

Misuse of institutions: The case of deposit insurance in Russia

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Abstract

I argue that the institution of deposit insurance (DI) was misused and abused in Russia. It was misused by the Russian authorities and abused by unscrupulous private bankers. While being common practice among industrial economies, household DI is a relatively recent (2003) addition to the institutional mix in Russia, under influence from international advisors and peer pressure. The classical model views DI as a means of preventing bank runs and quenching panic among depositors that poses a threat to financial system stability. In Russia, however, this was less relevant. By the time DI emerged, the bulk of household savings rested with the state-owned Sberbank and enjoyed an implicit guaranty of the state, therefore an explicit scheme was rather a formality. The true purpose of DI was to enhance artificially the competitiveness of private banks and reshape banking market structure in their favor, at the expense of Sberbank and other public banks. Neither public banks nor foreign bank subsidiaries were interested in DI and resisted the idea at the stage of conceptualization. Private bank owners and managers were the main beneficiaries of DI introduction and forced their way into the DI system never mind the cost. The same group of interests subsequently abused the institution of DI by luring depositors with higher interest rates and using their funds to finance improper investments or including outright stealing of those funds. The effects of DI in Russia have been largely negative in terms of moral hazard, bank instability, criminalization of private bank business models, and welfare loss. The competitiveness of private domestic banks received a temporary boost from deposit insurance; now the effect is vanishing. Russian experience suggests that DI is an unsuitable tool for enhancing bank competition and should not be used in that capacity. The parameters of the Russian DI system were in disregard with the local market structure and with the institutional context.

Contribution to the literature

This paper aims to contribute to three different streams of literature:

- (1) *Institutional transfer and misuse of institutions (Polischuk, 2008)*: I illustrate some of the patterns of misuse of institutions in the specific case of deposit insurance in Russia;
- (2) *Deposit insurance*: I show what happens when the design of the DIS is misaligned with the local institutional mix and the ownership structure of the domestic banking sector;
- (3) *Assessment of the regulatory impact of government policy*: I argue that DIS may fail a

cost/benefit test in Russia and try to quantify this allegation.

Motivation

The motivation for this paper came from the literature featured above. I was especially driven by the concept of misuse of institutions, its typology and the discussion of its causes (Polischuk, 2008) that augments the research of institutional change and institutional import (North, 1990; Polterovich, 2001; Oleynik, 2005; Kleiner, 2005; Kirdina). Literature on deposit insurance and its effects now embraces both theoretical works (Diamond, Dybvig, 1983; Keely, 1990) and empirical studies (Martinez-Peria, Schmukler, 2001; Demirgüç-Kunt, Kane, 2002; Demirgüç-Kunt, Detragiache, 2002; Demirgüç-Kunt, Huizinga, 2004; Demirgüç-Kunt, Karacaovali, Laeven, 2005; Cull, Sorge, Senbet, 2005; Anginer, Demirgüç-Kunt, Zhu, 2014). There are papers focused on the effects of DI in Russia (Avdasheva, Yakovlev, 2000; Kuzina, 2005; Camara, Montes-Negret, 2006; Peresetsky, 2007; Ungan, Caner, Özyıldırım, 2008; Karas, Pyle, Schoors, 2010; Chernykh, Cole, 2011; Chernykh, Sokolov, 2012; Pyle, Schoors, Semenova, Yudaeva, 2012; Karas, Pyle, Schoors, 2013; Ibragimova 2015). Existing literature, however, does not treat the negative effects of DIS in Russia as a systemic institutional failure, so my paper aims to put it in a new context.

Along with academic motivation, there was also empirical one stemming from the dramatic developments in the Russian banking industry where some large deposit-takers collapsed over the past several years causing huge fiscal and monetary impact for the rest of the economy. I see here a direct effect from the existence and the design of the DIS that eroded market discipline and enabled criminal business models by unscrupulous bankers in the private sector.

Data and Methods

The **empirical** component of the paper relies on bank-level statistical data for Q1 2005 through Q4 2016, available from the Central Bank of Russia. Apart from looking at the actual shares of different banks in the market for household deposits, I simulate the trends prior to DIS introduction to see what the market structure would have looked like in the absence of DIS. Cost-benefit analysis of the DIS involves data from the Deposit Insurance Association and the CBR.

Key words: Russia; deposit insurance; banks; misuse of institutions; assessment of regulatory impact; state-controlled banks

JEL codes: G21, G28, P23

I request that this paper be placed in the program of the **Section O “State and Local Government Challenges”** or **Section D “Theoretical Economics”**.