The Effect of DIS on Banking Sector Development: The Example of Kazakhstan, Russia and Ukraine

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THE EFFECT OF DIS ON BANKING SECTOR DEVELOPMENT: THE EXAMPLE OF KAZAKHSTAN, RUSSIA AND UKRAINE

The purpose of this paper is to assess the effect of deposit insurance systems (DIS) on banking sector development in emerging market countries, using the three largest post-Soviet economies – Kazakhstan, Russia and Ukraine – as examples. The present summary overview was prepared based on specific country-to-country research starting in early 2008.

The common feature of Kazakh, Russian and Ukrainian banking systems at the end of the 1990s was a low level of public confidence in banking and other financial institutions caused by the devaluation of bank deposits at the beginning of the decade, as well as by bankruptcies of a number of new commercial banks and financial fraud occurring during a period of turbulent social and economic change.

The impact of the 1998 financial and economic crisis on the money and credit systems of these countries was of a different magnitude. Nevertheless, the crisis became a powerful catalyst for restructuring banking systems, which were already weak due to a lack of confidence placed in them by a public which preferred to keep its savings in cash – so-called "under-mat" savings.

This prompted the leaders of Kazakhstan, Russia and Ukraine to adopt special measures aimed at protecting the rights and legal interests of mass depositors. Ukraine was the first of the three to set up a DIS, in September 1998[1], followed by the Republic of Kazakhstan, which established the "Kazakh Deposit Insurance Fund"[2] in November 1999.

Finally, in Russia in December 2003 the federal law "On Insurance of Household Deposits in Banks of the Russian Federation" came into force, and in January 2004[3] the Deposit Insurance Agency (DIA) was created. A special feature of the Russian banking system was that, until mid-2004, all depositors of Sberbank – which was government-controlled – were covered by a 100% government guarantee. Its deposit market share at that time was 63%, and it provided all its depositors with a full guarantee for their savings from potential loss. However, this situation carried considerable drawbacks, including: monopoly guarantee; distorted market competition conditions; and absence of a legally enshrined and

[1] Initially, the DIS in Ukraine was put into operation in accordance with the President's decree "On Measures Aimed at Protecting the Rights of Individuals Who are Ukrainian Commercial Banks' Depositors". Since October 2001, it has operated under the provisions of the law "On Insurance of Household Deposits".

[2] The National Bank of the Republic of Kazakhstan Decree of July 2003 significantly expanded the guarantee on public deposits, and raised the maximum insurance coverage amount. In 2007, the law "On a Mandatory Deposit Guarantee" came into effect, which expanded the DIF's powers and functions, and removed all exclusions with respect to deposit guarantee recipients.

[3] DIS participant banks entered the system in 2004–2005. In order to ensure equal conditions for all participants, from mid-2004 household deposits in all banks were guaranteed under the maximum insurance coverage – at that time it was 100,000 rubles or 3,500 US dollars.

organizationally structured mechanism for the government to implement such a monopoly guarantee.

Currently, in terms of format, the deposit insurance (DI) funds of Ukraine and Kazakhstan are similar to a paybox with extended powers (including collecting deposit insurance premiums, and reimbursement payment), but they have limited supervisory powers; the Kazakh fund has the authority to participate in the temporary administration of an insolvent bank and in compulsory liquidation procedures. The Russian agency has additional powers to conduct bankruptcy and liquidation procedures, acting in the capacity of a "corporate liquidator", under the terms of the law.

As regards determining the optimal level of coverage, the three countries' approaches are similar in many respects. Both Russia and Kazakhstan, when determining the maximum insurance coverage, take into consideration the following indicators: (a) the guarantee amount should be within 1–2 GDP shares per capita; (b) the maximum coverage should be able to reimburse the majority of depositors' savings (about 90%); (c) the ratio of DIS insurance liability to total deposits should be between 40% and 60%.

Ukraine follows a similar approach, with the focus on a wider range of coverage ratio to GDP: from 1 to 3 GDP shares per capita.

In all countries under review, DIS obligations are mostly secured by their DI fund's resources.

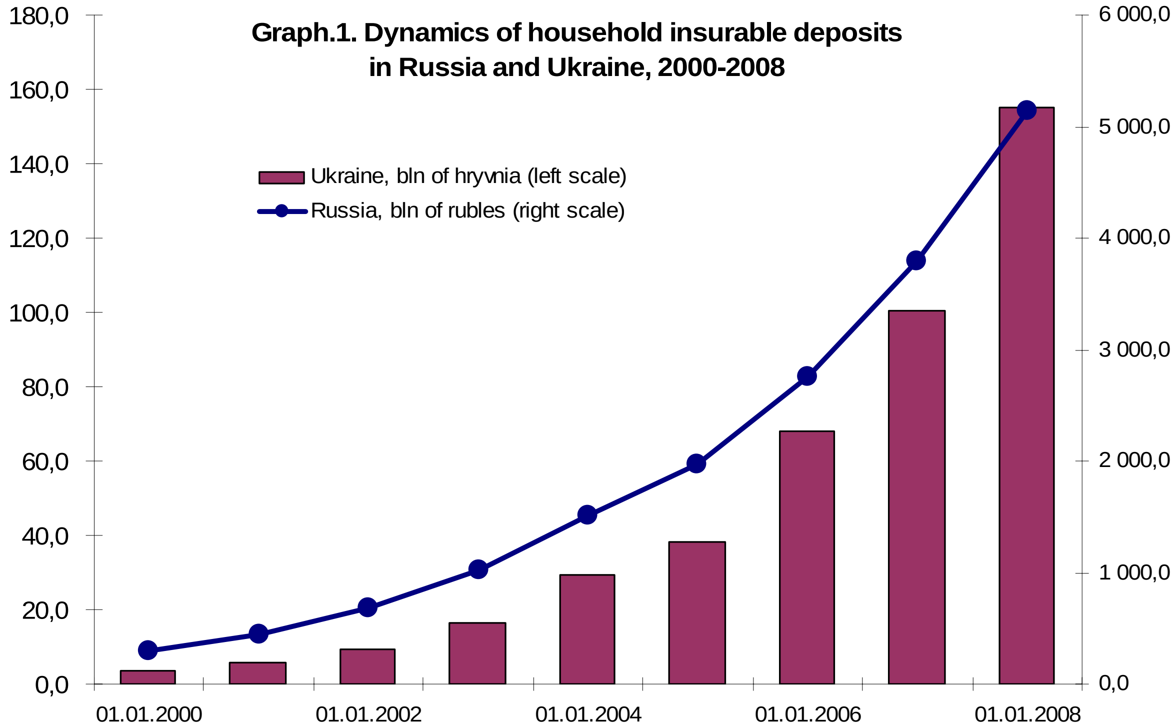
In order to analyze the effect of a DIS on deposit markets, the following parameters, whose change can be accounted for by DIS influence, were measured wherever possible:

1) dynamics and growth rate of household deposits;
2) share of public income used for savings deposits;
3) share of public deposits in aggregate banking system liabilities;
4) changes in temporary public deposit structure;
5) changes in currency deposit structure;
6) changes in public deposit structure with respect to deposit amounts;
7) changes in large, medium-sized and small banks' shares in the deposit market;
8) changes in public attitudes to the banking system based on sociological surveys.

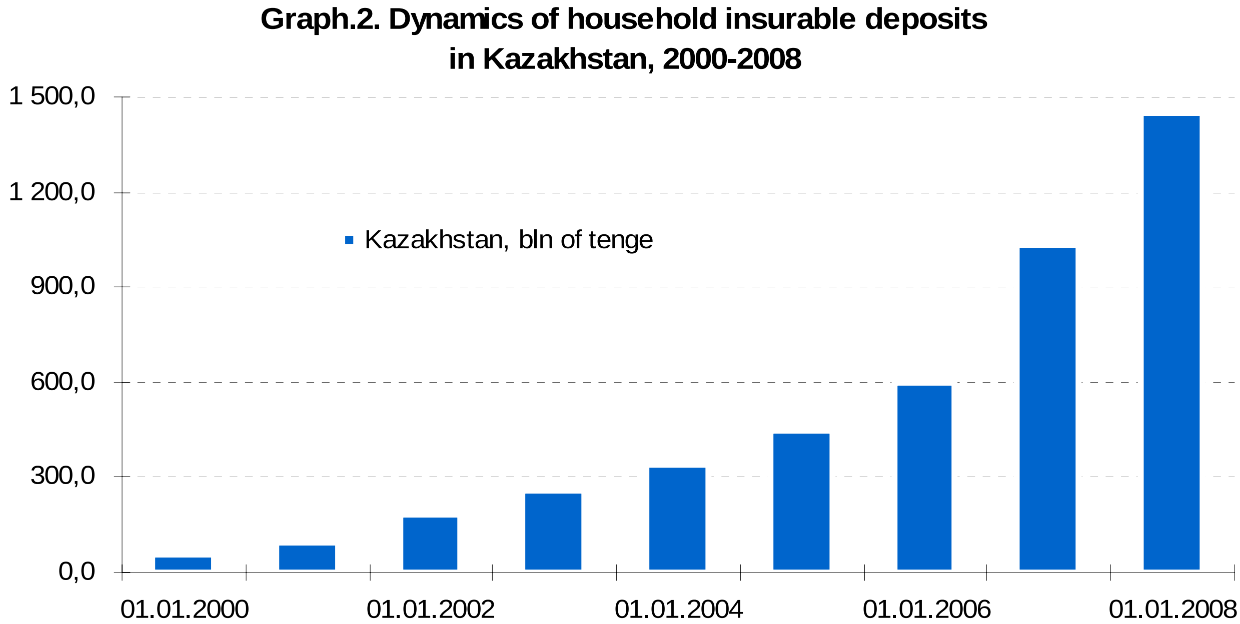
The review yielded the following results:

1)**. In all countries under review, significant deposit growth was observed after DIS introduction.** Thus, in Ukraine from January 1, 2000 through January 1, 2008, total household deposits multiplied 42.2 times – from 3.7 billion to 115.2 billion hryvnia. During the same period, the number of depositors underwent 6.5-fold increase – from 4.6 to 29.7 million people. This growth was due to a deconcentration and dispersal of deposits among various banks within the guaranteed coverage level.

The deposit market in Russia also showed a positive dynamic during 2001–2007. From 2005, when the DIS started operating, annual absolute deposit market growth more than doubled – from 430 billion rubles per annum (in 2002–2004) to 1.05 trillion rubles (in 2005–2007).



In Kazakhstan during the same period (2000–2007), the public deposit base grew by 26.3 times – from 55 billion to 1447.8 billion tenge. Alongside this, in every year except 2002 and 2007 absolute growth of public resources in banks increased.



The high deposit growth rate during the first years of DIS operations in the above countries testifies specifically to the growth of public confidence in banks, and the transformation of a considerable portion of "under-mat" savings into an organized format, which seems critical for countries' economic development and the implementation of a balanced money and credit policy.

It should also be noted that the increase in absolute growth occurred against the background of factors restraining the growth of public saving activities: depletion of so-called "under-mat" cash; development of alternative instruments (stock exchange and real estate); and turbulent growth of consumer lending.

2**) The dynamics of the earnings share used for saving deposits denote qualitative shifts in public investment behavior**. Thus, in Russia since DIS introduction the share of public earnings used for savings has multiplied 1.5 times – from 4.3% to 6.6%. In Kazakhstan, this growth was even higher – during 1999–2007 the share of savings within aggregate public earnings increased from 10% to 34.4%. The observed changes were caused not only by welfare progress, but also by enhanced public confidence in banks, including as a result of DIS influence.

3) **Public deposits became a more significant resource for banking system development, and their share in banks' liabilities began to go up.** In all three countries under review a common trend was discernible. After DIS introduction, the share of public deposits in aggregate banking system liabilities rose: by 35.3% in Kazakhstan by the beginning of 2004; by 33.2% in Ukraine and by 28.3% in Russia by the beginning of 2006.

After peaking in 2004–2006, the share of household deposits in banking system liabilities started to fall again. This decrease in individuals' deposits resulted from turbulent banking system development and higher growth recorded by other funding sources, such as external loans, legal entities' non-banking funds, banks' equity and profits.

4) **After DIS introduction in Russia and Kazakhstan, an upward trend was observed in resources placed by the public in long-term deposits; this is an important resource base factor for further economic reforms and investments**.

Thus, in Kazakhstan during almost the whole review period(1999–2007), the share of resources placed by households in "longer" deposits (time and escrow deposits) grew, from 61.6% at the end of 1999 to 86.7% at the beginning of 2008.

In Russia in 2005, shortly after the DIS started its operations, there was a notable increase in long-term deposits (more than 3 years) – their share doubled from 2.3% to 5.6%. Alongside this, the share of 1 to 3-year deposits grew by 10.3%, reaching 51.6%. Subsequently, long-term deposits showed a smoother trend.

5). **On the whole, the currency structure in all three countries under review showed growth in local currency deposits compared to those denominated in foreign currency.** In Kazakhstan during the period of DIS operations from 2000 to 2007, the share of public deposits denominated in tenge[4] grew by 10.8% – from 51.6% to 62.4%. In Russia, the share of ruble-denominated deposits[5] grew from 69.9% at the beginning of 2004 to 87.1% by 2008. In Ukraine, the share of hryvnia-denominated deposits[6] during 2001–2007 went up from 39.9% to 57.9%.

The decrease in foreign currency denominated deposits can be accounted for by enhanced confidence in banks on the part of so-called "small" and "mid-size" depositors, as well as by a general stabilization of market exchange rates for local currency against leading world currencies, and more attractive interest rates for deposits in domestic currency compared to those denominated in foreign currency.

6). **In Kazakhstan and Russia, distinct trends were observed in the growth of deposits after the DIS started its operations.** Thus, in Russia during 2005–2007, deposits in excess of 100,000 rubles grew much faster than smaller deposits. Indeed, growth in deposits exceeding 100,000 rubles accelerated significantly after the maximum coverage level was raised twice – to 190,000 and 400,000 rubles in 2006–2007.

In Kazakhstan in 2004–2007 the share of "mid-size" (700,000–10 million tenge) and large (over 10 million tenge) time and escrow public deposits showed sustained growth as a share of total deposits, while the share of "small" deposits (less than 700,000 tenge) continuously decreased during the same period. It should be noted that large deposits grew much faster compared to "mid-size" deposits, while the latter showed faster growth than "small" deposits. As a result, from 2004 to 2008 the share of large deposits grew from 26% to 60% for all time and escrow-type deposits.

[4] Current exchange rate: 1 US dollar =120 tenge.
[5] Current exchange rate: 1 US dollar = 24.6 rubles.
[6] Current exchange rate: 1 US dollar = 4.62 hryvnia.

7). **Improved competition conditions for banks and changes in deposit concentrations in large, medium-sized and small banks, on the whole, gave rise to banking sector soundness and safety**. In Russia and Kazakhstan after DIS introduction, growth by medium-sized banks' in the deposit market was observed, with a simultaneous reduction in large and small banks' shares.

In Russia during 2001–2007, Sberbank's monopoly in the deposit market gradually shrank. Sberbank's controlling stock belongs to the government. The largest decrease (by 5.5%) took place in 2005 – the year after DIS introduction. The fall in Sberbank's market share was above all accompanied by a rise in other large banks' share – over the course of one year the latter grew by 5%, from 21.1% to 26.1%. Moreover, during DIS operation the share of medium-sized banks also increased, from 13.8% in 2004 to 17.2% in 2007.

In Kazakhstan during 2001–2007 there was a steady reduction in the share of systemic banks (People's Savings Bank of Kazakhstan, TuranAlem Bank and Kazkommerzbank) in the public deposit market: from 73.5% in 2001 to 56.9% in 2006. However, in 2007, due to constraints arising in international finance markets and the resulting redistribution of a significant portion of public funds to the People's Savings Bank of Kazakhstan, the market share of the "big three" rose again, to 63%.

The share of medium-sized banks in Kazakhstan went up from 14.5% in 2001 to 38.3% in 2006, before falling to 32% in 2007. On the other hand, the share of the smallest banks continuously contracted in 2001–2007, decreasing by 7.1% in total.

8). **Growth of public confidence in the banking system based on sociological surveys**. All countries under review unanimously reported that DIS introduction had contributed to enhancing public confidence in the banking system.

Thus, in Russia, according to research on public investment behavior conducted by VTSIOM at the DIA's request, during the past three years 16% respondents had begun to feel a higher degree of confidence in banks. In total, 38% respondents had confidence in banks. About 7% of respondents mentioned that, owing to the existence of the DIS, they had opened bank accounts for the first time, increased their deposit amounts or extended deposit maturities.

In Kazakhstan, statistics collected by the DI fund also show that the level of public confidence in the deposit insurance system and the banking system is rising annually. From the survey results, it was clear that the best informed public resided in capital cities or in regions where the largest insurance event took place.

In Ukraine, it is reported that DIS introduction in 1998 had a positive effect on enhancing public confidence in the banking system and stimulating its development.

Conclusion. On the whole, the results of the review with respect to Kazakhstan, Russia, and Ukraine have shown that DIS introduction was conducive to enhancing public confidence in banks and the level of their protection. It also gave rise to fast savings growth – the banking sector resource base encouraged the formation of a competitive atmosphere in deposit markets and contributed to smoother deposit distribution within the banking system, which resulted in its growing stability.