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Transforming “Factory Towns”: Lessons Learned and Best Practices from East Germany

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1. Introduction

A well-developed banking system is one of the key determinants for economic growth. At the same time its performance depends to a great extent on the performance of the real sector of the economy. Therefore banks are highly vulnerable to liquidity and credit risks. Frequently, the failure of one bank can spill over to others, causing systemic problems for the banking sector[1]. Bank failures cause losses by depositors, creating incredibility to the national currency and the whole banking system. The importance of commercial banks, the need to prevent a systemic banking crisis and the danger of potential losses to depositors, all require that safety nets be provided. Besides banking regulations, supervision and lender-of-last resort facilities, such nets must include a system of deposit protection (deposit insurance system).

There are several options for promoting financial stability through deposit protection. They are 1) legal priority of the claims of depositors over other claims, 2) an implicit deposit insurance system, and 3) an explicit deposit insurance system[2]. Any design of a deposit protection system must create the right incentives for its participants: the insurance fund, the banks, and the depositors. Explicit and limited coverage of deposits is the best variant among the existing options. Currently this form of deposit protection is found in 74 countries.

Developing a well-functioning deposit insurance system is very important for Belarus, since it can help to achieve important goals of economic policy: growth of public confidence in the financial sector, preventing bank runs, attracting household deposits, lowering of the deposit interest rate, in sum, reducing the cost of credit. In this paper we consider the possibilities for developing a deposit insurance system for Belarus, which would create the right incentives for all participants. We define the features of a benchmark system (section 2), analyse the current deposit insurance system in Belarus (section 3) and the draft law on deposit insurance (section 4), and finally set forth some proposals for further improving the deposit insurance system in Belarus (section 5).

2. A Benchmark System

The main goal of any deposit insurance system is to enhance the stability of the banking sector and its development (in quantitative terms), and generally to increase public confidence in the banking system. It helps to achieve three main objectives:

1) To avoid runs on all banks in case one of them fails.
2) To increase savings by assuring depositors that a certain portion of their deposits is protected.
3) To provide protection for depositors, especially for small ones, through a mechanism of prompt repayment of the insured parts of the deposits in case of a bank failure.

Evidently, in order to solve these tasks it is necessary to design the deposit insurance system to suit the economic conditions of the country. But any deposit insurance system can be characterized as a well functioning if it creates the following incentives for its participants:

1) For the deposit insurance fund: The policy of the deposit insurance fund should aim at stability of the banking system, not at attracting huge deposits to the banking system through unlimited or excessive deposit coverage.
2) For the banks: The banks should set their interest rates and attract deposits according to their financial possibilities.
3) For the depositors: The depositors should carefully choose their banks, entrusting their resources to safer banks, not to ones with high interest rates but risky operations.

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[1] According to the World Bank, there were around 120 episodes of systemic bank crises in 93 countries during the past two decades.

[2] An implicit system is one where no rules and procedures exist for deposit protection, nor legal obligations and protection, i.e. the state decides ad hoc regarding protection. There is no ex-ante financing and the degree of protection could vary from non-protection to full protection. An explicit system of deposit insurance is one where regulations and procedures exist for deposit protection. There is a legal obligation for protecting depositors up to an insured limit. The insurer arbitrarily decides about the protection of the uninsured deposits, the degree of protection varying from limited to full protection. The banks usually finance the system through premium payments (although the possibility of the state making regular payments and financial injections is not excluded). In the case of bankruptcy of a bank, the Fund realizes the financing. (Parnargieva, M. "Deposit Insurance and Banking system Stability").

Thus, as a rule all well-functioning deposit insurance systems have common characteristics. In addition, such systems are explicit, i.e. clearly defined by law, because the public must know the rules applying to a possible repayment of deposits.

2.1. Design Features of Deposit Insurance Fund

In order to avoid insolvency, a deposit insurance fund must have a legally defined target for capital accumulation reflecting the overall economic situation. The fund should be able to repay all insured deposits in the worst possible case, e.g. if the largest bank fails.

As a rule, not only the commercial banks, but the government too takes part in financing the insurance funds' capital. The government could contribute to the deposit insurance fund capital on the stage of its establishing and/or it could provide credit should the insurance fund lack sufficient provisions to pay compensation to all depositors of a failed bank (banks).

The central bank should provide the deposit insurance fund with all the information it needs, not only on an ex-post basis (e.g. concerning the liquidation of a commercial bank), but also provide it with data about potential problems. This could help the deposit insurance fund to plan its operations and meet its obligations without problems.

2.2. Requirements for the Commercial Banks

Membership in the deposit insurance system should be compulsory for all banks, including foreign and state-owned ones. Otherwise, only weak institutions will have an incentive to join the deposit insurance system, reducing its financial stability. The banks should pay risk-adjusted premiums (i.e. premiums adjusted according to their performance) to the deposit insurance fund. Thus riskier institutions, which are most likely to have trubles, would have to pay more for coverage. In this way sound banks would not subsidize weaker ones. Also, depositors might be encouraged to move from weaker banks to safer ones.

2.3. Guaranties for the Depositors

In case of a bank failure the deposit insurance system should be able to offer prompt repayment of the insured deposits, otherwise the danger of a general run on all banks and a banking crises increases dramatically. A well-functioning deposit insurance system should be able to offer repayment within several days after the liquidation of a bank has been announced. Most repayments should be completed within a month.

The depositors should have incentives to put their money into safe banks. If the depositors do not carry any part of the risk, there would be no incentive for them to monitor the performance of the banks. Deposits would then tend to be made in banks with risky operations that pay higher interest rates, which in turn would increase the probability of a banking crisis. In order to create the right incentives for depositors, limited coverage of deposits and/or co-insurance should be introduced. Both of these possibilities eliminate the “moral hazard” problem. Limited coverage (full coverage up to a certain amount of deposit) is also desirable for social considerations, because it protects small depositors, who are unable to monitor banks. Co-insurance helps to redistribute deposits to safer banks, because it forces large depositors to monitor bank performance and choose safer banks. Unlimited or excessively high coverage could lead to situations, when the deposit insurance fund will lack resources to repay deposits and may go bankrupt.

Through the mass media, the deposit insurance system should provide depositors with detailed information about its operation, the level of insurance it provides and how it would function in case of a bank failure.

3. The Current State of the Deposit Insurance in Belarus

3.1. Characteristics of the Existing Deposit Insurance System

The establishment of a deposit insurance system in Belarus was started in 1995. In 1996 the NBB issued a regulation, which envisaged the creation of a deposit insurance fund – the Guarantee Fund for the Protection of Deposits by the Population. Later in 1998, the President issued a decree, promising full government backing for currency deposits placed with banks authorized to service government programs (the so-called authorized banks[3]). In 2000, the NBB issued rules regulating the currency deposit insurance for these banks. Finally, in 2001 the NBB issued additional rules regulating the insurance for ruble and for foreign currency deposits by the public, placed in non-authorized banks. So far there has been no need to use the resources of the Belarusian deposit insurance fund.

3.1.1. Features of the Present Deposit Insurance Fund

The present deposit insurance is regulated by at least four different legislative acts[4], not by a single law. Some of the regulations are not clearly defined anywhere. The deposit insurance fund (called Guarantee Fund) is one of the funds of the NBB, not an autonomous organization. The NBB pays interest for the capital accumulated in the Guarantee Fund, but the resources of the Guarantee Fund are not used by the NBB to earn further financial resources. The main source of the Guarantee Fund is the monthly payments made by some commercial banks.

3.1.2. Insurance Premiums Paid by the Banks

The current legislation distinguishes between 3 groups of banks[5], having different obligations:

Group 1, formed by the 2 large authorized banks Belarusbank and Belagroprombank, does not pay insurance premiums to the Guarantee Fund.

Group 2, consisting of 4 authorized banks (Belpromstroybank, Belinvestbank, Priorbank and Belvnesheconombank) pays monthly 0.1% of the household deposits to the Guarantee Fund.

Group 3 includes all other banks that have licenses for operations with deposits by the public. They pay insurance premiums according to the following principle:

Ratio of Households deposits to own capital, R	Monthly payments to Guarantee Fund, % of households deposits
$R \leq 1$	0.1
$1 < R \leq 2$	0.2
$2 < R \leq 3$	0.3

and so on.

This means that the banks belonging to Group 3 pay at least as much as the banks in Group 2 (0.1% of households deposits per month). Also, the amount of the premium does not depend on the bank safety.

3.1.3. Guarantees for the Depositors

The guarantees available for a depositor depend on the group his bank belongs to:

Group 1: The government provides an implicit guarantee for all household deposits (in national and in foreign currency).

Group 2: Unlimited guarantee for household deposits in foreign currency. There is also a limited guarantee for household deposits in national currency[6]. Both the government (central budget) and the Guarantee Fund are the guarantors. The sources of this guarantee are:

1) Credits of the NBB to the bank and other short-term instruments;
2) Obligatory and excessive reserves of a bank in the NBB;
3) Resources of the Guarantee Fund;
4) Resources of the central government.

[3] There are six banks authorized to service government programs: “Belarusbank”, “Belagroprombank”, “Belpromstroybank”, “Priorbank”, “Belinvestbank”, and “Belvnesheconombank”. The government has a controlling interest in all these banks. They hold about 95% of all deposits of the population in the banking system. The assets of these six banks amount to about 90% of all the banking system assets.

[4] The Banking Code of Belarus; Decree No. 4 by the President of Belarus (04/20/1998); Regulation of the NBB No.33.14 (12/27/2000); Regulation of the NBB No.75 (03/29/2001).

[5] The banks of Group 1 represent about 60% of the assets and about 70% of the deposits in the banking system. The banks of Group 2 represent about 30% of the assets and about 25% of the deposits. Group 3 (18 banks) comprises 10% of the assets and 5% of the deposits.

[6] In case a person has deposits both in BYR and in foreign currencies the following principle of compensation is applied: If the size of his deposits in foreign currency equals or exceeds USD 1000, then he gets compensation only for his foreign currency deposits. If below USD 1000, the depositor receives compensation for the total deposits in foreign currency and compensation of his deposits in BYR not exceeding USD 1000 minus the amount of his deposits in foreign currency.

Group 3: Limited coverage up to the equivalent of USD 1000 per person and per bank. No distinction is made between currencies. Only the Guarantee Fund insures deposits for the banks belonging to this group.

3.2. Major Drawbacks of the Existing Deposit Insurance System

The existing deposit insurance system in Belarus has five main problems. First, it is not transparent and rather complex. Second, it creates unequal conditions of operation for different banks (Groups 1, 2 and 3), i.e. unfair competition between banks. Authorized banks (Groups 1 and 2) can attract depositors with lower interest rates but better guarantees. Moreover, the banks in Group 1 have better guarantees than the banks in Group 2, and consequently operate under the most favourable conditions.

Evidently, the state guarantees attract small depositors to these banks, who are unable to monitor bank performances. Since the great majority of small depositors use the Belarusbank and other authorized banks[7], they are very vulnerable to the ability of the Government to meet its obligations. As shown in Table 1, should the Government have to compensate the depositors in the two largest banks, about 20% of the central state budget would be required. Currently, the law "On the budget of the Republic of Belarus" does not envisage such possible expenditures. Thus, the third problem is the inability of the Government to provide sufficient resources for its guarantees. At the same time the state guarantees lead to substantial distortions of the deposit structure of the banking systems and to potential instability.

Table 1. The Guarantors for Different Bank Groups

Bank group	Guarantor	Amount of the households deposits, in USD m*	Amount of households deposits as a % of annual central budget	Ratio of Guarantee Fund capital to the amount of households deposits, %
Group 1	Central budget	600	19	--
Group 2	Central budget and Guarantee Fund	155	5	5.8
Group 3	Guarantee Fund	170	--	5.3
Total		925	--	1.0

Source: Own calculations based on NBB data.
* approximate figures.

Not obliging Belarusbank and Belagroprombank to pay deposit insurance premiums doesn't create for them incentives to restrict inflow of deposits. At the same time, banks from group 3 must pay progressive insurance premium, so they have these incentives. Obviously, the Group 3 banks also face discrimination vis-à-vis banks from Group 2, because the latter pay a flat insurance premium. All this encourages the fourth problem – monopolization of the banking system in Belarus.

The fifth problem is unfair competition between foreign currencies and the Belarusian ruble. Better guarantees for deposits in foreign currency in the Group 2 banks do not help to solve the dollarization problem and will not create confidence in the national currency. Currently, a high growth rate of deposits in Belarusian rubles is possible only due to relatively high positive real interest rates for these deposits and negative real interest rates for deposits in foreign currency.

As for the banks in Group 3, the capital in the Guarantee Fund is enough to provide credible guarantees for USD 1000 compensation per person per bank. It exceeds 5% of the household deposits at these banks (table 1) and meets international standards. However, the main source of instability is not the small non-authorized banks, but the large authorized ones.

There are some additional problems with the existing deposit insurance system. Currently, the banks most likely to fail pay the same premiums as sound banks, i.e. the latter subsidize the weak banks. From this point of view, there are poor incentives for banks to improve their safety. Also, the repayment of the insured deposit amount is not immediate. If an authorized bank faces problems and needs to return deposits in foreign currency, the depositors receive compensation from the Guarantee Fund only after all other sources (credits of NBB, resources from the reserve fund, etc.) have been exhausted. In the case of bankruptcy of a non-authorized bank, the resources of the Guarantee Fund are used only if the bank itself is not able to discharge its obligations. Such delays may lead to bank runs.

[7] About 70% of all household deposits of the banking system are placed in two banks (Belarusbank and Belagroprombank). They have accumulated most of the bad loans and get many government exemptions.

Thus, one can conclude that the main goal of the deposit insurance system, to promote financial stability, is not being achieved and that the present system needs improvement.

4. Draft Law “On Compensation of Deposits of the Population”

4.1. Essential Features of the Draft Law

In order to improve deposit insurance in Belarus, the NBB, the Association of Belarusian Banks, and Parliament prepared the draft law “On Compensation for Deposits by the Population”.[8] The draft law substantially improves most drawbacks of the current deposit insurance system. Its essential features are the following:

4.1.1The Deposit Insurance Fund

The draft law foresees the deposit insurance fund (called “Reserve Corporation”) to be an autonomous legal entity governed by a supervisory board and directors. Only the law “On Compensation of Deposits of the Population” will regulate the new deposit insurance system.

The Guarantee Fund’s capital will be transferred to the Reserve Corporation. Resources from the central government and insurance premiums are supposed to increase the capital of the Reserve Corporation. The main source is will remain insurance premiums. The resources of the Reserve Corporation will be held in accounts at the NBB. The latter will pay interest for using these funds. The Reserve Corporation will be mandated to inform the public through the mass media about registration of banks in the Reserve Corporation and their liquidation.

4.1.2. Obligations of the Banks

All banks will pay equal premiums into the Reserve Corporation (0.3% of the insured deposits per quarter), including “Belarusbank” and “Belagroprombank”. The banks shall provide their clients with information about their memberships in the Reserve Corporation.

4.1.3. Guarantees for the Depositors

The equivalent of USD 2000 (per person per bank) will be fully covered by the new insurance. 80% coverage will be provided for the next USD 3000 (that is from USD 2000 to USD 5000). Amounts exceeding the equivalent of USD 5000 per person per bank are not insured. The draft law makes no distinction between different banks and different currencies. Also, an eventual repayment of the insurance coverage must be made within a month.

4.2. Results Expected from Adopting the Draft Law

Let us consider how this draft law is likely to improve the existing situation. First, the deposit insurance system will acquire transparency, with clearly defined regulations within a single law. Second, the draft law creates preconditions for de-monopolizing the banking system. According to the draft law, all banks have to pay equal insurance premiums, including Belarusbank and Belagroprombank. Hence, the banks that now attract large amounts of deposits must pay large insurance payments. This will increase their costs, impelling them to lower interest rates, which in turn will reduce their deposit inflows. This, in its turn, should lead to a redistribution of deposits between banks, i.e. to de-monopolization.

Third and fourth, as the draft law eliminates the 100% government guarantees for deposits at Belarusbank and Belagroprombank, as well as the 100% government guarantees for deposits in foreign currency at the other authorized banks, it solves problems of unfair competition between banks and between currencies. If the draft law is adopted, depositors will choose the bank and the currency of deposit based on interest rates. Moreover, large depositors would choose the bank carefully because of co-insurance. Introduction of co-insurance is a very important element of the draft law, because it helps to create appropriate incentives for large depositors and protects small depositors.

Obviously, adoption of the draft law would lead to more stability and to further development of

[8] The draft law has not yet been presented to Parliament, because a number of ministries and banks oppose its adoption. The Ministry of Finance doesn’t support it either, since it would have to pay an initial capital contribution to the new deposit insurance fund. The Ministry of Justice points out that the draft law contradicts the Presidential Decree No.4 (which envisages complete coverage of all deposits in foreign currency placed in authorized banks) and the Banking Code (which states that “Belarusbank” and “Belagroprombank” do not pay insurance premiums to the Guarantee Fund). In addition, “Belarusbank” and “Belagroprombank” oppose the draft law because of the high insurance payments that they would have to make.

the banking sector. We strongly support the draft law because it substantially improves the existing drawbacks of the deposit insurance system in Belarus. However, some additional features would further improve the law.

5. Proposals for further Improvements to the Deposit Insurance System in Belarus

Improvements to the draft law are needed for several reasons. First, inclusion of Belarusbank and Belagroprombank in their current state in the deposit insurance system could undermine its stability, because should one of these banks fail, the resources of the Reserve Corporation would be insufficient to provide compensation for all its depositors. We agree with the draft law that all banks should be included in the new system. But to avoid problems within the system Belarusbank and Belagroprombank must be restructured as soon as possible.

Second, the draft law envisages equal insurance premiums for all banks (0.3% of household deposits per quarter). But the underlying major working principles of the Reserve Corporation should be just the same as those of any other insurance company: premiums are collected from insured agents and stand ready to repay insurance if needed. It is therefore logical to assume that riskier agents with higher chances to call for help should pay higher insurance premiums. According to this principle, the deposit insurance funds in many countries (including transition economies) use risk-adjusted premiums: commercial banks with more high-risk operations pay higher premiums than do safer ones. Flat premiums are undesirable since by paying equal premiums healthy banks subsidise weaker ones. In consequence, riskier banks would – at least in this respect – have no incentive to improve their safety.

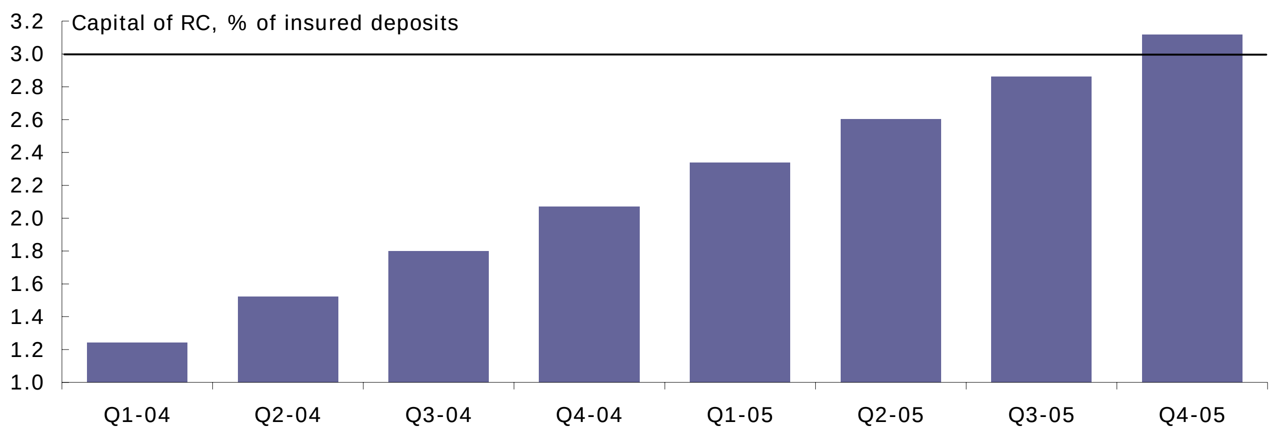
Third, the public must have confidence in the Reserve Corporation. Therefore its capital must be sufficient to compensate all depositors. In order to avoid problems with deposit repayments and reach an adequate deposit coverage, a legally defined target for the capital of the Reserve Corporation should be set.

Based on the above we propose the following.

First, it is necessary to restructure Belarusbank and Belagroprombank as soon as possible. Second, we propose the introduction of risk-adjusted insurance premiums[9]. However, the Reserve Corporation should not be responsible for monitoring bank risks and rating the banks accordingly. We believe that the NBB should conduct the ranking of the banks and provide the Reserve Corporation with this information. The rankings should be based on international accounting standards in order to evaluate the real performance of all commercial banks.

Introduction of risk-adjusted insurance premiums is very important in the case of Belarus, because it would help to redistribute deposits from weak banks to sound ones. This measure will impel banks to improve their performance in order to pay lower insurance premiums.

Figure 1. Estimation of Capital Accumulation of the Reserve Corporation



Source: Own calculations.

Our third proposition concerns the size of the Reserve Corporation's capital. Currently, the

[9] For the purpose of bank rankings the NBB could use, for example, the ranking methodology named CAMELS, a widely used banking rating system, which includes the following components: C – capital adequacy, A – asset quality, M – management factors, E – earnings, L – liquidity, S – sensitivity to market risk.

capital of the Guarantee Fund amounts to less than 1% (table 1) of total household deposits[10] in the banking system. International practice shows that advanced countries with stable financial systems tend to set relatively moderate targets: 0.5% of total deposits, subject to insurance in Belgium, 0.8% in Italy, 1.25% in the USA, etc. Transition and developing economies face higher risk and consequently tend to select higher targets: 1.5% of total households deposits in Hungary and Slovakia, 3% in Estonia. In our view, an appropriate medium-term target for the Belarusian deposit insurance system should be 3% of total household deposits. To reach this target, about 2 years will be needed, assuming the quarterly insurance premiums are (on average) equal to 0.3% of the household deposits (figure 1).[11]

6. Conclusions

A well-functioning deposit insurance system is of great advantage to the economy. The main benefit derives from building confidence in the financial system and promoting its stability. It induces households to trust in financial intermediaries, that eliminate part of the risk premium built into the interest rates and pushes the latter downwards. This encourages financial intermediation, allows to expand crediting and, thus, investment and economic growth. Besides that, a deposit insurance system is important for its social meaning: it protects the public, especially the least wealthy, from loosing their savings in case of a bank failure.

The present Belarusian deposit insurance system has many drawbacks. The new draft law represents a definite improvement. Our point of view is that this law is very comprehensive and well designed, and we strongly support it. But we also support some further improvements.

Two main tasks need to be solved. The deposit insurance system should enhance the stability of the banking system through fair competition among the banks and by redistributing deposits from weak to sound banks. Also, the deposit insurance system should increase the confidence in the national banking system through fast repayment of compensation in cases of bank failures. The capital of the deposit insurance fund should be sufficient to compensate existing amounts of coverage.

In order to address the first concern we propose to introduce risk-adjusted insurance premiums set in accordance with a bank rating calculated by the NBB. We further propose that Belarusbank and Belagroprombank be restructured before they are included in the deposit insurance system. In order to address the second concern, we propose to set a legally defined target for the Reserve Corporation’s capital (3%).

The last point that we would like to mention is that although a deposit insurance fund may be very well designed, it makes little sense if the public does not know much about it. The core of a deposit insurance system is that people are aware of its benefits. For this purpose it is very important to run a broad information campaign, convincing the public of the safety features built into the financial system. This kind of activity should be practiced more actively in Belarus.

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[10] Data concerning the size of the insured deposits is not available; therefore we compared the deposit insurance fund’s capital to the total amount of household deposits.
[11] For these calculation we assumed that deposits by the public in dollar terms will grow at an average rate of 0.5% a month. Also, we assumed that the draft law will be adopted during the first quarter of 2004.