A Critical Comment on the Planned Deposit Insurance Reform in Belarus

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Abstract

The transformation of private savers’ funds into business loans – the very essential function of banking intermediation - is weak in Belarus compared to other Eastern European economies. High concentration, governmental interference, an inconsistent regulation and a difficult business environment characterise the overall situation of the Belarusian banking sector. In order to improve the capability of the banking system to attract private savings a reform of the deposit insurance system is presently under discussion. This is expected to contribute to economic growth and development. Given the weak institutional environment, deposit insurance might however bear the risk of unfolding multifarious moral hazard effects. This paper analyses whether the proposed deposit insurance system is likely to improve the present situation and how it could be better adjusted to the country’s situation.

JEL-Classification: G21, G28, K23, O16.

Keywords: Deposit insurance, Belarus, deposit banking, banking regulation and banking system.
1 Introduction

Since its enlargement in 2004 the European Union has had a new Eastern neighbour: Belarus. According to international organisations, Belarus is one of the least liberalised countries worldwide. It holds the rank of 143 in the *Index of Economic Freedom* (Heritage Foundation/Wall Street Journal (2005)) and the rank of 26 within 27 Eastern European countries in the *Transition* Achievements ranking of the European Bank for Reconstruction and Development (EBRD (2004b)). Belarus’ economic development suffers from a reorientation towards a centrally planned economy, few foreign investments and long-term hyperinflation. The economic growth is amazingly high with annual growth rates varying between 6.3% and 11% from 1996 to 2004 (IMF (2005a), p. 43). However, these figures might not be trustworthy because of the doubtful reliability of official statistics (IMF (2004b), S. 5). Only a few large institutions with major state shareholdings dominate the banking sector, which is comparatively underdeveloped and struggles with high risks (Daneyko/Kruk (2005), p. 78, IMF (2004a), p. 37, S. 41-42; Neunhöffer (2001), p. 61-62). Particularly the weak retail deposit business and a resulting shortage of long-term capital are regarded as primary obstacles to economic growth and development.

In order to attract a higher proportion of savers’ funds into the financial system and to stimulate the economy, a redesign of the existing deposit insurance system is presently under discussion. Unfortunately, the safeguarding of deposits also triggers multiple moral hazard effects that might jeopardise the desired results and might even destabilise the banking system. On this account, the purpose of this paper is to analyse if and to what extent the planned reform can contribute to the stability and economic development of Belarus. A comparison with the to a great extent privately-organised German deposit insurance system will show alternative design features that are more consistent with the country’s circumstances and might help prevent some pitfalls of the proposed reform.

The rest of the paper is organized as follows. In section 2 we give an outline of the Belarusian banking system and its most important basic conditions. Section 3 discusses the features and the side effects of deposit insurance systems. On this basis section 4 explains the existing deposit insurance systems, analyses the intended revisions and presents proposals for alternative designs. Section 5 offers some concluding remarks.

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1 The growth rate forecast of an independent Belarusian institution for 2005 is 8.5%-9%, IPM (2005), p. 1.
2 Deposit and Loan Business in the Belarusian Banking System

2.1 Deposit and loan business

The essential role of finance is to channel savings to investments (Thiel, 2001, p. 7). The amount of savings attracted by financial intermediaries directly impacts the availability and the costs of corporate loans. A well-functioning financial sector can therefore be seen as a precondition for the efficient allocation of financial resources and promotes economic growth and development. (Volz (2004), p. 7). In Belarus, commercial credit is generally less accessible and more expensive than in neighbouring countries (World Bank (2005), p. 12-13); the transformation of private savers’ funds into investments is underdeveloped. The total volume of loans to non-financial enterprises and individuals proportional to GDP amounts to 12.9% (see Table 2). This is low not only compared to a well-situated country such as Germany but also with respect to other Eastern European countries, which show a figure of 27% of GDP on average. Within the European Union, the amount of non-financial sector loans relative to GDP reaches 109% (Volz (2004), p. 6).

Figure 1: Deposits of individuals as a percentage of the total bank liabilities in %

![Deposit graph](image)


One central reason explaining this situation is the insufficient capability of the banking system to attract private savings. Deposits from households and non-financial firms amount to just about 10% of GDP respectively, which makes up approximately a quarter of the total bank financing (see Figure 1). In addition, most of the deposits are short-term. According to the National Bank of Belarus (NBB) statistics, only 2.34% of Belarusian Rouble (BYR)-denominated deposits show maturities beyond 1 year. Within deposits in foreign currencies this fraction is 27.2%. Bank deposits, especially when denominated in the domestic currency,
do not seem to be attractive for private savers. This is not surprising, as several bank failures during the recent years have undermined the trust in the safety and stability of the banking system. Due to high inflation real interest rates on deposits were often negative in past years. In addition, the interest rates and the customer service offered by the dominant governmentally controlled banks might not be very attractive. As the existing deposit insurance system with its complicated and opaque provisions is not suited to improve the problem, a reform is under discussion. However, deposit insurance, when not designed properly might distort the marketplace and destabilise the banking system. To avoid undesirable side effects the structure of the banking system, the legal environment and other components of the financial safety net need to be considered carefully.

2.2 Macroeconomic framework and National Bank’s situation

After the collapse of the former Soviet Union, Belarus gained independence in 1991. In 1992, the development of the current Belarusian banking system started on the foundation of two fairly progressive banking laws (Daneyko/Kruk (2005), p. 69). The National Bank’s independence from government agencies was secured by the law “On the National Bank of the Republic of Belarus”. Commercial bank regulation according to the law “On Banks and Banking Operations in the Republic of Belarus” was modelled on the international Basel principles. It was not until 1994 that the currency union with Russia was resolved and the Belarusian Rouble was established as an independent currency with a flexible exchange rate (Neunhöffer (2001), p. 58). By means of restrictive monetary policies, the National Bank succeeded in containing inflation and stabilising the foreign exchange market. Since then the banking regulation and the banking system have undergone significant transformations.

When the Belarusian economy suffered from considerable recession during the transformation process, the operational independence of the NBB was curtailed and the NBB was allowed to grant direct loans to the government. After the presidential elections in 1995, Belarus’ macroeconomic policy was fundamentally reoriented. Administrative regulation was strengthened to guarantee stability and growth. The National Bank’s main function became to serve the financing needs of the government by direct lending and to grant directed loans to non-financial enterprises. Since 1997, the exchange rate has been governmentally controlled so that multiple rates emerged. Besides the official National Bank’s rate, there was a different rate between commercial banks and the grey market rate that was approximately twice the official one (Neunhöffer (2001), S. 63). After a monetary crisis in March 1998 and further
turbulences caused by the Russian financial crash, the National Bank was subordinated to the government. In 1999, inflation reached a record level of 294%.

Resumed negotiations with Russia concerning a political and currency union demanded an adjustment of economic conditions (Gulde/Jafarov/Prokopenko (2004), S. 4). In 2000, Belarus was forced to return to restrictive monetary policies. With the adoption of the Banking Code of the Republic of Belarus, the NBB regained formal authority once again. Nonetheless, the NBB’s independence is still one of the lowest in the transition countries of Central and Eastern Europe (Daneyko/Kruk (2004), p. 71). Inflation has been reduced, but with a figure of 18% for 2004, it still remains the highest in Eastern Europe (IMF (2004a), p. 44, IPM (2005), p. 4). The chief cause of this is a continually high level of directed loans for governmental programmes, such as house construction or deposit reimbursements for insolvent banks. Approximately 80% of the Belarusian economy is controlled by the government, which sets wage targets and forces quasi-fiscal activities and cross-subsidising of other enterprises. (Gulde/Jafarov/Prokopenko (2004), S. 27). Since 2001, the Belarusian Rouble has been de jure linked to the Russian Rouble by a “crawling band”- regime, de facto it tracks the U.S. dollar (IMF (2004b), S. 7). In June 2004, the proposed currency union with Russia was indefinitely deferred (Gulde/Jafarov/Prokopenko (2004), pp. 4-6).

2.3 Commercial banks in Belarus

Most of the present 32 Belarusian corporate banks are universal banks. The fairly progressive banking law formally guarantees independence from governmental interference. The foundation of a bank requires a license granted by the National Bank. Subjects of current supervision are equity, capital adequacy, liquidity and large exposures. Specific business sections, especially retail deposit business, foreign and securities business and consulting activities need a special authorisation. Due to restrictions in currency trading, each long term foreign trade business requires its own permit. However, supervision is not accomplished consistently. While small and medium-sized banks are supervised in strict adherence to the law, violations are often tolerated for large banks.

Corporate banks in Belarus are divided into three clusters as shown in Table 1 (Daneyko/Kruk (2005), S. 79). The first cluster, the quasi-fiscal bank sector, is composed of Belarusbank and Belagroprombank, which are both publicly owned. The Belarusbank maintains the largest branch network throughout the country and holds the majority of private deposits. Another
four banks, cluster 2, feature a lower, but nevertheless significant state share. Cluster 3, consisting of 26 “private” banks, only presents a small market share (see Table 1).

Table 1: Bank market shares at January 1, 2005 (in %)

<table>
<thead>
<tr>
<th>Cluster</th>
<th>Bank Name</th>
<th>Total Assets</th>
<th>Loans to NFE* and Individuals</th>
<th>Deposits from NFE* and Individuals</th>
<th>Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cluster 1</td>
<td>Belarusbank</td>
<td>41.8</td>
<td>42.6</td>
<td>57.4</td>
<td>34.4</td>
</tr>
<tr>
<td></td>
<td>Belagroprombank</td>
<td>14.1</td>
<td>15.9</td>
<td>8.3</td>
<td>36.2</td>
</tr>
<tr>
<td></td>
<td>total (1)</td>
<td>55.9</td>
<td>58.5</td>
<td>65.7</td>
<td>70.6</td>
</tr>
<tr>
<td>Cluster 2</td>
<td>Priorbank</td>
<td>11.6</td>
<td>9.9</td>
<td>8.6</td>
<td>9.4</td>
</tr>
<tr>
<td></td>
<td>Belpromstroibank</td>
<td>8.2</td>
<td>7.4</td>
<td>6.6</td>
<td>5.9</td>
</tr>
<tr>
<td></td>
<td>Belinvestbank</td>
<td>7.1</td>
<td>6.6</td>
<td>4.1</td>
<td>4.1</td>
</tr>
<tr>
<td></td>
<td>Belvneschekonombank</td>
<td>4.2</td>
<td>3.4</td>
<td>4.6</td>
<td>2.7</td>
</tr>
<tr>
<td></td>
<td>total (1+2)</td>
<td>87</td>
<td>85.8</td>
<td>89.6</td>
<td>92.7</td>
</tr>
<tr>
<td>Cluster 3</td>
<td>other banks</td>
<td>13</td>
<td>14.2</td>
<td>10.4</td>
<td>7.3</td>
</tr>
<tr>
<td></td>
<td>total (1+2+3)</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>


As reported in table 1, clusters 1 and 2 dominate the banking system by concentrating 92.7% of total bank equity, 85.8% of total assets and 89.6% of total deposits. With the exception of Belarusbank, all these banks arose from former Soviet banks through privatisation. They all have the privileged status of authorised banks, which allows them to serve government programmes and large government enterprises. Financing “strategic” state-run enterprises is indeed their main focus. Approximately 30% of their loan portfolio accounts for such programmes. In 2004, the government expected them to provide loans for investments to the extent of 3% of GDP. As those credits were often given without an appropriate risk assessment, those banks combine the majority of non-performing loans in their portfolios.

The remaining smaller banks that make up cluster 3 are privately owned. They show a variety of ownership structures and business models, but most of them have one or a few major
shareholders. Roughly half of those banks do not pursue any deposit business with private clients. As they cannot offer competitive interest rates on corporate deposits, funds are primarily raised from insiders and affiliated businesses. A shortage of equity capital and a shortage of creditworthy borrowers restrict the business (Daneyko/Kruk (2005), p. 86). Therefore, these banks concentrate on services such as loans, securities transactions, factoring, leasing and consulting in foreign trade, mainly addressed to smaller private enterprises, often bank insiders. The profitability in this cluster is comparably high but comes at the price of high risk, as 21 insolvencies since 1991 clearly document.

Table 2: Characteristics of the Belarusian and German banking sector (as of 31 Dec. 2004)

<table>
<thead>
<tr>
<th></th>
<th>Belarus</th>
<th>Germany</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of banks</td>
<td>32</td>
<td>2147</td>
</tr>
<tr>
<td>Number of bank branches</td>
<td>463</td>
<td>42659</td>
</tr>
<tr>
<td>Total assets</td>
<td>5,094 (Mio. Euro, 29.5 % of GDP)</td>
<td>6,663,797 (Mio. Euro, 300.76 % of GDP)</td>
</tr>
<tr>
<td>Equity</td>
<td>1,012 (Mio. Euro, 5.9 % of GDP)</td>
<td>245,630 (Mio. Euro, 11.09 % of GDP)</td>
</tr>
<tr>
<td>Loans to NFE and individuals</td>
<td>2,233 (Mio. Euro, 12.9 % of GDP)</td>
<td>3,005,935 (Mio. Euro, 135.67 % of GDP)</td>
</tr>
<tr>
<td>Deposits from individuals</td>
<td>2,007 (Mio. Euro, 11.6 % of GDP)</td>
<td>1,288,580 (Mio. Euro, 58.16 % of GDP)</td>
</tr>
<tr>
<td>Deposits from NFE</td>
<td>1,844 (Mio. Euro, 10.6 % of GDP)</td>
<td>2,472,382 (Mio. Euro, 111.59 % of GDP)</td>
</tr>
<tr>
<td>ROAE</td>
<td>6.3%</td>
<td>4.21%</td>
</tr>
</tbody>
</table>


Foreign investments in the banking system, generally seen as beneficial for the system’s development, are very low in Belarus compared to other Eastern European countries. Shares of foreign banks only account for 7.5% of total bank equity, which is well below the official upper limit of 25% (EBRD (2004a), S. 17). Consequently, most of the funding sources (95% on average during 2001-04) are domestic ones (World Bank (2005), p. 58). A major reason for this is that foreign banks are not allowed to establish branches in Belarus. Therefore, investments can only be made by the foundation of a subsidiary or by purchasing shares of a domestic bank, which both require administrative approval. With the exception of Priorbank,
which participates in projects with the European Bank for Reconstruction and Development (EBRD), Belarusian banks do not have access to international capital markets.

Despite the difficult economic environment\(^2\) and the structural deficiencies, the banking system has remained stable. The official capital adequacy figures as well as the liquidity ratios are quite good. Similarly, the officially reported proportion of 15% to 17% non-performing loans within the overall bank portfolios is surprisingly low. Nevertheless, the significance of these figures is questionable due to the low quality of the accounting system, the weak disclosure practices and a potentially even purposeful disguise of the real situation. In spite of that, the officially reported overall return on total assets (6.3%) is low (see Table 2). With full loan provisioning, the banking system would even have reported losses during several years recently (IMF (2005b), S. 9-11). The banking system is judged to be prone to significant risks (World Bank (2005), p. 31-32; IMF (2004a), p. 41). The intended currency union with Russia is likely to further acute vulnerability because of a more restrictive macroeconomic policy, increased competition in the financial sector and less influence from the NBB (IMF (2004a)). Whether in this situation the proposed deposit insurance regime is an adequate measure to enhance stability and spur investments needs careful exploration.

3 Objectives and Limits of Deposit Insurance

Due to the structure of their transactions, banks are exposed to specific risks. Especially the transformation of short-term deposits into long-term, risk-encumbered loans threatens a bank’s liquidity and credit standing. If investors lose confidence in the solvency of a bank, the sudden withdrawal of numerous deposits, called a ‘Bank Run’, may cause the failure of such a bank, even if in the ordinary course of business a repayment of the deposits was ensured.\(^3\) Due to the interlinking of financial institutions and panic-related chain reactions by depositors of other banks, the crisis of an individual bank may pass over to other sound banks and, thus, jeopardise the entire banking system (Körnert (1998), pp. 102-117, Burghof (1998), pp. 88-99). Deposit insurance systems try to prevent such events via a repayment guarantee given by a state or private insurance that reinforces the depositors’ trust. According to the World Bank (2003), the number of states entertaining an explicit deposit insurance system increased from 17 in 1980 to 88 in 2003. Developing countries in particular contributed to that number, as

\(^2\) In 2003 approximately 27.2% of all enterprises incurred losses, most of them belonging to the unreformed government sector, IPM (2004), p. 42.

\(^3\) About the disciplining virtue of bank runs and the desirability of financial fragility see Diamond/Rajan (2001a and b).
establishing a system of explicit deposit insurance guarantees has become a principal advice given by outside experts. (Demirgüc-Kunt/Kane (2001), p. 3).

The introduction of a deposit insurance system is usually targeted on two main objectives: protecting small depositors against losses and stabilising the banking system. It is not their intention to prevent the failure of individual institutions. The organised and effective exit of banks is as much part of an efficient banking system as the entry of new banks (Beck (2003), p. 8). What needs to be avoided, however, is the expansion and transfer of a crisis to other banks. Thus, the banking system as a whole is to be protected against panicking. Often, the hope for other effects is added, including the mitigation of an economic downturn and the protection of the payment system.\(^4\) By means of an increased depositors’ confidence and a resulting influx of savings deposits to the financial system, a deposit insurance is expected to have a positive influence on economic growth. Furthermore, the competition among banks is to be enhanced, especially where competition is distorted through insolvency-protected banks in public ownership. Not least of all, the desire to avoid any claims for damages often raised against the state in cases of bank insolvencies plays a major role.

In how far the above mentioned objectives and the stabilisation of the banking system in particular are achievable by a deposit insurance, is still disputed both from the theoretical and from the empirical perspective (Demirgüc-Kunt/Detragiache (2000), p. 25). The existence of insurance protection creates incentives for depositors, bank managers, shareholders, creditors, the government and taxpayers to change their conduct. Most importantly, insured depositors have a lower motivation to adequately supervise the bank management. If large groups of claimants, including big depositors or even shareholders, count on compensation if a crisis occurs (Demirgüc-Kunt/Detragiache (2000), p. 26 or Beck (2003), pp. 4-5) the bank management may end up insufficiently supervised. It then might realize its self-interests in higher risks so that the risk level in the banking system will rise in general. Despite a lesser ‘run’ risk, the safeguarding of deposits may therefore weaken the stability of the banking system. Moral hazard effects resulting from the risk transfer to the insurance system jeopardise the intended objectives (Laeven (2004), p. 202). Another point to be considered in this respect is that each deposit insurance scheme can guarantee deposit protection only in a few isolated bank failures (Financial Stability Forum (2001), p. 8). In the most feared

\(^4\) A list of objectives pursued by a deposit insurance is given by Garcia (1996), pp. 15-19; see also Carisano (1992), p. 17.
scenario, the general banking crisis, the guarantee facility will be overextended, because it is impossible to retain a major share of the total deposits as cover funds.

The effects actually unfolded through the introduction of a deposit insurance system depend upon its concrete design and the prevailing local conditions. A limitation of the insurance amount and a restriction to private depositors, for example, will further the supervision of the bank management by large and institutional market players. An obligatory membership in the insurance system will avoid adverse selection phenomena. If the deposits are covered by premium-based fund assets, a scheme of risk-dependent contributions may be an effective instrument to limit moral hazard effects as well. Another major feature of a protection scheme are its intervention powers. Such powers may be modest, if the guarantee institution just passively manages the insurance assets. But the insurer can also be endowed with supervisory powers that might encompass a participation in the granting of the bank license and the current supervision up to a major role in a potential settlement.

Not only the features of the deposit insurance system, but also its reconciliation with the other components of the financial security net may essentially limit - or boost - the much feared moral hazard effects. Usually the components of the financial safety net include a banking supervisory authority and a central bank which, in the event of a crisis, provides liquidity for endangered banks as a "Lender of Last Resort" (Carisano (1992), pp. 22-29). The structure of the banking environment, the legal system, especially the bank insolvency law (Krimminger (2004), p. 16), as well as the accounting standards and market transparency impact the way a deposit insurance operates. It is found that especially in a weak regulatory environment the introduction of deposit insurance is prone to trigger negative effects on the banking system stability and the financial development (Cull/Senbet/Sorge (2001), p. 40, Demirgüc-Kunt/Detragiache (2000)). Because of these multifarious interactions between the insurance system and the prevailing political and economic conditions, a reasonable deposit insurance must be exactly tailored to the specific situation in the country concerned (Kane (2000)).

4 The Current Situation of Deposit Insurance in Belarus

4.1 The existing deposit insurance system

Currently 19 out of 32 Belarusian banks offer deposit banking with individuals. In the course of time, several protective measures have been put in place to protect depositors. Deposit
banking with private customers requires a separate license from the National Bank that will be granted, at the earliest, two years after foundation of the bank and requires a minimum equity of 10 million Euros. Evidence of successful business must be provided as well. A very high proportion (12% to 16%) of the deposit amount needs to be deposited as a reserve with the National Bank. Although this sum is also available for deposit reimbursements it primarily serves the purpose of monetary policies. The first explicit deposit insurance system was introduced with the formation of a 'fund for the insurance of deposits of individuals' (deposit insurance fund) in 1995. The main goal was, by way of strengthening depositors’ trust, to increase the proportion of private savings available for the financial system and thereby financing the economic growth. The membership in the fund is mandatory for all banks. The fund is controlled by the National Bank, which is also responsible for investing the moneys collected from contributions. Insured by the fund are deposits of individuals in Belarusian Rouble and foreign currencies. Interbank deposits and corporate deposits are excluded. The maximum amount refunded, initially fixed to US$ 2,000, was reduced to US$ 1,000 per depositor and bank in 2001.

Table 3: Current deposit insurance in Belarus by bank groups

<table>
<thead>
<tr>
<th>Bank group</th>
<th>Group 1</th>
<th>Group 2</th>
<th>Group 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Associated banks</td>
<td>Belarusbank</td>
<td>Priorbank</td>
<td>13 smaller banks</td>
</tr>
<tr>
<td></td>
<td>Belagroprombank</td>
<td>Belpromstroibank</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Belinvestbank</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Vneshekonombank</td>
<td></td>
</tr>
<tr>
<td>Share in total volume</td>
<td>80.1</td>
<td>15.3</td>
<td>4.6</td>
</tr>
<tr>
<td>of deposits of</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>individuals %</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Insolvency cases</td>
<td>0</td>
<td>0</td>
<td>21</td>
</tr>
<tr>
<td>(1990-2004)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deposit insurance</td>
<td>Total deposits guaranteed by government</td>
<td>Foreign currency deposits guaranteed by</td>
<td>Total deposits up to 1,000 US$ per</td>
</tr>
<tr>
<td></td>
<td></td>
<td>government</td>
<td>client/bank</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Rouble deposits up to 1,000 US$ per client/bank</td>
<td></td>
</tr>
</tbody>
</table>


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6 Following this reasoning Russia is thinking about the introduction of a deposit insurance as well, Beck (2003), p. 22.
In addition to the deposit insurance fund, all foreign currency deposits with the six largest banks (groups 1 and 2) were guaranteed by the government by presidential decree. In 2000, an amendment to the banking code granted a 100% cover for all deposits with banks having state shareholdings of more than 50% (group 1). Currently this applies to Belarusbank and Belagroprombank. Once again, the objective was to channel more savings from the population into the state-controlled economy. The partially overlapping regulations created different protection levels within the three groups (see Table 3).

With Belarusbank and Belagroprombank, Rouble and foreign currency deposits are fully guaranteed by the state. Therefore, they are not obliged to contribute to the deposit insurance fund of the National Bank. For banks of group 2 the full repayment guarantee by the government exists for foreign currency deposits only. Rouble deposits are insured by the National Bank’s fund wherein a monthly sum of 0.1% of the deposit amount of national individuals has to be paid. Finally deposits with private banks of group 3 are protected by the deposit insurance fund only. The monthly contribution to be paid in was initially defined analogously to that of group 2. In order to take into account the different institutional risk, contributions were linked with the ratio between the bank’s deposits and equity capital according to Table 4 in 1999.

### Table 4: System of contributions by private banks

<table>
<thead>
<tr>
<th>R = Deposits / Equity capital</th>
<th>Monthly contribution: % of deposits</th>
</tr>
</thead>
<tbody>
<tr>
<td>R ≤ 1</td>
<td>0.1</td>
</tr>
<tr>
<td>1 &lt; R ≤ 2</td>
<td>0.2</td>
</tr>
<tr>
<td>2 &lt; R ≤ 3</td>
<td>0.3</td>
</tr>
</tbody>
</table>

For R > 3 the system can be carried on analogously.

Source: own representation.

A clearly regulated procedure for handling bank insolvency and refunding deposits is not in place. The capital of the deposit insurance funds has so far remained untouched. In the case of insolvencies, that up to now have exclusively affected private banks, the deposits were taken over by a quasi-governmental bank and covered by loans from the National Bank. A good example is the breakdown of the Belbatia Bank. The National Bank feared destabilising consequences for the banking system and therefore delayed the liquidation. Due to the extremely non-transparent information policy, deposits were still accepted, even after the bank license had been withdrawn. Despite a later official recognition of insolvency by the
National Bank, the deposit insurance fund remained untouched. Instead, the deposits of Belbatia Bank amounting to US$ 17.6 million were taken over by Belarusbank, who was in return granted an interest-free loan by the National Bank. So far, it has refunded deposits equivalent to US$ 13.2 million. Although full repayment shall be completed by 2007, the major part of the Rouble deposits got lost for the depositors due to the high inflation in 1999 and 2000\(^7\).

Besides the unclear handling and the fact that inflation has not been considered, the existing deposit insurance system features a number of additional drawbacks:

- The deposit insurance fund is not an independent facility but controlled by the National Bank. Its capital is deposited on a National Bank’s account and invested in Belarusian government securities. In case of a crisis, a considerable amount of securities would have to be sold. The resulting expansion of the money supply could come into conflict with the National Bank’s monetary policy duties.

- The deposit insurance system supports the distorted competitive conditions between the bank groups and promotes the concentration within the banking system. This particularly applies to the six banks with state shareholdings (groups 1 and 2), who can provide a higher security level and, thus, lower interest rates. While the private banks have to pay progressive contributions, their contributions to the deposit insurance fund are either reduced or zero.

- A full government deposit guarantee in the event of bankruptcy might be generally expected also with group 2 banks. Hence, there is little incentive for depositors to supervise the management for a true risk assessment and effective risk management. Therefore, the deposit insurance weakens the market discipline and the stability of the banking system.

- The protection level of foreign currency deposits is higher than for Rouble deposits. This distorts the currency competition and supports the tendency of "dollarization". Although a targeted interest-rate policy of the National Bank has lowered the share of foreign currency deposits in Belarus from a peak of 60% in 2000 to approximately 38% currently, it still exceeds that of most CIS countries (IMF (2004a), p. 37, World Bank (2005), p. 15)). This is dangerous for the stability of the banking system, because a high share of foreign currency deposits leads to high currency risks with commercial banks.\(^8\)

- An insolvency of Belarus- or Belagroprombank would drive the total amount of government-guaranteed deposits up to approximately 20% of Belarus’ annual budget.

\(^7\) Inflation rate was 294% in 1999, 169% in 2000 and 61% in 2001, IPM (2005), p. 4.

\(^8\) About the problem of growing dollarization of deposits worldwide see World Bank (2004).
Such expenditure is not provided for in the state budget, so that the government would be unable to meet its obligations in case of need. Consequently, the promised protection of depositors basically rests on deception.

4.2 The current draft of a new deposit insurance law

In order to reform the deposit insurance system in Belarus, a bill ("On the refunding of deposits of individuals") was put forward after years of discussion. The new law is to replace all existing regulations as regards deposit protection and to remedy major drawbacks of the existing system. The bill was initially accepted in January 2005 by the first chamber of the Belarusian Parliament and is currently being revised. It provides the foundation for a new deposit insurance fund (called "Reserve Corporation") and assigns to it the competence to refund deposits of insolvent banks. All commercial banks, irrespective of their state shareholdings, shall join the fund. The deposit insurance fund shall be an independent legal entity controlled by a board of directors and a supervisory board. Two representatives each from the government and from the National Bank are supposed to be supervisory board members. Upon foundation the government and the National Bank will provide initial capital of equal shares. From the contributions of the participating commercial banks a reserve will then be built up, which shall be the primary source for deposit refunds. The contributions shall be equal for all commercial banks and amount to a one-off 0.5% of the equity capital upon accession, and thereafter annually 0.15% of the deposits of individuals. The fund assets shall be deposited on an account of the National Bank and invested in government securities. In addition, the fund is authorised to raise money from the government and the National Bank at an interest rate below the market rate. The maximum amount of such loans is to be planned in the state budget on an annual basis. Deposits in Rouble and foreign currencies will be fully protected up to an amount of US$ 2,000 and with 80% up to US$ 5,000. If a depositor holds more than one deposit, the maximum refund of US$ 5,000 cannot be exceeded. Corporate and interbank deposits will not be protected. As regards the procedure, the law requires the reserve corporation to refund the deposits within one month, if a bank loses its license for transactions with individuals.

4.3 Efficiency and security of the new deposit insurance system

The central goal of the deposit insurance reform is to attract more savings as deposits and thus enhance economic growth. This aim can only be achieved if no undesired side effects jeopardise the stability of the banking system and the depositors can really trust the new fund.
Both conditions can only be met by an insurance system furnished with substantial restrictions.

Undoubtedly, the new bill will improve the situation of the deposit insurance system in several respects. The system will become more transparent since the rules and procedures for insolvencies are laid down in one uniform law. The two-stage restriction of the protected deposit amount offers protection for small depositors but maintains the market discipline of bigger depositors taking a residual risk. According to this bill, the protection level for Rouble- and foreign currency deposits will be the same, thus mitigating the currency competition. The scope of protection and contribution amounts will be equal for all banks so that several elements of the former system that distort competition will be eliminated. Although the moral hazard-reducing effect of risk-dependent premiums will disappear as well, private banks will not be put at a disadvantage compared to banks with state guarantee. Indeed, banks of the groups 1 and 2 enjoy a higher credit standing because of their state shareholdings, and this would systematically give them an advantage in a risk-dependent premium system with regard to the private banks of group 3. In addition, it would be necessary to develop an efficient system of risk assessment before a general risk-related premium system is introduced. Its implementation in Belarus seems to be difficult under current conditions. Even in the comparatively highly developed German banking system, risk-related contributions were introduced only recently.

The positive effects of the proposed system are faced with a number of challenging issues:

- Owing to the significant one-off contribution as well as the periodical ones, the planned insurance system presents an additional burden to the deposit business.
- The reform shows no attempt towards a strengthening of the prevailing regulatory conditions. Especially with the semi-governmental banks, a restriction of risk taking is not consistently implemented by the bank supervisory authority. Since the risk disclosure requirements and the accounting standards are low, the bank management is only insufficiently supervised and, because of the protection of the depositors, may receive additional impetus to increase the risk.
- It has to be expected that a full protection of deposits will continue to be generally assumed for banks with state shareholdings. Consequently, the existing distortion of competition in deposit banking will not be effectively combated. The limitation of the protection level in order to reduce moral hazard problems will most likely fail its purpose.
- A considerable amount of money is likely to accumulate in the reserve fund over time. If the administration of the reserve corporation is not precisely defined and controlled,
misuse and incorrect use may be a consequence. In the event of damage, the paid in capital might therefore not be available (Beck (2003), p. 6).

As the above argumentation shows, the new protection system is likely to trigger considerable incentives that might put the efficiency and stability of the banking system at risk. Another crucial point for assessment is the question whether the new deposit insurance system can actually guarantee that deposits are refunded in the event of insolvency. To this end, it should be considered that in a transition country the investment of capital in government securities would not by any means prove safe in the case of a crisis. A lesson in this regard could be drawn from the Russian banking crisis in 1998, during which government loans were no longer serviced. Another essential aspect is the fact that, despite the reduced scope of protection, the insolvency of a large bank, especially of Belarusbank, could not be absorbed by the reserve corporation. The transacted insurance obligations would by far exceed the funds of the reserve corporation. This casts doubts on whether the proposed system is adequately adapted to the highly concentrated banking system of Belarus.

Despite the existence of very different bank groups in Belarus, that partly possess an explicit or implicit government guarantee, they have planned a joint protection system. This insurance design is not likely to be able to combat the distortion of competition between the various bank groups. The joint protection system moreover implies the danger that risks existing with the large banks will put a burden on the protection of smaller banks. Such a starting position with different and partly government protected bank groups can also be found in other transition countries. There, as a possible solution, the structure of the German deposit insurance system in particular was recommended as being worthy of consideration (Beck (2001), p. 24).

Similar to Belarus, the German savings bank sector represents an economically important group of banks that, based on being a corporation under public law, had long been in possession of a government guarantee for all deposits. The development of the deposit insurance was here such that, in order to avoid any competitive disadvantages, a system of full protection of deposits was put in place with all banks, causing a tendency towards a distinct moral hazard problem and putting a strain on the market discipline. Despite this, no difficulties have occurred so far regarding the stability of the banking system, which is essentially a result of the consistent supervision of the banks. In Belarus, however, an explicit protection of the whole deposit amount for all banks is precluded due to the weak prevailing regulatory conditions. This would further be financially unbearable. However, two other
aspects of the German deposit insurance system appear to be a useful element: The separation of the insurance system by bank groups and the private management of the reserve fund. In the German model private banks, cooperative banks and savings banks each have an own independent insurance system at group level. Particularly with the savings banks and cooperative banks there are close ties and limited competition within the sector. Together with the private ownership of the insurance system this ensures a high level of information for the guarantee facilities, strong powers of intervention and a flexible scope of action. Furthermore, substantial incentives for mutual control arise from the fact that other banks of the group concerned are responsible for the settlement in case of the insolvency of a member institute.9 This shows that it is possible to combat moral hazard incentives and reduce risks by means of a deposit insurance organisation adjusted to the individual bank environment. No use of this opportunity is made by the proposed insurance system in Belarus.

In general, it could be anticipated that the stability of the Belarusian banking system will not be improved by the planned reform of the deposit insurance.10 The risk most feared by the depositors (a crisis involving the entire banking system and high inflation rates) will be hardly mitigated by the new law, and possibly even increased triggered by moral hazard incentives. Provided that the intended influx of long-term Rouble deposits is achieved, the depositors will rely only on a suggested security. The reform affects by no means the main cause for the high system risks which actually lie outside the banking sector. The problems of governmental interference with the business of enterprises and banks and the lack of good investment opportunities cannot be overcome by a deposit insurance “the establishment of a deposit insurance system is not a remedy for dealing with major deficiencies” (Financial Stability Forum (2001), p. 3).

5 Conclusion

The banking system of Belarus has been suffering from high concentration and structural weaknesses, which are the result of the difficult economic environment and the government interference in economy and finance. Due to high inflation and low investors’ confidence in the banking system, deposit banking with retail customers is poorly developed. The resulting shortage of capital for investments is, in fact, putting a burden on economic growth. The

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10 The introduction of a deposit insurance system in Russia, in which the general conditions indicated similar structures, was also considered to be premature, Beck (2003), p. 24.
planned reform of deposit insurance is to help attract more capital as savings and thus provide support to the Belarusian economic development. The analysis has shown that the proposed changes will indeed rectify some weaknesses of the existing deposit insurance system. However, the central issues will not be solved. On the one hand, due to moral hazard effects triggered by an insurance provision, it cannot be expected that the stability of the banking system will improve. On the other hand, there is serious doubt whether the insurance system can guarantee a repayment of deposits in the event of damage: amongst others the financial resources of the reserve corporation would be overstrained by the insolvency of a large state bank. Despite the substantial differences in structure and risk profile between government-dominated and private banks, a joint insurance system has been planned for all groups. This results in a transfer of risk to the smaller banks. A deposit insurance break down by bank groups – following the German example - would fit the existing banking system more properly and especially help combat moral hazard problems more effectively.
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