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An evaluation of draft legislation on Russian deposit insurance

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Contents

Abstract 3

Background 4

The proposed deposit insurance scheme 4

Evaluation of the proposed scheme 5

Systemic risk in Russia 8

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Abstract

On 18 November 2002, the Russian cabinet approved a plan to introduce deposit insurance. The introduction of deposit insurance is an essential condition for the modernisation of Russia's banking sector, and, in particular, for ending the near-monopoly of Sberbank, the State Savings Bank, in the retail segment. In this note, we compare the main features of the proposed system with its European and US equivalents. Although several important aspects of the Russian scheme have yet to be defined, our initial evaluation is positive. Concerns about the stability of the Russian banking system, however, remain.

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Background

The lack of deposit insurance has long constituted a major obstacle to establishing a modern banking sector in Russia. One might, of course, argue that, given the state of public finances at the onset of the 1998 banking crisis precluded the possibility of a sizeable budgetary intervention, the absence of explicit deposit insurance actually benefited the economy. Nevertheless, Russians hold a deep, understandable, distrust of banks, which prevents the emergence of any serious contender to Sberbank. The bank benefits from a state guarantee[1] and holds over 70% of all deposits.

Sberbank's dominance has clearly stifled the emergence of a modern banking system in Russia. Its state-conferred competitive advantage discourages both domestic and foreign banks from offering retail bank services, so other major Russian banks tend to concentrate on corporate services rather than lending. International financial institutions (IFIs) and the EU have long insisted that introduction of a deposit insurance scheme is a necessary first step in establishing a level playing field in the sector. However, any deposit insurance scheme must be compatible with budgetary stability, particularly in a context of weak banking supervision.[2] In other countries, banking crises have usually had large budgetary implications (e.g. the US savings & loan crisis in the 1980s, the Nordic banking crises in the early 1990s and the Asian financial crises in 1998).

Moreover, any insurance scheme is potentially vulnerable to moral hazard problems. Thus, while the introduction of deposit insurance may boost deposits, it could simultaneous diminishing depositors attention to the solidity of banks. Increased availability of funds and reduced prudence on the part of depositors can lead banks to increase their exposure to riskier customers. In such a "risk-free" environment, banks could also attempt to raise their market share by offering depositors higher returns. This could encourage banks to engage in riskier, more lucrative lending to offset higher returns offered on deposits.

The proposed deposit insurance scheme

From January 1, 2005, banks participating in the scheme would pay 0.15% of their average quarterly deposits into a fund managed by ARCO, the Agency for Restructuring of Credit Organisations. Only banks deemed viable by the CBR would be allowed to participate. Banks opting out of the scheme would have to withdraw from issuing deposits.

After the law comes into effect, deposits of up to RUB 20,000 (€635) in member banks would be fully covered, while deposits of between RUB 20,000 and 120,000 would be covered 75%. No coverage would accrue to deposits above the RUB 120,000 threshold. The highest possible payout would be RUB 95,000 (€3,000). Prime Minister Kasyanov claims such a scheme would protect about 95% of present deposits.

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[1] It is not entirely clear whether this guarantee is wholly binding from a legal point of view. There is, however, no question that Sberbank could be allowed to fail without an intervention by the government and the central bank. The Central Bank of Russia (CBR) holds the majority stake in Sberbank.

[2] There is a broad consensus among economists that banking supervision in Russia still gives too much weight to compliance with formal requirements rather than de facto financial solidity of banks.

The new act on deposit insurance should be approved by April 2003. The law would enter into force in 2005. Ahead of the law's implementation, the CBR would determine the banks eligible to participate in the fund and issue them new licenses granting them the right to accept deposits. The decision to reissue general banking licenses reflects the government's expressed intention to tighten licensing requirements.

During a transition, Sberbank clients would be fully covered against losses. However, they would not have access to the unified insurance account until four years after the scheme is in place. Sberbank would nevertheless contribute fully to the unified account from the start in 2005. From January 1, 2007, the government would cease providing Sberbank with its implicit 100% deposit guarantee.

Before the draft law is finalised, several issues must be resolved. These include the criteria required for banks to participate in the insurance system, details on operation of the fund and accumulation of reserves.

Evaluation of the proposed scheme

Approval of a deposit insurance scheme is an indispensable step towards establishing a modern banking system in Russia. Currently, the financial system fails to perform the crucial task of intermediating credit from households to the productive sector. Households maintain large savings in cash, while businesses – especially small and medium-sized enterprises (SMEs) – typically rely on retained earnings to meet their financing needs. Hence, consumers and businesses are likely to welcome the scheme.

The scheme must include safeguards against moral hazard and should not threaten budgetary stability. In this sense, earlier Duma appeals to the government that the scheme should provide unlimited deposit guarantees caused great concern. The Russian executive was well advised to ignore them.

The elements of the scheme revealed to date preclude any final judgement on the sufficiency of safeguards against risk. However, one can try to evaluate whether the proposed insurance premia levied under the scheme would be adequate to cover expected losses. A comparison of the Russian scheme with established schemes in other countries may provide useful indications.

With a ceiling of 0.6% annually (the precise amount is to be fixed later by ARCO), Russia's envisaged contribution rate could well exceed the current rates in the United States. The Federal Deposit Insurance Corporation (FDIC) currently charges between 0.03% and 0.24% per year for adequately capitalised banks, depending on their supervisory rating, and between 0.1% and 0.27% for undercapitalised banks. FDIC rates, it must be noted, considerably underprice risk. FDIC research[3] suggests that an appropriate pricing of risk in the US would entail rates of between 0.10% and 0.50% for adequately capitalised banks, and 0.20% and 0.97% for undercapitalised banks.

In Europe, some deposit guarantee systems do not fix contribution rates *ex ante* as in the US system and the proposed Russian system, but rather call upon guarantee fund members to contribute *ex post* when the fund has intervened and its capital has fallen below a

[3] *"Keeping the Promise: Recommendations for Deposit Insurance Reform,"* Federal Deposit Insurance Corp., Washington, April 2001.

certain threshold[4]. The choice of an *ex ante* system seems the right one for Russia, because it can offer more solidity and reliability and hence have a greater confidence effect on depositors.

Obviously, the contribution rate is related to the degree of protection offered to depositors. The systems vary widely, but the typical contribution rate for an *ex ante* scheme does not exceed 0.2% of deposits (see Table 1, which shows contribution rates in those European systems that seem to be more easily comparable to the Russian system)[5].

Under the, admittedly strong, working assumption that risks in Russia remain comparable to those in Europe and the US, an insurance premium of 0.6% per annum could theoretically be more than enough for adequately capitalised banks.

The US deposit insurance fund is capped at 1.25% of deposits. If it exceeds this threshold, the FDIC is compelled to lower the insurance premium regardless of the actual risk level. Our information on the draft Russian legislation makes no mention of capping the deposit insurance fund, which might eventually exceed 1.25% of deposits and hence offer more protection. Finally, Russia has recently raised its capital adequacy ratios to 10%, which is well above the US level.[6]

In the medium term, inflation could strengthen the fund's solidity. To our knowledge, the proposed legislation does not provide for indexation of insurance ceilings. Given that Russia has a double-digit inflation rate that is unlikely to decline rapidly, the low[7] compensation ceiling will be eroded quickly, while contributions to the fund remain linked *de facto* to inflation. Thus, even though the currently envisaged ceilings cover 95% of deposits, they would cover a significantly lower share of deposits within a few years without upward adjustment. Experiences of other countries indicate that such thresholds are rarely adjusted. The US last raised its insurance ceiling in 1980.

FDIC research further suggests that factors other than capitalisation play important roles in determining the effective level of risk. Table 2 shows how the FDIC estimates equilibrium premia on the basis of capitalisation and the quality of banks, measured in terms of CAMELS ratings (capital, asset quality, management, earnings, liquidity, sensitivity to market risks).[8] The variance of risks across ratings, some of which include judgements on soft variables, show that they play as big a role in measuring risk as capitalisation. This underscores the importance of an effective supervisory system in keeping systemic risk at bay.

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[4] Hence, in ex post systems, contributions may be quite low for a number of years and then be increased suddenly; for example, banks in Italy may be called upon to pay between 0.4% and 0.8% of their deposits. The "Study of Deposit Guarantee schemes in credit institutions in Europe", prepared for the European commission in 2002, identified 9 countries in Europe as having *ex ante* systems, three as having *ex post* systems, while the remaining 6 had a mixed system. The study examined the 15 EU countries plus Liechtenstein, Iceland and Norway.

[5] There is one exception, Finland, where, according to the "Study of Deposit Guarantee schemes in credit institutions in Europe", the contribution rate, which is risk-based, can reach up to 0.25% of deposits.

[6] Russian capital adequacy ratios are comparable to western capital adequacy ratios only if international accounting standards are used.

[7] The compensation ceiling per account is about €3,000 in Russia, compared to $100,000 in the US. In Europe, Italy has the highest ceiling, €103,000. No European country has a compensation ceiling below €20,000.

[8] The table was estimated on data from 1984 to 1999, a period which included an economic boom and a banking crisis and which can therefore be considered suitable for covering a range of economic conditions.

Table 1: Annual contribution rates to deposit guarantee schemes in selected European countries

Country	Type	Contribution rate
Belgium	Ex ante	0.0175% of deposits; can be increased up to 0.0525%
Denmark	Mixed	Cannot exceed 0.2% of deposits
Finland	Ex ante	Maximum 0.25% of deposits
France	Ex ante	Risk-based contribution; calculation is based on several parameters; system average is currently around 0.02% of deposits
Germany	Mixed	Private banks: statutory: 0.008% of funds owed to customers; a voluntary scheme exists which usually charges 0.03% of funds owed to customers (more for some types of banks)
Greece	Mixed	Degressive scale based on size of deposits. Maximum 0.125% of deposits
Iceland	Mixed	0.2% of deposits, but can be raised in exceptional circumstances
Ireland	Ex ante	0.2% of deposits
Norway	Ex ante	0.1% of deposits, plus 0.05% of risk weighted assets on which assessments of capital adequacy are based. If core capital is less than 8%, the annual contribution will be increased by a percentage equal to four times the gap from 8%, e.g. if a bank's core capital falls to 7%, the contribution will be increased by 4%.
Portugal	Ex ante	Between 0.1% and 0.2% of total capital. May be lower than 0.1% if bank is particularly well capitalised.
Sweden	Ex ante	0.4% to 0.55% of guaranteed deposits*.

Source: Study of Deposit-Guarantee Schemes in Credit Institutions in Europe, European Commission, Internal Markets DG, Brussels, June 2001

* The figure is for 1999. In 2001, draft legislation foresaw that the contribution could be cut to a minimum of 0.1% of deposits if the guarantee fund reaches a prescribed amount.

Unfortunately, most observers have little confidence in the effectiveness of Russian banking supervision, which tends to focus on compliance with formal requirements rather than financial fundamentals. Hence, it seems appropriate for the Russian deposit insurance scheme to have higher contribution requirements than comparable European or US schemes (especially given that the deposit guarantee fund will have to accumulate reserves at an accelerated pace in its first years of existence). Until we know more, it is probably desirable that the actual contribution rate is set close to the envisaged maximum rate of 0.15% of deposits in each quarter.

Table 2: Unrestricted risk-based premia according to rating and capital, in basis points*

Capital	Supervisory rating		
	A	B	C
Well capitalised	3.7	8.9	17.8
Adequately capitalised	10.3	20.7	50.3
Undercapitalised	19.8	41.6	96.8

*Note: 1 basis point=0.01 %
Source: FDIC, *op. cit.*, 2001, page 15

In the final analysis, no deposit guarantee scheme by itself offers satisfactory protection against systemic (i.e. widespread) bank failures. Russia will therefore have to ramp up its efforts at strengthening bank supervision, particularly after the introduction of a deposit insurance scheme, which inevitably weakens investor incentives to be vigilant. In this sense, it is encouraging that the proposed legislation foresees that all bank licenses will have to be renewed by the CBR – a possible signal from the regulatory authorities of a toughened stance on granting bank licenses.

Systemic risk in Russia

Although from a low starting base, Russian bank lending has been expanding recently at a rapid pace. Between August 2001 and August 2002, bank loans (90% of which are extended to corporations) grew 39.2% compared to nominal GDP growth of little more than 20% in the same period. However, the total stock of bank loans currently corresponds to only 12 – 13 % of GDP, which is still a low level.[9] Nevertheless, while an increase in the share of bank loans to GDP is in itself a positive development, *any* rapid expansion of credit in an environment of weak banking supervision carries obvious risks.

Sberbank's dominance could reduce or even enhance Russia's vulnerability to systemic risk. On the one hand, its public nature might make it less inclined to pursue a speculative behaviour. On the other hand, the fact that Sberbank controls 70% of deposits and 26 % of assets *de facto* makes its risk difficult to insure. If Sberbank's stability was ever threatened, the government and the central bank would have to intervene, triggering a classic "too big to fail" response from the state. Moreover, while Sberbank risk cannot be insured effectively, it will have to participate in the fund four years after inception. This violates the logic of insurance funds, but there are no obvious alternatives. Exempting Sberbank from the scheme would *de facto* imply continuation of some form of the state guarantee; withdrawing the deposit guarantee from 70% of depositors runs counter to the objective of extending protection a larger group of depositors.[10]

A conclusive judgement on the merits of the envisaged deposit insurance scheme will have to wait until more details are known, but the proposed system overall seems to improve the current situation and appears to follow a balanced approach. It is a step towards diminishing Sberbank's domination of retail banking in Russia and modernising the banking system.

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[9] See Troika Dialog (2002) "Banking sector: Will reform take root?"

[10] So far, strongly negative real interest rates on deposits have allowed the system to generate growing profits despite credit losses. This will become increasingly difficult as the government succeeds in bringing down inflation. The average interest rate on personal rouble-denominated deposits was 5.4% in August 2002, compared with a CPI inflation rate of 16.2% in the same period. The average of course reflects the fact that cashing accounts pay no or very limited interest; however, even interests offered on term deposits (which currently vary from 11% to 15% depending on the maturity) are below the inflation rate. See "*Generating returns with Sberbank,"* (opinion piece), Prime-TASS, Moscow, Nov. 12, 2002.

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