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## The drivers of institutional change in a post-socialist economy: The case of deposit insurance introduction in Russia

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## КАКИЕ ФАКТОРЫ ВЛИЯЛИ НА ИНСТИТУЦИОНАЛЬНЫЕ ИЗМЕНЕНИЯ В ПОСТСОЦИАЛИСТИЧЕСКОЙ ЭКОНОМИКЕ (НА ПРИМЕРЕ ВВЕДЕНИЯ В РОССИИ СТРАХОВАНИЯ БАНКОВСКИХ ВКЛАДОВ)

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*На примере введения в России страхования банковских вкладов показано, что институциональные изменения в постсоциалистических странах зависели от субъективных факторов, а выбор импортных институтов был относительно случайным. Обстоятельства появления в России формальной системы гарантирования вкладов помогают понять причины последующей неоптимальной работы данного института и вызванные им общественные издержки. Когда гарантирование вкладов стало темой парламентских обсуждений, материальные и институциональные условия для него ещё не сформировались. Основные акторы – крупнейшие банки и их вкладчики – не предъявляли особого спроса на право в сфере защиты банковских вкладов. Преимущества официальной системы гарантирования вкладов перед уже имевшейся системой имплицитных гарантий вкладов населения в Сбербанке были неочевидны, так как основной объём вкладов находился как раз в государственных банках. Автор полагает, что на институциональные изменения действовала комбинация факторов, а именно: искренние благие намерения авторов законопроекта; демонстрационный эффект со стороны опыта США и других западных стран; желание подорвать монополию Сбербанка на сбережения населения и улучшить конкурентные позиции частных коммерческих банков – возможно, под влиянием идеологического императива о преимуществе частной собственности перед общественной; наконец, поиск новой сферы деятельности для себя инициаторами закона о гарантировании вкладов. Несмотря на большую долю случайности в появлении данного института в России, он хорошо вписался в местную систему институтов благодаря своей патерналистской направленности.*

**Ключевые слова:** *институциональные изменения; Россия; импорт институтов; гарантирование вкладов; страхование вкладов; спрос на право; банки; стейкхолдер; групповой интерес; государственный патернализм; общественный выбор; политическая экономия.*

## THE DRIVERS OF INSTITUTIONAL CHANGE IN A POST-SOCIALIST ECONOMY: THE CASE OF DEPOSIT INSURANCE INTRODUCTION IN RUSSIA

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*The case of deposit insurance introduction in Russia may suggest that institutional change in transition economies was partly driven by subjective factors, and the choice of imported institutions was rather random. The circumstances under which explicit deposit insurance emerged in Russia might explain its subsequent (mal-)functioning and social costs. Material and institutional pre-conditions were missing at the time the topic of deposit guaranteeing came up in the parliament. The key actors (large banks controlling most household deposits and their depositors) did not demand hard a formal scheme of deposit protection. The advantage of an explicit protection scheme over the existing implicit one was unclear because of the prevalence of state-owned banks. I suggest that the introduction of deposit insurance was driven by a combination of factors such as: genuine good intentions of its proponents; demonstration effect of western experiences; the desire to disrupt the monopoly of Sberbank and boost the competitiveness of privately-owned commercial banks, probably stemming from ideological bias in favor of private ownership; and, last but not least, search for a new field of activity for deposit insurance initiators themselves. Despite the random selection, the institution of deposit guaranteeing fit well in the Russian setup because it was consistent with the long tradition of state paternalism.*

**Keywords:** *institutional change; Russia; import of institutions; deposit guarantee; deposit insurance; demand for law; banks; stakeholder; interest group; state paternalism; public choice; political economy.*

**JEL:** *E65, G21, G28, P34*

### 1. Introduction

Explicit deposit insurance<sup>1</sup> was enacted in Russia at the end of 2003 (*Law, 2003*) to become one of the multitude of foreign institutions imported into this country over the past two or three decades. Deposit insurance is an additional safety net that the government or market participants themselves use to protect deposit taking institutions and their clients. Explicit deposit insurance schemes have lately become omnipresent around the world, especially in Europe (*Demirgüç-Kunt, Kane and Laeven, 2015*). Still, the emergence of an explicit deposit insurance scheme in Russia was by no means pre-determined. The thrust of deposit insurance is essentially paternalistic and protectionist, which contrasts this institution against other foreign institutions imported into Russia in the 1990s whose thrust was to create a market economy and dismantle the paternalistic centrally-planned economy.

Institutional change in a post-socialist economy can be influenced by import of foreign institutions and their subsequent adaptation (*Tambovcev, 1997; Polterovich, 2001; Kuzminov,*

<sup>1</sup> I use terms “deposit insurance” and “deposit guarantee” interchangeably. The Russian Law refers to «deposit insurance» (*Law, 2003*), whereas the European bank regulator now leans toward the term “deposit guarantee” (*Directive, 2014*). Russian lawmakers have played with both terms; one of the numerous drafts carried the title, «On State Guaranteeing of Household Bank Deposits in the Russian Federation».

*Radayev and Yakovlev, 2005; Volchik, 2012*). Being introduced into post-socialist economies, a Western institution can yield dramatically different results depending on when and how it is introduced (*Woodruff, 2004*). The new institution can face a blockage by the existing institutional setup (*North, 1990*) as well as unforeseen effect such as misuse, manipulation, capture by interest groups, or corruption (*Radygin and Simachev, 2005; Polishchuk, 2008; Korytcev and Belokrylov, 2014; Guseva, 2014*); an imported institution can mutate (*Vernikov, 2009*). The circumstances of the inception of a new institution and the coalition of interests behind it matter for its sustainability and impact.

The institution of deposit guarantee malfunctions in Russia in terms of high costs it generates for the society (*Vernikov, 2018*). 461 cases of insured loss took place between 2004 and October 2018, meaning that over 40 percent of deposit insurance system members went bankrupt or lost their operating license. It affected 8.9 million depositors, and the total amount of compensations paid out by the deposit insurance system comes close to RUB 2 trillion (*ASV, 2018*), or USD 32.4bn if converted at the average exchange rate for each respective year. This figure corresponds to 2 percent of Russia's annual GDP in 2017 but reflects only one part of the fiscal cost because the authorities bailed out several large failed banks bypassing the deposit insurance system<sup>2</sup>.

With that in mind, I revert to the circumstances under which explicit deposit insurance emerged in Russia, focusing on the interests of its stakeholders. I rely upon publicly available statistical data along with personal pronouncements and statements made by the key participants, rather than the writings of unrelated experts. This study will hopefully shed additional light on the mechanism of public choice regarding economic institutions borrowed abroad. I view this as an element of «error analysis» meant to minimize damage from imported institutions.

The rest of the paper is organized as follows. Section 2 summarizes the reasons for explicit deposit insurance and their validity in the particular case of Russia. Section 3 investigates the motivation of Russian deposit insurance proponents. Section 4 considers the interests of other stakeholders such as depositors, bankers, bureaucrats, politicians, and external parties. Section 5 concludes.

## 2. Explicit deposit insurance in the Russian context

The main theoretical argument in favor of deposit guarantee relates in essence to liquidity management at the bank. Any deposit-taking institution faces the risk of a «run» by depositors trying to withdraw their funds all at the same time due to a sudden panic and herd behavior. No bank can handle such a liquidity crisis independently, regardless of its soundness and long-term solvency. Depositor runs on banks produce mass-scale bank failures that carry high social costs and are therefore deemed unacceptable to the society. Hence the idea of putting in place an additional safety net. Deposit guarantee is called to prevent bank failures by quenching panic (*Merton, 1977; Bryant, 1980; Diamond and Dybvig, 1983; Keely, 1990; Calomiris, 1999; Allen, Carletti and Goldstein, 2015*). By aiding banks to maintain their deposit base, the guarantor, in most cases the state, acts on the micro-level but ultimately pursues macroeconomic stability.

Another commonplace argument in favor of deposit guarantees reflects the social dimension. The government offers additional protection to the interests of small depositors («ordinary people») who are most vulnerable financially and presumably unable to assess the quality and riskiness of their bank. Deposit insurance is presented as an inclusive institution that improves access to banking services for broad public on a fair and equitable basis. Deposit guarantee schemes are often biased in favor of relatively small deposits.

<sup>2</sup> At the same time, a part of the fiscal cost can later be recovered by claiming the assets of the failed banks. Recovery ratio is, however, low, in the range between 12 percent and 20 percent of nominal.

Explicit deposit insurance became a topic in Russia in the early 1990s<sup>3</sup>. By that time, the traditional goal of maintaining household savings at depositary institutions was only partly relevant. Much of personal savings accumulated prior to 1991 had evaporated due to hyperinflation. Households and even businesses switched to foreign currency banknotes as a means of savings and payment for big-ticket items. A large proportion of the population sank into misery, had no monetary savings to speak of nor use banks to store them. That being the case, the name of the game was not to safeguard existing deposits but rather to ensure an inflow of fresh funds into banks and to encourage households to convert cash savings into bank money.

The idea of deposit guarantee was tackled by parliamentary and executive authorities against the backdrop of high inflation rates, economic downfall, and political instability. Monetary circulation was “dollarized”, and households credited commercial banks with little trust. Most importantly, Russia’s key peculiarity was the existence of a state-owned depositary institution, the Savings Bank (Sberbank), which follows a secular trend of active state involvement in financial entities. By contrast, in the United States all deposit-taking institutions were private before and after the introduction of explicit deposit insurance in 1933. It then makes sense for the government to create a safety net for unrelated private market players. In the Russian case, however, the informal institution of implicit state guarantee covering all household deposits at Sberbank had been performing satisfactorily (*Avdasheva and Yakovlev, 1998*), therefore the advantages of an explicit scheme over the implicit one were not immediately obvious. In addition, the poor state of public finances in that period hardly allowed for experiments with assuming additional fiscal or quasi-fiscal liabilities. It was largely due to fiscal constraints that implementation of the idea of explicit deposit guarantee was postponed until 2003 when Russia’s economic and fiscal position improved.

In the early 1990s, the survival of Sberbank as the national champion in the household deposits market was questionable. It looked quite probable that the largest state-owned bank would either undergo disruption and annihilation, following the fate of other «spetsbanki» (specialized state-owned banks), or fall into the hands of a strategic foreign investor similarly to what happened repeatedly in central and south-eastern Europe. Either of these two scenarios would call into being an explicit scheme of deposit guarantee, because popular trust in Sberbank would face a serious test. However, by 2004 when the Deposit Insurance Law came into effect, such a probability was already remote while the recovery of public sector, the leadership of Sberbank and the moderation of foreign bank expansion in Russia had become undisputed trends. If so, then the case for an explicit guarantee scheme was objectively weak.

Introduction of explicit deposit insurance and its key features can relate to external obligations of the country. The European Directive 2014/49/EU (2014) prescribes at least one deposit guarantee scheme for each member country in order to embrace all deposit taking institutions without exception. The protection limit is set at EUR 100,000 (*Directive, 2014*) which is over-generous with regard to average incomes and savings in central and south-eastern Europe. Those countries were forced to implement the entirety of European legal institutions (*Acquis Communautaire*) and could not choose parameters of deposit insurance appropriate for them. Russia was and still is free of any international obligations in respect of deposit guarantees, so whatever happened was of its own devise.

American theorists of deposit insurance warned about potential risks and hazards of an explicit scheme, with a special emphasis on moral hazard in the shape of reckless irresponsible financial behavior. The owner of an insured deposits has lesser reason to invest efforts in

<sup>3</sup> I find relevant and pertinent to consider the circumstances prior to the Federal Law adoption in December 2003. Deposit guaranteeing of some sort can have appeared several years earlier. Presidential Decree No. 409 «On Protection of Russian Citizens’ Savings» (<http://www.kremlin.ru/acts/bank/3286>) was issued in March 1993 but never implemented. The first draft law on deposit guaranteeing dates back to spring 1994.

the monitoring of her bank's soundness and riskiness. Parasitic attitudes of depositors erode market discipline because an insured depositor relies on the guarantor for a bailout and is less likely to punish reckless banks by an outflow of deposits. As far as banks are concerned, deposit insurance indirectly encourages them to act more aggressively and choose riskier projects for investment of the collected resources (*Martínez-Pería and Schmukler, 2001; Cull Sorge and Senbet, 2005; Hogan and Johnson, 2016*). Due to deposit guarantees, banks depend less on a potential outflow of funds whose owners may find out about high-risk investments made by the bank. «Moral hazard» increases the risks of individual banks and the banking sector as a whole and thus the chances for individual failures and the likelihood of a systemic crisis. The connection between deposit guarantee and «moral hazard» finds proof in most of the empirical studies, including those covering Russia (*Peresetsky, 2008; Cámara and Montes-Negret, 2006; Ungan, Caner and Özyıldırım, 2008; Karas, Pyle and Schoors, 2010; Chernykh and Cole, 2011; Karas, Pyle and Schoors, 2013*). Availability of deposit insurance in combination with the rehabilitation of failed banks with the use of huge public funds have affected the attitudes of Russian depositors who are now less likely to panic over negative media coverage on banks. Depositors' sensitivity to their bank capitalization diminishes after the introduction of deposit insurance, and the numbing effect of deposit insurance remains in place even during a financial crisis (*Karas et al., 2013*). Depositors are aware of the fact that in case of scarcity of funds in the deposit insurance system due to the failure of large banks, the central bank will immediately replenish those funds.

To put deposit guarantee in a slightly broader context, it has strong repercussions with the paternalism that has long been, and still remains, a powerful social institution in Russia (*Nureev and Latov, 2017*). According to a public opinion poll by Levada Center in July 2018, 62 percent of respondents supported the view that «the state must look after all its citizens by ensuring them a decent living standard» (<https://www.levada.ru/2018/08/23/rossiyane-trebuyut-ot-gosudarstva-zaboty/>). A typical person expects the authorities to reimburse her for the losses suffered due to an unfortunate selection of a bank. It is presumably the duty of the state to be liable for failed banks, because it was the state who authorizes the activity of the bank in question and the public advertising of its services. Rightly or wrongly, the state perpetuates such expectations by meeting them.

The design of the Russian deposit protection scheme reflects its thrust towards paternalism. In the majority of instances the legislators opted in favor of the more paternalistic alternative instead of the less paternalistic one.

### 3. The proponents of deposit insurance in Russia and their motivation

It is hard to determine what exactly drives the proponents of a new institution. A researcher can only make assumptions with regard to the motivation and the true interests of the initiators of deposit insurance in Russia on the basis of available documents and known facts.

Deposit protection was promoted by a small group of politicians and experts spearheaded by two members of the parliament, Mr. Pavel M. and Mr. Alexander T. The idea of deposit insurance came about spontaneously, or at least there is no evidence of its origins. According to the main proponent of deposit guarantee in Russia, some “unfamiliar Americans accidentally” dropped into his office at the Supreme Soviet of Russia and gave him as a gift some 100 American books on banking. From those books Mr. M. learned that deposit insurance was a “good cure” against such a malaise as defrauded depositors (*Krotov, 2009, pp. 39–40, 42*). I find no evidence of deposit insurance being an element of a broader plan or a blueprint of reforms, something going back to the theory of institutional design (*Ostrom, 2005*). Instead, it was largely an *ad hoc* response to immediate challenges.

The most basic and self-evident motivation of the proponents of an initiative like deposit insurance is, by default, the sincere good intention to improve the current situation. In the early 1990s, the current situation in the Russian economy and finance was unsatisfactory.

Another powerful potential driver is the demonstration effect, i.e. the desire to arrive at a similar setting as that in so-called “advanced” or “civilized” countries. In the 1990s, Russia remained one of the few industrial countries without an explicit deposit insurance scheme. Demonstration effect and references to foreign countries were very prominent in the public statements made by deposit insurance initiators during that period. The fact that other countries already had deposit insurance was a reason good enough to argue that a similar system must be introduced in Russia too (*Krotov, 2009, pp. 45, 134*), regardless of specific domestic circumstances. The demonstration effect of western practices was reinforced by travel: «The first foreign trips to study banking experience proved the correctness of our efforts» (*Krotov, 2009, p. 134*). An instrumental learning trip to the United States was organized in 1993 by Mr. Gerald Corrigan, President of the Federal Reserve Bank of New York. The experience of the United States with deposit insurance served as the central reference point in the mind of Russian deposit insurance adepts. According to a key project team member, they later studied the best practices of a quite a few countries, but, «to be fair, we mostly relied upon the experience of the United States as the first country to put in place a system of deposit protection that proved to be effective» (*Krotov, 2009, pp. 66, 214*).

Personal factors and *ad hoc* considerations played a significant role in the shaping of the position of the parliamentarians. The personality of the main initiators was the key driver of the process. A project team member recalls that the draft law was promoted exclusively by the enthusiasm of a few highly motivated individuals. The entire structure of mutual understandings and compromises would have collapsed, had those individuals dropped out for a month or even a week. Many MPs would only agree to endorse the deposit insurance draft after being approached personally and individually by Mr. M. whose charisma and reputation were strong (*Krotov, 2009, pp. 98-99, 113, 130, 303*).

### 3.1. *Explicit motivation*

Describing one of his discussions on deposit insurance, Mr. T. says, «We were so firmly convinced in the need for that law that no objections of the government whatsoever could upset us» (*Krotov, 2009, p. 77*). I thus try to trace the sources for such a firm conviction. The official arguments for an early introduction of deposit insurance in Russia were a standard set including the following points: deposit insurance can stabilize the banking system, significantly reduce the risk of a systemic crisis, and protect the small saver.

The instigators of the deposit insurance law point out that their key task was to ensure an inflow of household savings into banks by improving trust. Neither the population nor the government trusted commercial banks, so an explicit guarantee scheme was viewed as a tool to overcome that. The authors of the draft law saw no alternative solutions to the issue of mistrust other than guarantee deposit repayment (*Krotov, 2009, pp. 59–60*). Improving bank quality, setting up prudential regulation and withdrawing unsound banks were not viewed as viable alternative options because their implementation required too much time. This is an important point. American theorists of deposit insurance made their modelling on the basis of the assumption that the banking industry consists of fundamentally sound banks with sufficient long-term solvency. These banks are undeservedly punished by a liquidity crisis stemming from depositors’ panic and herd behavior, so here is the case for deposit guarantee. The Russian situation was quite different. Many existing banks did not meet basic soundness requirements and essentially did not deserve the trust of the depositors. Instead of being a means to prevent only inefficient runs on sound banks due to merely psychological reasons, in Russia deposit insurance was from the inception meant to achieve something else, namely to prevent efficient runs on fundamentally unsound banks whose existence presented a genuine threat to the funds entrusted by private depositors.

The task of improving trust in the banks had a macroeconomic dimension by bringing savings into the formal banking system. But its relevance varied from one actor to another.

The nation's leading depository institution, Sberbank, had handled the task of savings accumulation before and would have been able to keep doing so, largely thanks to state ownership. The Russian state produces institutional-based trust in the banking system through its roles as bank owner and regulator (*Spicer and Okhmatovskiy, 2015*).

The Russian proponents argued that deposit guarantee would enhance a beneficial bank competition<sup>4</sup>. The rhetoric about the benefits of competition meant in the particular Russian context just one thing, namely the disruption of the leading position of Sberbank in household deposits. This articulation was usually avoided in public, with the notable exception of the then minister of economic development and trade who at an official meeting on 18.09.2000 argued for a joint government – Central Bank of Russia (CBR) scheme to fight against the monopoly of Sberbank on private deposits via household savings guarantee (*Krotov, 2009, p. 256*). If breaking up Sberbank monopoly was the true goal, then other things start making sense, in particular the timing of deposit guarantee introduction that was suboptimal from other viewpoints, and also the parameters of the deposit protection scheme.

One faction within the top management of the CBR endorsed the unorthodox idea of using deposit insurance as a leverage in order to clean up the banking sector. According to them, a strict selection at the entrance into deposit insurance system could convert an upgrade of banking supervision, a rehabilitation of the banking sector and the introduction of deposit insurance into a single mutually-complementary process (*Krotov, 2009, pp. 282–283; 308*). The feasibility of a really sharp entry selection was, however, illusionary because banks possessed substantial lobbying potential often exceeding that of the CBR. As a result, the regulator had to accept a compromise in various instances by accepting into the deposit insurance system a vast majority of applicant banks. Approximately three-fourth of all Russian banks became system members. Many of those had subsequently to be withdrawn from the system at the expense of huge loss of funds, both public and private.

Therefore, the explicit reasoning in favor of a soon introduction of an explicit scheme, as a matter of fact, called for a misuse of the institution of deposit insurance, i.e. an application not provided for by the theory nor the logic of deposit insurance in an advanced market economy (*Vernikov, 2018*). Employing deposit guarantees as a competition-enhancement mechanism and a tool for removing weak or criminal agents from the banking sector is an institutional innovation that bears the features of misuse of an institution (*Polishchuk, 2008*). Other ways and means exist to pursue the same objectives more effectively.

### **3.2. Implicit motivation<sup>5</sup>**

Paternalistic instincts and views influenced explicitly and implicitly the idea of deposit guarantee and the parameters of the would-be scheme. A former senior official of the CBR argues that “*ordinary bank clients are a passive majority, and their material interests must be protected out of general humanity as well as for the sake of banking system stability*” (*Krotov, 2009, p. 77*). After an extensive fierce debate, the principle of voluntary bank membership in the deposit protection scheme was abandoned. In a paternalistic environment, neither depositors nor commercial banks would take their commitment seriously. Banks would fail to ensure voluntarily the accepted deposits. After bank failure, its depositors would anyway urge the government to reimburse them, regardless of legal grounds for reimbursement. The government, in its turn, would have to commit public funds for reimbursement like it did in 1998 and on many other occasions<sup>6</sup>.

The true agenda of the main actors can be different from that publicly voiced and written down. An unaffiliated researcher can make a judgment in that respect with the help of logic

<sup>4</sup> Contemporary literature offers empirical proof that, depending on various country-level specificities, more intense bank competition can increase either bank stability or bank fragility (*Berger, Klapper and Turk-Ariss, 2009; Beck, De Jonghe and Schepens, 2013*).

<sup>5</sup> All assumptions and allegations contained in this section are speculative and subjective.

<sup>6</sup> In 1998, the CBR transferred household deposits from 6 large failed banks into Sberbank. «Transfer» was a euphemism because those failed banks had insufficient liquidity anyway, so the state essentially undertook to replay depositors at its own expense in order to calm down the public. It was 5 years before the formal deposit guarantee was introduced, and the government was in no way liable for deposits at private “oligarchic” banks. Legality thus matters less than the “spirit” of the prevalent social norm.



and documented written statements made during the debate around deposit insurance law. Apart from paternalism, I assume the effect of the following two implicit motives:

- To boost the competitiveness of privately-owned banks; and
- To create a new sphere of activity for the initiators themselves.

The trust of depositors in Sberbank was beyond the scope of discussion and certainly not a priority, at least there is no documental trace of it. Initial drafts and understandings left Sberbank beyond the deposit protection scheme, so the latter was meant to benefit privately-owned banks exclusively. The reason for such a focus was clearly the distrust that private commercial banks enjoyed due to their youth and fragility. Also, commercial banks were seen as a superior financial intermediary as compared to the then proliferous non-bank deposit-takers many of which were essentially fraudulent Ponzi schemes. The presence of such actors is an important special feature of Russia which may not be relevant for other countries contemplating deposit insurance.

Deposit insurance equalizes the capability to attract household deposits of a large state-owned bank that is trusted by the population, on the one hand, and banking institutions that are not. The initiators of deposit insurance counted on its selective action that would provide resources to privately-owned banks and strengthen them at the expense of Sberbank, the state-run monopoly. As noted before in this paper, the disruption of market leadership of Sberbank was an implicit goal of high priority, although the proponents of deposit insurance for private banks avoided spelling it out in public. It is hard to trace the origins of such a motivation. I admit here a primary ideological bias in favor of private ownership which presumably is, on its own right, superior to public ownership. Other types of motivation may have been present too.

Introduction of a new economic institution in a post-socialist country can as well be driven by the desire of its initiators to create a new sphere of activity and a new organization offering well-remunerated executive positions of high prestige (*Yakovlev, 2003*). The deposit insurance project enjoyed active support from members and employees of the parliamentary sub-committee on banking. Another deeply involved entity was the Agency for Rehabilitation of Credit Institutions (ARKO). ARKO was established to accomplish a definite task, and by the early 2000s the task has been successfully accomplished. Its managers knew that the functions of ARKO would soon become redundant (*Krotov, 2009, p. 247*). They were objectively interested in an extension of ARKO mandate and mission. Hence ARKO aspired for the status of administrator in the new deposit insurance fund, claiming broad powers in the field of bank regulation that had been CBR monopoly hitherto. The objective was attained with some corrections, ARKO was converted into Deposit Insurance Agency (ASV), and the head of ARKO became ASV head.

My hypothesis about implicit motivation of deposit insurance promoters is consistent with the sequence of implementation of the new institution. Speed received priority over substance and quality. Deposits received protection despite the risks coming from hundreds of weak banks and the general lack of trust in the market. In the legislative process the initiators of the deposit insurance law accepted various compromises in the design of the new institution, for the sake of its expeditious introduction, no matter what. The Presidential Decree «On the Protection of Household Savings in the Russian Federation» (1993) contained mistakes: for instance, bank assets were confused with bank liabilities. But for the proponents of deposit insurance the substance of the document mattered less than the very fact of finding support at the top level of authority. Mr. M. was satisfied with the fact that «the President endorses our idea. Moreover, we identify in the text entire sentences, albeit distorted, that were borrowed from our proposals. ... In order to see any kind of law on deposit insurance enacted, I would even accept a narrow mandate of the (deposit insurance) fund that would be restricted to just a paybox» (*Krotov, 2009, pp. 44, 63*).

#### 4. The views and the motivation of other stakeholders

##### 4.1. Bank depositors

The most sensitive subjects for Russian households in 1993–1994, when the deposit insurance discussion started, were actually unrelated to deposit insurance as such. Savers were much more concerned with the loss of their savings resulting from hyperinflation and domestic currency depreciation. Another hot issue was the large scale activity of Ponzi schemes and other crooks. Explicit deposit insurance was incapable of directly addressing either of those problems.

The bulk of household deposits (70.5 percent in 1997 and 63.3 percent by end-2003) rested with the state-owned Sberbank (Fig.1). Those deposits enjoyed an implicit guarantee from the government, although no special allocation in the annual budget existed to back up the guarantee. Sberbank depositors were nevertheless contempt with the implicit protection scheme. They did not push for an explicit one which would add them little value, if any. Paradoxically, the formal protection scheme lowered the level of protection of Sberbank depositors instead of raising it, because the implicit guarantee had no coverage limit, whereas the explicit scheme introduced a relatively small one.

According to this author's calculation based on CBR data, foreign subsidiary banks had ca. 8 percent of household deposits at the end of 2003. They showed no interest in a formal involvement of the Russian government. Domestic privately owned banks controlled ca. 24 percent of household deposits. The client base of privately owned banks included urban middle class, a younger and more economically literate audience (*Karas et al., 2013*). Those relatively affluent citizens who had benefited from socio-economic reforms since 1991, i.e. a numerically lesser group of Russian depositors, were objectively interested in an additional guarantee of repayment of their bank deposits. The idea of deposit guarantee thus obtained support from active and influential elements of this depositor group.

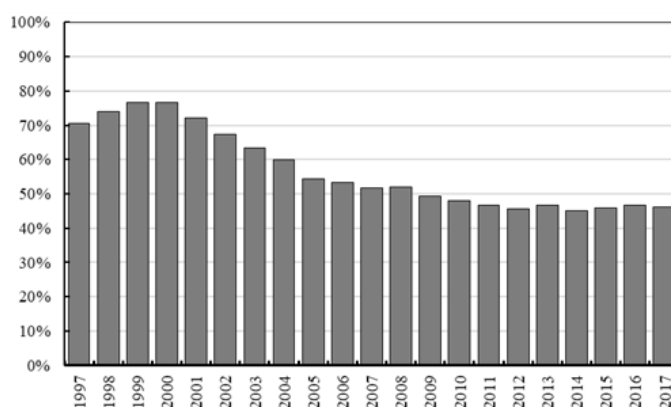


Fig.1. The market share of Sberbank in household deposits

Sources: Sberbank; CBR

Assuming that the average size of deposit was equal across all banks, it can be argued that ca. one-quarter of all depositors objectively needed a formal guarantee scheme run by the government. The actual average size of deposit at Sberbank may have been somewhat lower than at privately-owned banks, so the share of private banks in the number of depositors could be lower than in the volume of deposits.

While the majority of Russian depositors felt indifferent about the would-be deposit guarantee system, the introduction of that institution met no opposition either. The paternalistic thrust of deposit guarantee ensures it overwhelming support from the population that expects from it windfall gains and no costs. Immediately after being enacted, deposit guarantee created itself an extremely broad social basis.

#### 4.2. *Bank owners and managers*

Neither Sberbank nor foreign subsidiary banks sought additional deposit protection from the Russian government whose financial position in the 1990s was precarious. Foreign subsidiary banks rather relied on the strength of the parent bank brand. In most cases the financial standing and the credit rating of those parent banks was much higher than that of the Russian Federation. This was became even truer after the confidence crisis in 1998–1999 when foreign subsidiaries remained as the most trusted financial intermediaries in the market.

Therefore, the main, if not the only, direct beneficiaries of explicit deposit guarantee belonged to the group of domestic private banks. For them the ability to collect household deposits was a vital competitive advantage and sometimes a survival tool, in view of unavailability of other feasible sources of funding. Among privately-owned banks some pursued malign intentions from the outset, planning a tunneling and theft of depositors' funds. According to the author's calculation, it grew from 20 percent in 2002, when deposit insurance was still missing, to its peak level of 35 percent in 2007, a few years after deposit insurance adoption. Deposit insurance boosted the household deposit volumes at private banks indiscriminately, i.e. including small and regional banks (*Chernykh and Cole, 2011*), many of which had no previous experience of serving that customer base. According to deposit insurance initiators, however, owners and senior managers of private banks usually stood against an explicit guarantee scheme because participation in that scheme would necessarily imply their financial contributions and additional external control.<sup>7</sup> That applies to large private banks (the so-called "oligarchic" banks) as well as second-tier private banks. The "oligarchs" claimed that their banks were trustworthy enough and could do without an additional safety net, but they mainly did so because there was little trust between private bankers themselves. In the 1990s, the Russian banking industry was even more fragmented than it is now. There were too many banks, their transparency was low, and so bankers had little trust in each other. By declining to participate in voluntary guarantee schemes, private bankers expected that at the end of the day they could get a free ride because the government would undertake all costs.

A plethora of banking unions, associations and clubs existed all around Russia, including two large associations disputing national leadership. One of them subscribed to the idea of deposit guarantee. The leaders of the Association of Russian Banks (ARB) supported deposit insurance and made their personal opinion well heard by signing appeals for deposit insurance. The opinion of the broad membership base of ARB on the same issue was, however, negative, and the majority of bankers disapproved the deposit insurance initiative. On one occasion in 1995, ARB management may have misrepresented the outcomes of a poll of commercial bankers regarding deposit insurance that showed support to the initiative (*Krotov, 2009, pp. 46, 67, 86*). I see this as an illustration of public choice peculiarity in Russia. The opinion of a social organization or a business association presented to the national authorities can contradict the opinions of the majority of individual members. It goes against public choice theory which assumes that a flagship industrial association is a collective representative of the interests of its members. That is the basis for viewing the business association as a mechanism for coordinating the interests between business and the state (*Yakovlev and Govorun, 2011*). One cannot be sure that the opinion of stakeholders of a business association is adequately relayed to the authorities; what *is* relayed might reflect the opinion of just the association leader.

#### 4.3. *Bureaucrats and public politicians*

The discussion over the draft law on deposit insurance lasted more than 9 years. It reflected a conflict between populism and paternalism, on one hand, and pragmatism, on the

<sup>7</sup> Commercial banks in the city of St.-Petersburg were a notable exception because they succeeded coming to terms about a local mutual guarantee scheme, quite similar to those that existed in the United States before FDIC.

other. Deposit insurance is a potentially profitable subject in terms of political dividends. It enables a politician to position himself as a defender of vital material interests of “ordinary people” who presumably cannot distinguish between a good bank and a bad one. Populist themes like deposit insurance help winning elections. The subject of deposit insurance was prominent in the parliamentary election materials of Mr. M. (*Krotov, 2009, pp. 105, 244*).

On the other hand, Russia could not afford deposit insurance in 1993 when the idea was first floated. It neither had financial resources to jump-start the system nor the tools to discipline the hundreds of financial institutions calling themselves banks. Pragmatists used to challenge the enthusiasm of deposit guarantee proponents by pointing to the weaknesses in the banking sector and the fiscal situation. No politician would want to appear as the opponent of deposit insurance, regardless of economic and legal details. Even opposition party members were reluctant to openly attack the draft law pushed by the ruling party, on the fear that such a motion would give them a bad image. Opposition MPs would rather endorse the initiative verbally but then use bureaucratic maneuvering in order to hinder or impede the adoption of binding resolutions. The proponents of deposit insurance allude that large commercial banks were lobbying in the parliament and the government with the aim of delaying or blocking the adoption of deposit insurance law

President Boris Yeltsin issued two decrees on deposit protection and recovery in 1993 and 1994 (neither was implemented) and subsequently lost interest in the subject (*Krotov, 2009, p. 44*).

A consensus regarding deposit insurance was missing in the top echelon of the executive branch and monetary authorities. The proponents of the new institution had to overcome the resistance of the bureaucrats. The draft law on deposit insurance has collected abundant negative feedback from ministries, CBR, and governmental and presidential staff. The Federation Council, the supreme chamber of the parliament, vetoed it twice, and the President once. The discussion mostly rotated around matters such as:

- (a) The status, mandate and amount of resources at the disposal of the would-be agency to run the deposit insurance system;
- (b) The method and the precise sources of funding and other parameters of the insurance scheme;
- (c) the feasibility and risks of introducing deposit guarantee prior to a strengthening of the banking supervision and a removal of unsuitable unviable players from the banking industry; the timing of the deposit insurance law relative to the failed bank resolution law; and
- (d) Voluntary or compulsory membership of banks in the deposit insurance scheme and the role of Sberbank.

Prior to the crisis of 1998, what I perceive to be a majority of senior officials and experts at government agencies in charge of finance and the economy, including the CBR, were skeptical about a fast introduction of deposit guarantee. The common concern was that the government, the relatively solid banks and especially Sberbank would waste their funds to reimburse the depositors of weak delinquent banks. The government and the taxpayers at large would thus assume responsibility for improper operation of banks (*Izvestiya 19.11.1994*). The minister of finance warned that his Ministry and the CBR would become liable for the lending policy of private commercial banks, never mind sound or not (*Kommersant-Vlast' 27.10.1998*). Mr. Sergey K. Dubinin, the CBR head, insisted that deposit insurance fund or corporation should not appear until a rehabilitation of weaker lending institutions is completed (*Krotov, 2009, p. 146*). His successor at the top of CBR Mr. Viktor V. Gerashchenko objected to the government assuming obligations before private commercial bank depositors who had lost their savings. Citizens made a free choice between deposits in Sberbank and in a commercial bank and must now face the consequences without appealing to the government (*Krotov, 2009, p. 197*).

Many experts pointed to the limited capability of the bank regulator to deal with over 2,000 banking entities that existed at the time the deposit insurance initiative emerged. By the date of deposit law adoption, the number of banks fell to 1,277, in addition to several hundreds of banks in the process of liquidation, which was still a very high number overstraining the resources available for bank supervision and regulation.

I do not rule out that the main objection of bureaucrats to deposit insurance had to do with the above listed point (a), i.e. the status, mandate and amount of resources at the disposal of the would-be agency in charge of deposit insurance. The new agency claimed some of the powers of the CBR, especially in the field of bank licensing, supervision and regulation. The significance of disagreements over other contentious matters (b), (c) and (d) was then somewhat overdone in order to leverage the opponents on point (a).

#### 4.4. External stakeholders

The World Bank has sponsored extensive surveys displaying explicit deposit insurance as international «best practice» deserving a universal implementation (*García, 2000*). At the same time, leading experts from international financial institutions (IFI) refer to evidence from dozens of developing countries to warn against premature introduction of official deposit insurance in an environment of inadequate transparency and weak regulation including failed bank resolution, banking supervision, external and internal audit, reputed lender of last resort etc. (*Demirgüç-Kunt and Kane, 2002; Cull et al., 2005; Cámara and Montes-Negret, 2006*). Russia did not meet such criteria in 2003 when the Deposit Insurance Law was adopted, and even less so in the 1990s when first attempt to introduce an official deposit insurance took place.

IFIs such as the World Bank and the International Monetary Fund have played an instrumental role in promoting structural reforms worldwide, particularly financial system reforms (*Orenstein, 2008*) in post-communist economies. Russian promoters of deposit insurance garnered encouragement, technical assistance and financial support from international bodies such as European Commission and European Bank for Reconstruction and Development, from western central banks and governments, as well as from peculiar NGOs like the Financial Sector Volunteer Corps (FSVC) of the United States. European Union allocated a special personal grant to Mr. M. to finance the preparation of the Deposit Insurance Law (*Krotov, 2009, p. 109*). One might wonder, what exactly interest the EU pursued by committing that funding. At the same time, pro-deposit insurance pressures coming from either IMF or the World Bank are not documented. Operative staff of the IMF and World Bank directly involved in lending programs for Russia disapproved immediate introduction of an explicit protection scheme (*Krotov, 2009, pp. 258; 357–358*), pointing to the presence of unfit actors in the banking sector and the budget constraints.

#### 5. Conclusion

The case of explicit deposit insurance dealt with in this paper is interesting from the viewpoint of identifying the drivers of institutional change in post-socialist economies like Russia in the 1990s. Contrary to the teachings of economics of transition, the selection of institutions to be imported from the West and implemented locally was, to a large extent, done *ad hoc* under strong influence of random, personal and cognitive factors. Russian banking industry could well have survived until now without an explicit deposit protection scheme. Economic and social actors such as large banks and their depositors presented little, if any, demand for a formal legal institution. The country's economy and governance system were unprepared for the introduction of explicit deposit protection in the early 1990s when the idea was first floated. The domestic banking sector was full of tiny weak banks whose number was actually on the rise. At the same time, many important institutions were still missing in the area of bank regulation and resolution. Importantly, the government simply

could not afford taking on additional material liabilities to the households because its fiscal position was unsatisfactory. The advantages of an explicit scheme over an implicit one are less obvious in cases where the bulk of household deposits already sits at state-owned banks and is thus already guaranteed by the government. That holds true for Russia and other emerging markets likewise.

Those considerations did not matter, after all, and explicit deposit insurance was successfully pushed by a small group of highly motivated individuals comprising parliament members, experts and bureaucrats. The political economy of deposit insurance adoption in Russia suggests a combined action by three groups of drivers:

- Good intentions and personal beliefs of the proponents, under demonstration effect from the experience of the United States and other western countries;
- The interest in disrupting the monopoly of the state-owned savings bank for the sake of promoting bank competition and improving the competitiveness of privately-owned banks (probably deriving from an ideological bias in favor of private ownership);
- Search for a new sphere of activity for a specific group of civil servants and politicians.

Neither the main potential beneficiaries of deposit guarantee (private bank owners and depositors) nor did external parties drive the process in our case, unlike on many other occasions of western institutions import into Russia. Despite the random choice and the compromising design of deposit insurance in Russia, this institution soon acquired a broad social base and fit the local institutional setup, due to the coherence with the secular tradition of state paternalism.

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