comprehensive qualitative risk assessment of individual banks based on international best practice. In addition to the standard measures of portfolio risk, diversification, capital adequacy, liquidity, profitability, and disclosures, the Central Bank now pays close attention to indicators such as the transparency of ownership structure and quality of bank governance. The Strategy for the Development of the Banking Sector in the Russian Federation also proposes changes in legislation consistent with the full implementation of Basle Core Principles, including those on effective preconditions for effective supervision. Thus, the Central Bank is indeed taking measures to increase its regulatory capacity to meet the new challenges created by deposit insurance. .

In the short term, the Central Bank and Deposit Insurance Agency will also need to make difficult decisions concerning the eligibility of commercial banks for participation in the deposit insurance program. The success of this program requires the exclusion of banks that are not well-capitalized or do not reveal information in a clear and transparent manner. Some such banks will most likely resort to political connections in an attempt to influence the outcome of this process. Therefore, a special effort will be needed to protect the independence and impartiality of the Central Bank at this crucial time for the reform and development of commercial banking in Russia. In general, it is very important that bank supervisory bodies (CBR and DIA) are well-funded and can function in an independent manner.

Deposit insurance can potentially play a key role in facilitating the growth, restructuring, and development of Russian banking over the medium and longer term. The Strategy for the Development of the Russian Banking Sector contains a comprehensive set of measures aimed at meeting the significant challenges that deposit insurance raises in bank regulation. The success of the reform will depend on the successful implementation of these measures though determination on the part of the Central Bank and Russian government.