DOES DEPOSIT GUARANTEE ALWAYS CONTRIBUTE TO INCLUSION AND WELFARE? THE CASE OF RUSSIA

ANDREI VERNIKOV
INSTITUTE OF ECONOMICS, RUSSIAN ACADEMY OF SCIENCES, MOSCOW

WINIR Conference (Lund, 19-22 September 2019)

Motivation

- Literature on transfer of institutions [North, 1990; Rodrik, 2000; Polterovich, 2001; Kleiner, 2005; Kuzminov et al., 2005; Oleynik, 2005; Polishchuk, 2008]
- The theory of "inclusive" institutions [Acemoglu, Robinson, 2013]
- Literature on deposit insurance [Diamond, Dybvig, 1983; Keely, 1990; Martínez-Pería, Schmukler, 2001; Demirgüç-Kunt, Kane, 2002; Demirgüç-Kunt, Detragiache, 2002; Demirgüç-Kunt, Huizinga, 2004; Demirgüç-Kunt et al., 2005; Cull et al., 2005; Anginer et al., 2014; Hogan, Luther, 2014, 2016]
  - deposit guarantee in Russia [Camara, Montes-Negret, 2006; Peresetsky, 2007; Ungan et al., 2008; Krotov, 2009; Karas et al., 2010; Chernykh, Cole, 2011; Chernykh, Sokolov, 2012; Pyle et al., 2012; Karas et al., 2013; Vernikov, 2019]

Research framework

- Purpose: To study the wealth-distribution effect of an imported institution, in the case of deposit guarantee
- Research question: Who benefited, and at whose expense, from deposit guarantee?
- Data sources:
  - banking statistics (Central Bank of Russia),
  - data on deposit guarantee scheme (Deposit Insurance Agency),
  - general socio-economic data (Rosstat)

«Inclusion» or «extraction»

- Acemoglu, Robinson [2013]:
  - Institutions are "inclusive" when many people have a say in political decision-making. These institutions promote economic prosperity because they provide an incentive structure that allows talents and creative ideas to be rewarded.
  - “Extractive" institutions: where a small group of people control political institutions and are unwilling to change. These institutions permit the elite to rule over and exploit others, extracting wealth from those who are not in the elite.
- Can a particular institution switch its mode of functioning, from ‘inclusive’ to ‘extractive’ ?

Financial inclusion and deposit guarantee

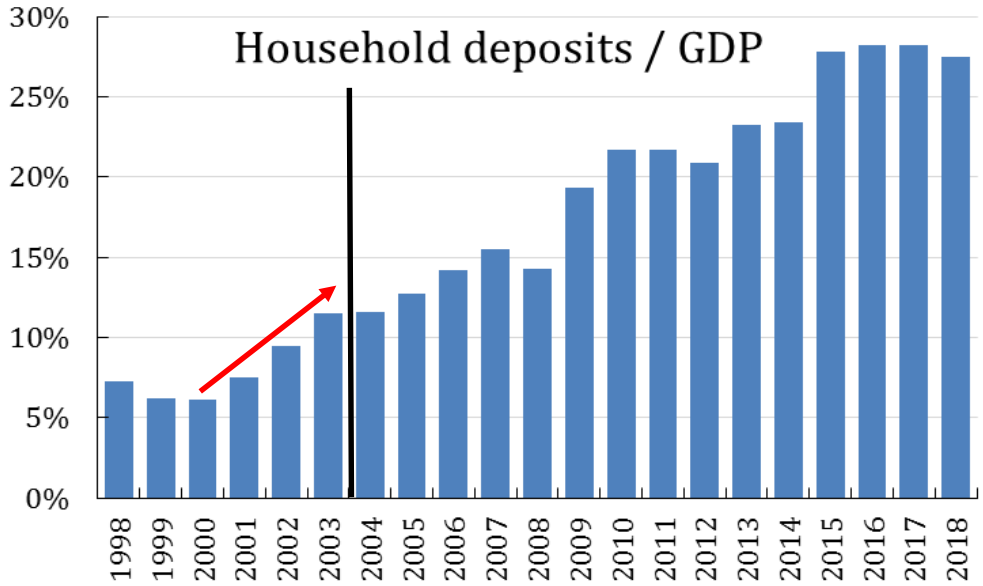
- Financial **inclusion** is:
  - where individuals and businesses have access to useful and affordable financial products and services that meet their needs and are delivered in a responsible and sustainable way;
  - the availability and equality of opportunities to access financial services.
- Deposit guarantee promotes financial inclusion by reducing risks borne by depositors and thus broadening the access to banking services
- Implementation of deposit guarantee is usually followed by inflow of household savings into banks or by a slowdown of deposit outflow

Stylized facts on deposit guarantee in Russia

- Spring 1994: the first draft law on deposit guaranteeing
- December 23, 2003: Federal Law No. 177 «On Deposit Insurance of Natural Persons in the Banks of the Russian Federation»
- January 2004: Deposit Insurance Agency is established
- 2004-2005: commercial banks are scrutinized and admitted into deposit insurance scheme
- Member banks by end-2005: 931
- 2005: The first insured bank failure
- 2004-2018: 481 insurance cases, overall.
- 9.3 million depositors have been affected
- 4.1 million depositors claimed compensation from DIA

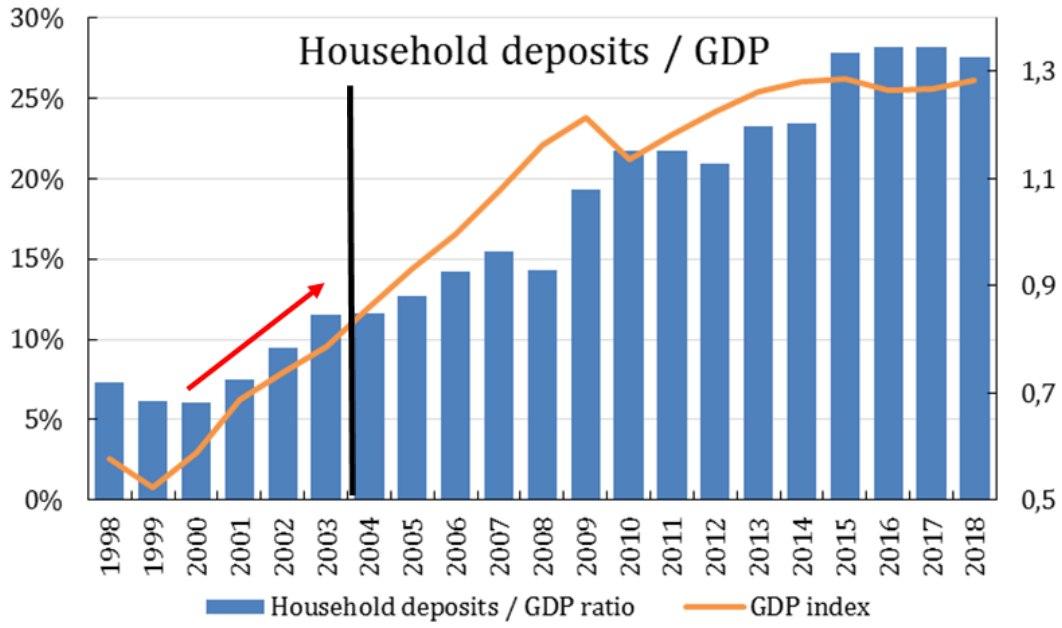
Deposit insurance and financial inclusion (1)

- Household-deposits-to-GDP ratio started growing *before* the launch of explicit deposit guarantee in December 2003 (vertical black line).
- It would have continued growing regardless, because …



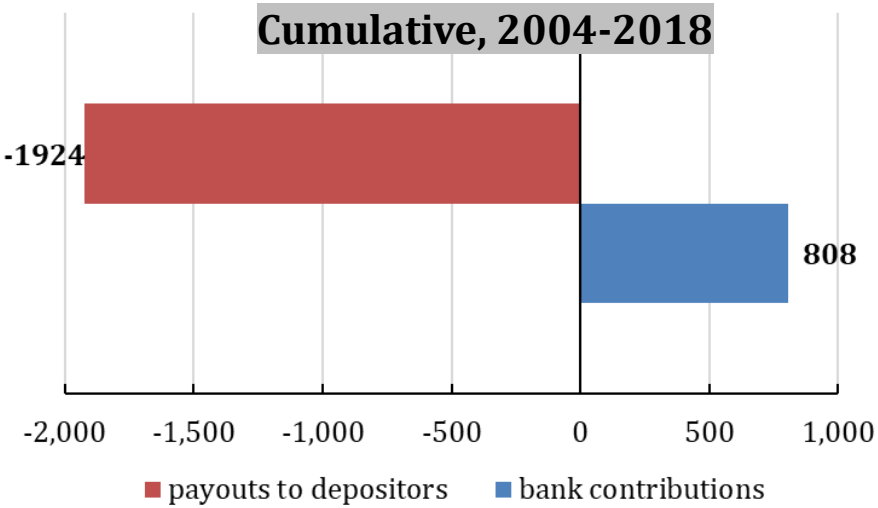
Deposit insurance and financial inclusion (2)

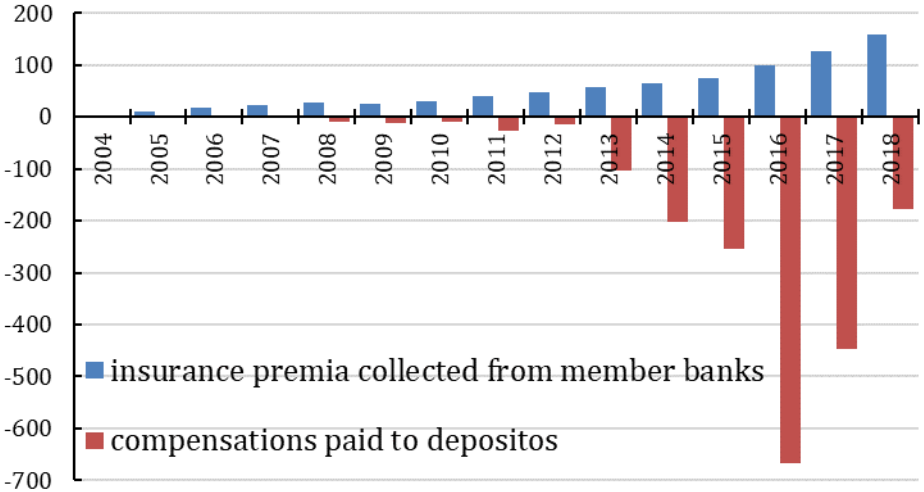
- Household-deposits-to-GDP ratio started growing *before* the launch of explicit deposit guarantee in December 2003 (vertical black line).
- It would have continued growing regardless, because it is correlated with GDP growth



On the paying end: Who bears the costs of deposit guarantee

- Depositors of failed banks collected RUB 1,924bn = USD 30bn
  - Less than half of that came from CDIF accumulated funds
  - The major part came from other sources (CBR loan to CDIF, federal contribution to the equity, accumulated profits, recovered funds)
- CBR spent another c. RUB 2 trln = USD 30bn on bank resolution via FKBS, i.e. beyond the DIS

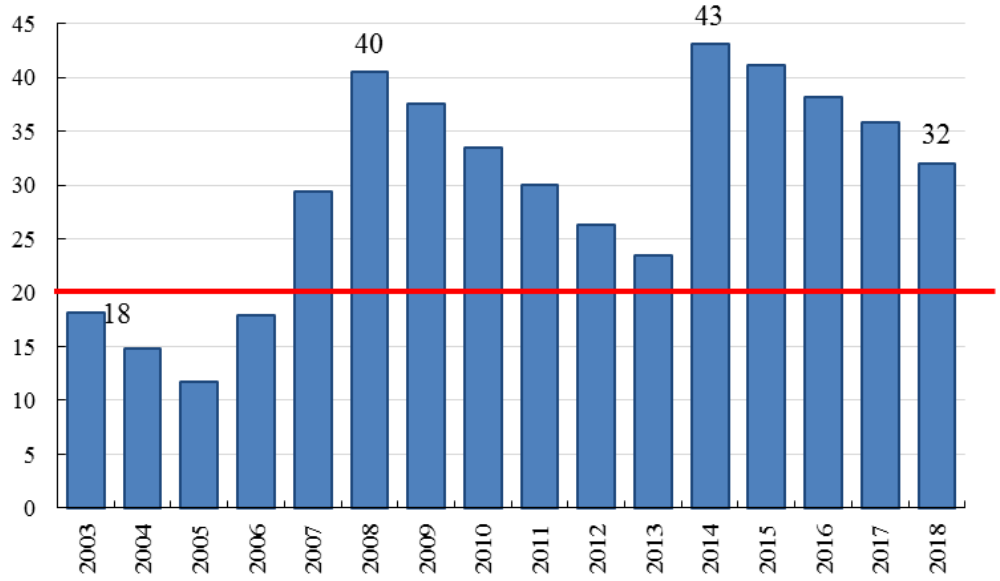




Bank contributions to Compulsory Deposit Insurance Fund and compensation payments to depositors, RUB bn

On the receiving end: The beneficiaries of deposit insurance (1)

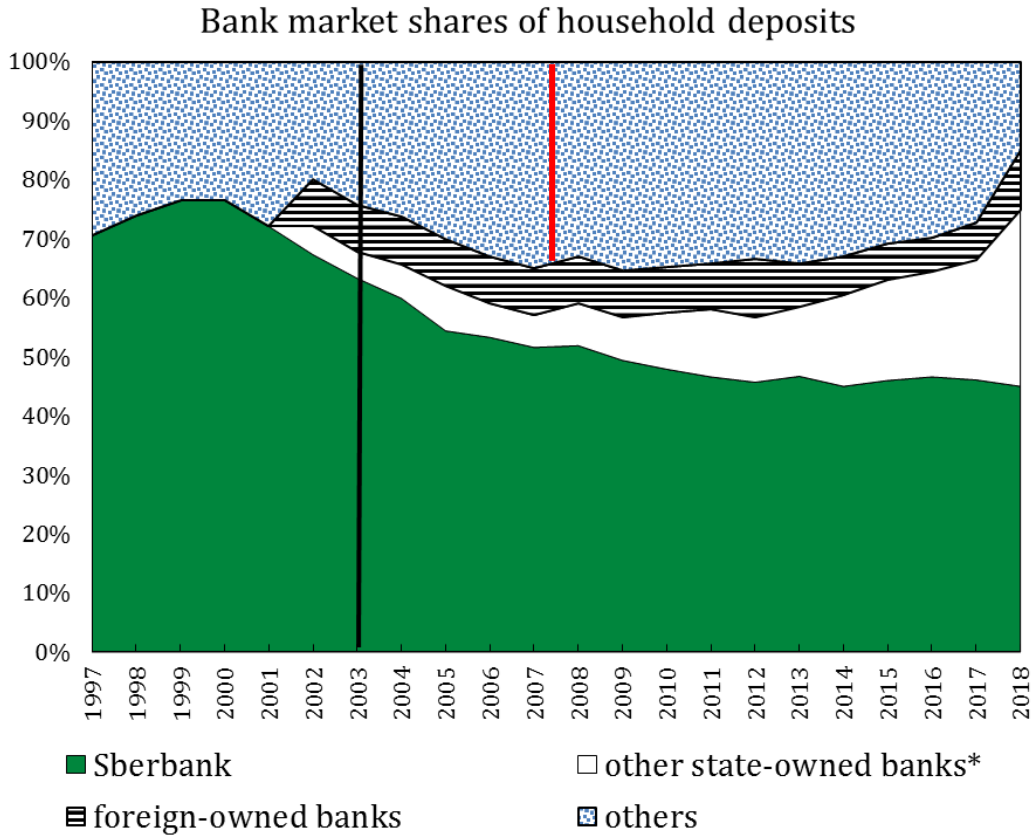
- The depositors of private banks enjoy higher interest rates at low risk or no risk
- A relatively generous scheme geared towards urban middle classes rather than the 'unprotected small saver'
  - Coverage limit / average wage ratio is above the notional 'optimal' level of x20
  - Coverage limit is 8.4 times the size of average household deposit



Coverage limit / average wage

On the receiving end: The beneficiaries of deposit insurance (2)

- The owners and top managers of private banks benefited from the inflow of customer funds that otherwise would have been unavailable
- Between 2004 and 2008 was the honeymoon of deposit guarantee scheme

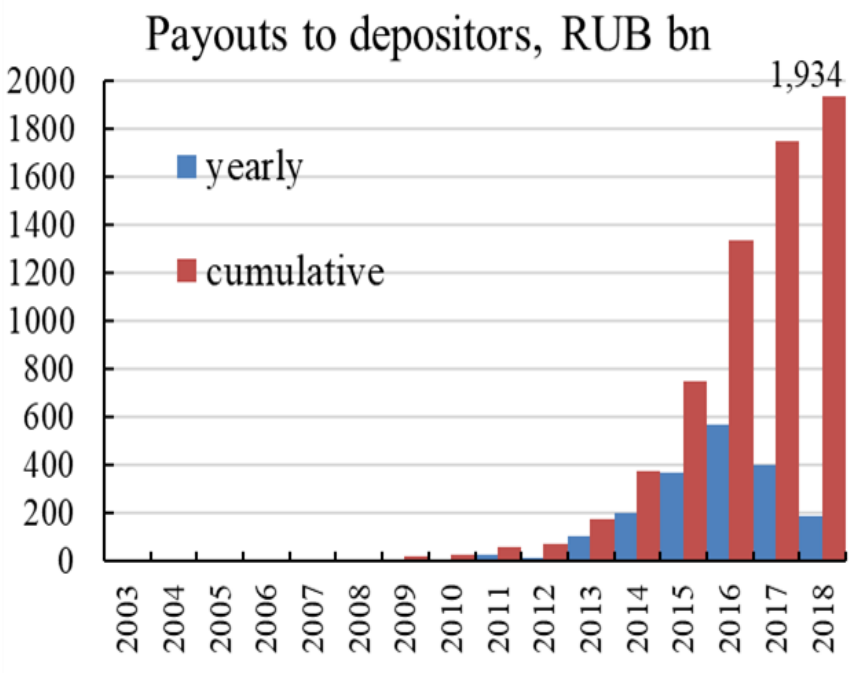


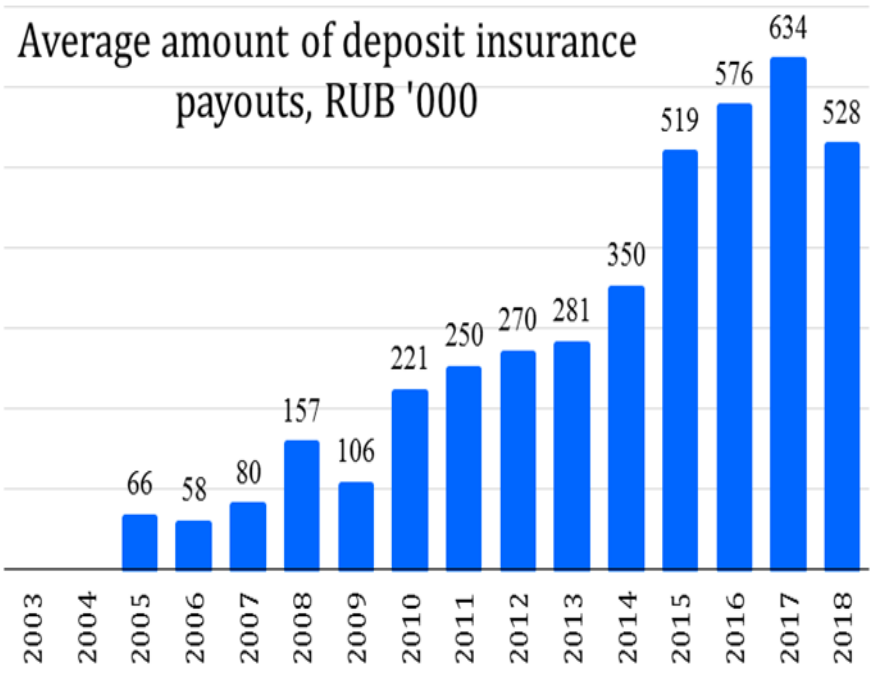
* including banks under resolution

Sources: own calculations; CBR; Sberbank

On the receiving end: The beneficiaries of deposit insurance (3)

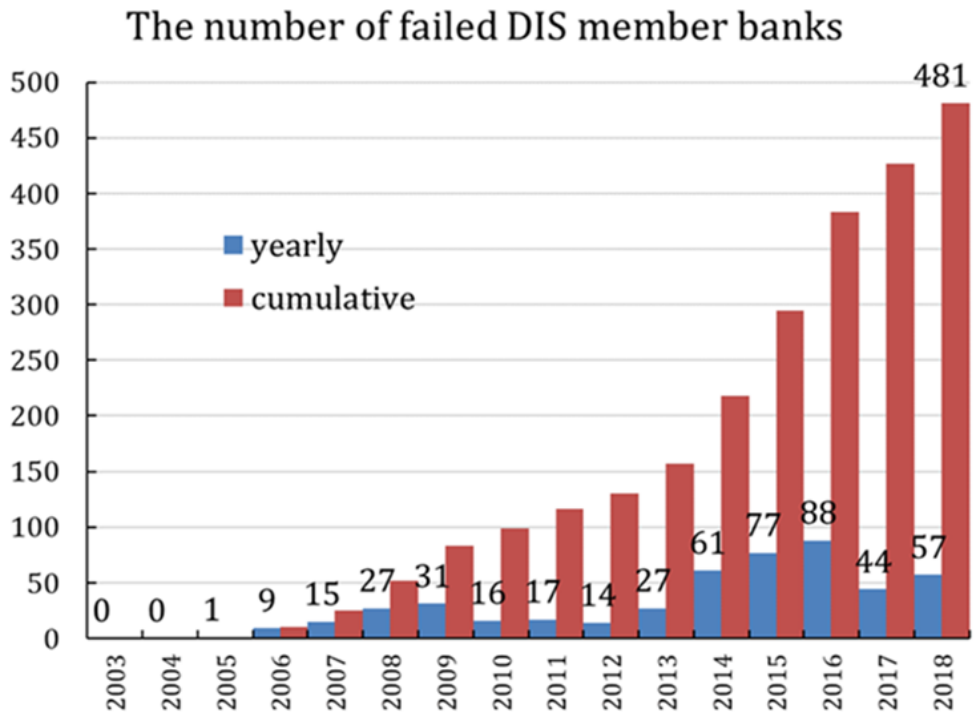
- The depositors of failed private banks (4.1 million people, maybe double-count)
  - Payouts peaked in 2016 (*chart on the left*)
  - The average size of paid compensation is more typical for urban middle classes than the 'poor' (*chart on the right*)
  - 'serial depositors': move recovered funds to another weak bank.





On the receiving end: The beneficiaries of deposit insurance (4)

- Some of the owners and top managers of failed private banks had misappropriated bank funds
  - Banks handled by DIA
  - Banks handled by Central Bank through FKBS (TRUST, Otkrytie, etc.)
  - Special cases (Bank of Moscow)

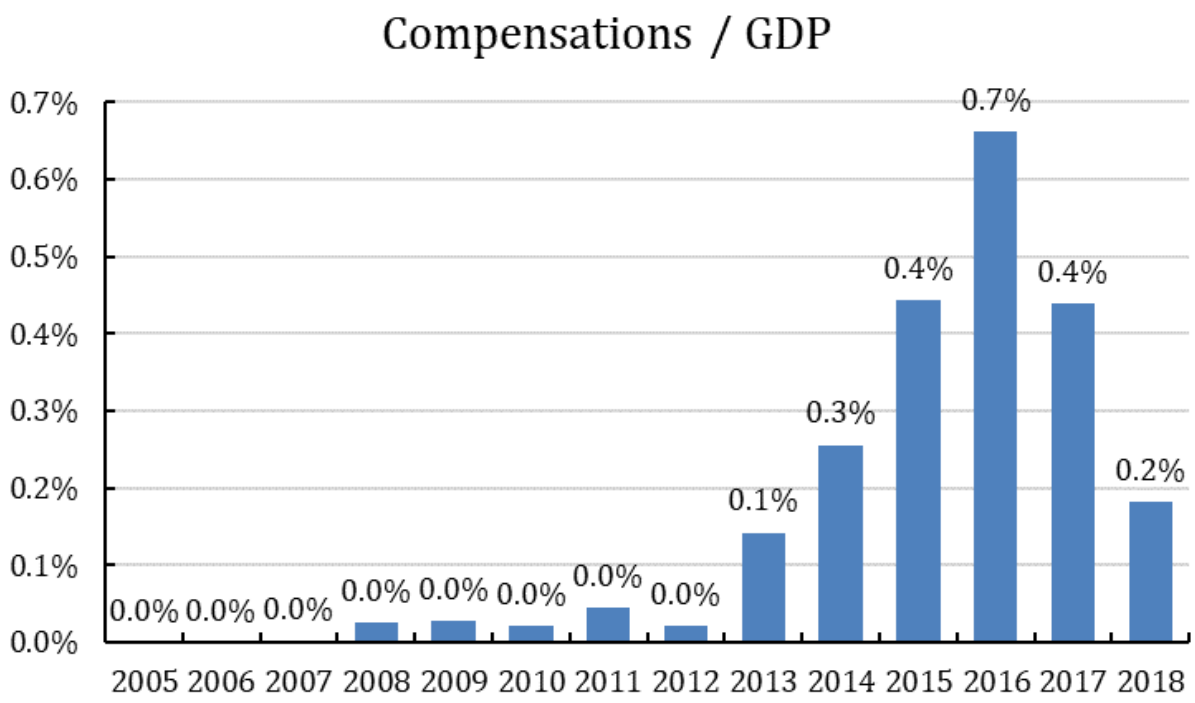


Source: DIA

On the receiving end: The beneficiaries of deposit insurance (5)

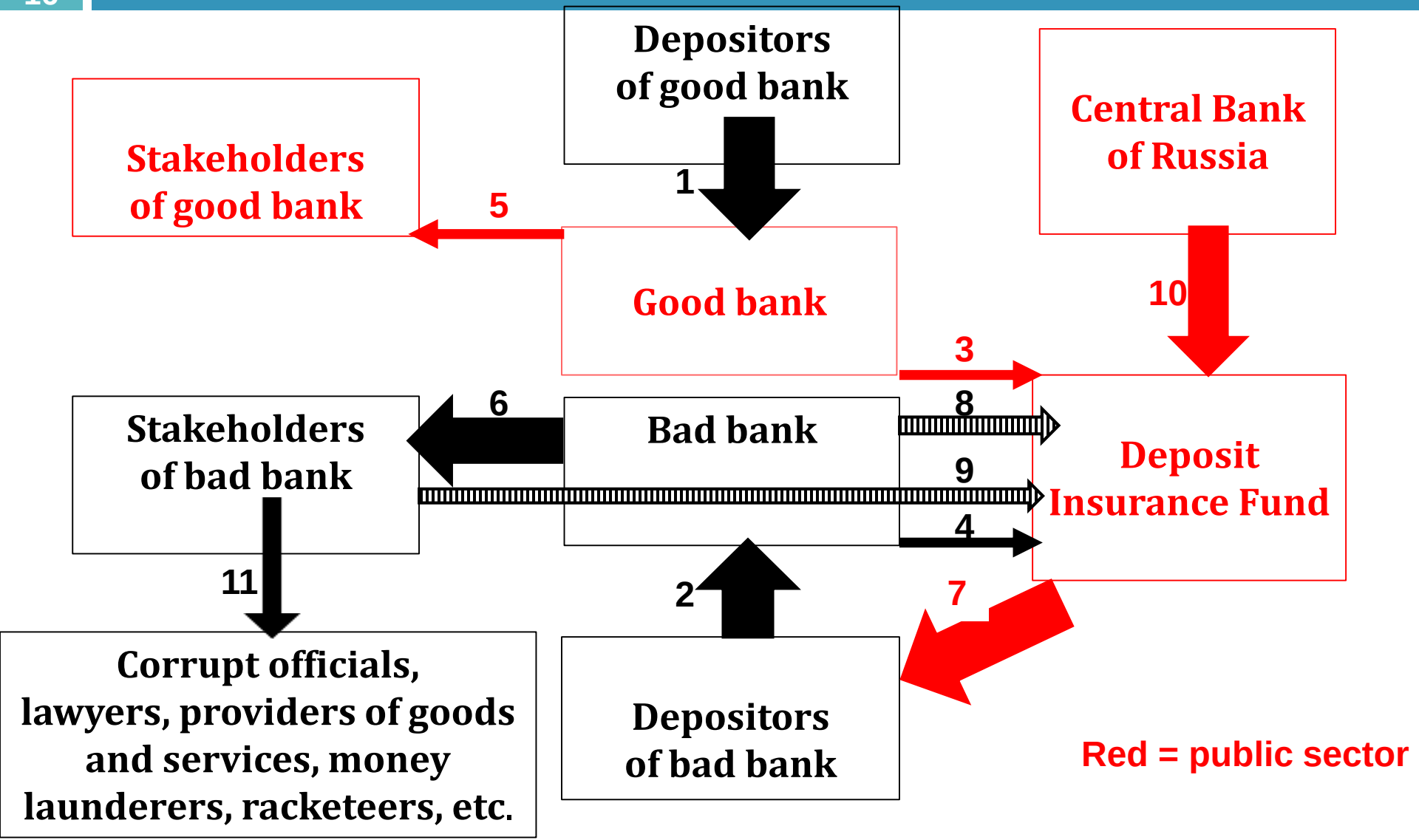
- Bureaucracy
  - Funds spent on the administration of the scheme, although DIA has other tasks beyond the administration of bank deposit insurance
  - DIA administrative expenses = RUB 4.5 bn in 2018, or EUR 62m

The magnitude of wealth redistribution



- At its peak, the deposit guarantee scheme redistributed wealth equivalent to 0.7 percent of Russia's annual GDP
- This is the floor estimate, because many bank failures were resolved by CBR or DIA without exercising deposit guarantee
- The ultimate social cost might be twice higher.

Cash flows


Depositors of good bank
Central Bank of Russia
Stakeholders of good bank
1
5
Good bank
10
3
6
8
Stakeholders of bad bank
Bad bank
Deposit Insurance Fund
9
4
11
2
7
Corrupt officials, lawyers, providers of goods and services, money launderers, racketeers, etc.
Depositors of bad bank
Red = public sector

Cash flow (legend)

1 – Depositors of good bank place their funds

2- Depositors of bad bank place their funds

3 – Good bank contributes to Deposit Insurance Fund

4 – Bad bank contributes to Deposit Insurance Fund

5 – Stakeholders of good bank benefit reasonably from inflow of customer funds

6 - Stakeholders of bad bank benefit unreasonably from inflow of customer funds (funds withdrawal; asset-stripping)

7 – Bad bank fails. Its depositors receive compensation from Deposit Insurance Fund

8 – Deposit Insurance Agency tries to recover funds from the failed bank (questionable)

9 - Deposit Insurance Agency tries to recover funds from stakeholders of the failed bank (questionable)

10 – Deposit Insurance Fund wipes out its resources. CBR replenishes them

11 - Stakeholders of bad bank pay to corrupt officials, lawyers, money launderers, racketeers, etc., in order to protect their illicitly acquired funds

Value extraction and wealth redistribution related to deposit guarantee

- Value extraction from:
  - Depositors of higher quality banks (lower interest rates)
  - Other stakeholders of higher quality banks (contributions to DIS)
  - **Public sector**
- In favor of:
  - Depositors of bad banks (mispriced deposits: risk-free high interest rates)
  - Owners and top-managers of bad banks (legitimately raised funds; illicitly withdrawn funds), from them further to
    - Providers of 'protection' and other services
  - **Private sector**
- Measurement of value extraction:
  - Net present value of public funds committed to bank bailout
  - Recovery rate from failed banks and their stakeholders.

Why did deposit guarantee perform as an extractive and redistributive institution in Russia?

- Capture (state, regulatory, institutional)
  - Public choice; economics of regulation
  - «... *As a rule, regulation is acquired by the industry and is designed and operated primarily for its benefit*...» [George Stigler]
- Design
- Timing
- Implementation

Design (1)

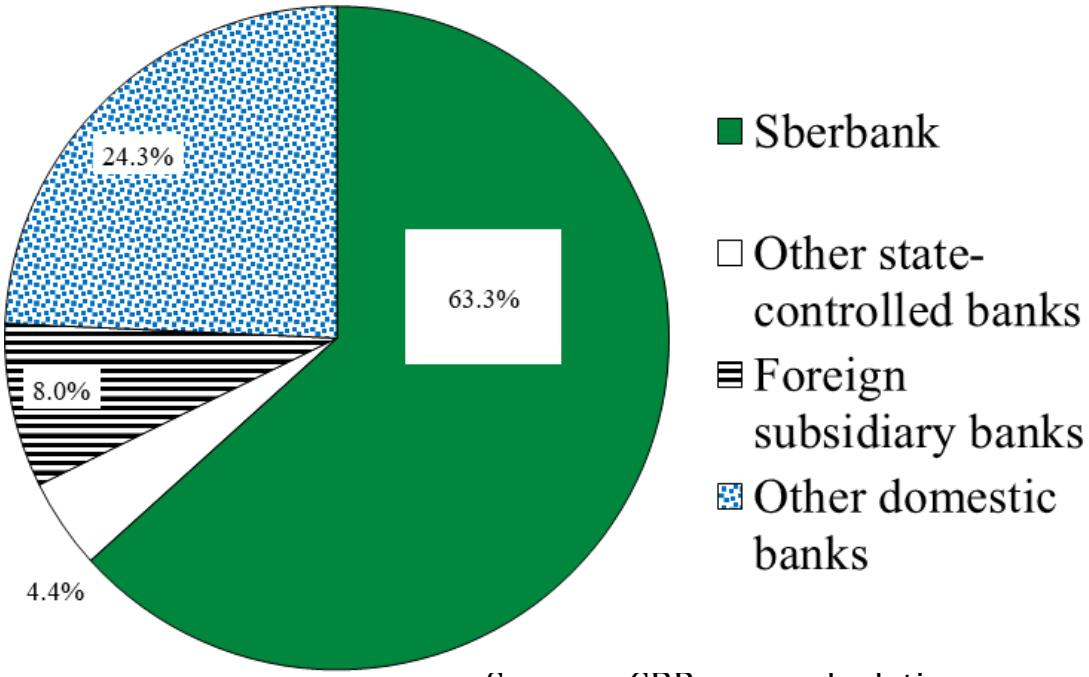
- Government-provided deposit guarantee is a redistributive institution by its very design [Hogan, Luther 2014, 2016; Hogan, Johnson 2016]
- One size does not fit all: The institutions and the market structure of the host country were unaccounted for
  - The bulk of deposits were kept at state-owned banks = already protected by the government
  - Strongly embedded institutions of redistribution [Bessonova, Kirdina] and paternalism [Rubinstein]
- The wealth distributing effect of the guarantee scheme was perfectly predictable – and indeed predicted by many [Krotov 2009]

Design (2)

- The institution of deposit guarantee was misused in Russia, i.e. employed to attain objectives other than those for which it was created [Vernikov 2018]:
  - To attract new deposits into the system – rather than reduce volatility of the existing deposit base
  - To boost the competitiveness of privately-owned banks at the expense of the state-owned Savings Bank (*Sberbank*), i.e. to regulate competition
  - To purge the banking industry.

Only a minority of all depositors actually needed an explicit deposit guarantee scheme

Household deposits breakdown on the eve of deposit guarantee introduction (31.12.2003)



Sources: CBR; own calculation

- Household deposits at Sberbank were already implicitly guaranteed by the government
- Less than ¼ of all deposits were held at private domestic banks. Assuming a higher average size of deposit, a smaller yet share of all depositors, probably between 15 and 20%

Timing

- Domestic circumstances were not in favor of its immediate introduction in 1993 when discussion started
  - Citizens' Soviet-era savings wiped out by hyperinflation
  - Depositors defrauded by Ponzi schemes and other crooks
  - Volatile domestic currency
  - The bulk of savings in the form of foreign banknotes
  - A myriad of weak untransparent institutions calling themselves banks
  - Banking supervision and regulation in embryonic stage of development
  - Empty government coffers
- Domestic circumstances were still immature by 2003 when deposit insurance scheme was adopted

Implementation

- Inadequate institutional capacity for a successful implementation
  - Central Bank of Russia did not possess sufficient political clout to resist political pressures and lobbying
- Compromises on standards and quality resulted in low quality of protection scheme membership

Then, why ?

- "*Deposit insurance spread throughout the world in the latter half of the 20th century as a result of external and internal political pressures favoring its adoption*" [Calomiris, Jaremsky JoF 2018].
- Original proponents: A small group of politicians and experts led by two members of the parliament [Krotov 2009]
  - Strong demonstration effect of foreign practices, mainly those of the USA
  - Ideological biases and preferences (de-nationalize at all costs)

Other stakeholders of deposit guarantee introduction

- Bank depositors and their interest in formal guarantees:
  - Sberbank (No)
  - foreign subsidiary banks (No)
  - privately-owned banks (Yes).
- Bank owners and top managers:
  - Opportunistic behavior: Avoided commitment to contribute to an explicit deposit guarantee scheme
- Civil servants (those without a vested interest):
  - Mostly opposed, claiming unfeasibility and moral hazard risks
- Public politicians:
  - Opportunistic behavior: Took advantage of the widespread expectation of government paternalism
- External stakeholders:
  - In the Russian case, external political pressure did not drive the process
  - An ambivalent attitude among IMF staff.

Conclusion

- An institution can switch from one mode of functioning to another when transplanted into a different environment: An institution meant to promote inclusion starts extracting and redistributing wealth
- The mode switch depends on the design, timing and implementation
- It matters how we measure the effect:
  - Focus on wealth redistribution, instead of gross metrics such as deposits/GDP ratio
- Direction for future research: Quantification of the flows of value
  - Net present value of public funds committed to bank bailout and depositors payout
  - Recovery rate from failed banks and their stakeholders.

Thank you!

Andrei Vernikov
vernikov@inecon.ru