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Republic of Belarus: Financial Sector Assessment Program— Technical Note—Deposit Insurance

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FINANCIAL SECTOR ASSESSMENT PROGRAM

REPUBLIC OF BELARUS

TECHNICAL NOTE

DEPOSIT INSURANCE

JANUARY 2006

THE WORLD BANK
FINANCIAL SECTOR VICE PRESIDENCY
EUROPE AND CENTRAL ASIA REGIONAL
VICE PRESIDENCY

INTERNATIONAL MONETARY FUND
MONETARY AND FINANCIAL SYSTEMS
DEPARTMENT

Contents

I. Current Status of the Deposit Insurance System in Belarus

1. **The current system of deposit insurance is governed by two different pieces of legislation, each in turn elaborated by a separate National Bank of Belarus (NBB) resolution.** The two legislations cover foreign exchange accounts in state owned banks and all other accounts, respectively. The first legislation was the presidential decree of April 20, 1998, which established full coverage for foreign exchange accounts in six state banks. The second legislation is Article 121 of the Banking Code which is the legal basis for coverage for all other deposits and which became effective October 12, 2000. The resolution of the Board of the NBB as of December 27, 2000, N 33.14, lays out the rules following the 1998 decree and regulates coverage for foreign currency accounts in authorized banks. The resolution of the Board of the NBB as of March 29, 2001, N 75, lays out the rules for Article 121 and regulates compensation of all other accounts[1].

2. **The deposit insurance system is currently characterized by preferential treatment of the authorized banks and in particular Belarusbank and Belagroprombank.** Most striking in the system is that while Belarusbank and Belagroprombank benefit from a full guarantee on all their deposits, they are not required to pay any contributions to the Guarantee Fund. Foreign currency deposits are fully guaranteed in the four authorized banks, Belpromstroybank, Belinvestbank, Belvnesheconombank, and Priorbank. Local currency deposits in those banks are covered up to 1,000 U.S. dollars equivalent. These four banks pay monthly 0.1 percent of the household deposits to the Guarantee Fund. All other banks are covered up to 1,000 U.S. dollars equivalent both for their local and foreign currency deposits and they pay monthly contributions according to the level of deposits: (i) 0.1 percent if the level of deposits do not exceed the capital of the bank; (ii) 0.2 percent if the level of deposits exceed the amount of the own capital of the bank two times; and (iii) 0.3 percent if the level of deposits exceed the amount of the own capital of the bank three times.

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[1] **Article 121 is in the process of being amended to remove a contradiction from the current legislation.** According to Article 121, paragraph 2: "Safety and compensation of individuals' deposits in banks *created by the state and in banks where the state has more than fifty percent of voting shares* are guaranteed by the state in the procedure established by legislative acts of the Republic of Belarus." Whereas the resolution of the Board of the NBB of March 29, 2001, N 75 which lays out the rules for Article 121 of the Banking Code (March 29, 2001, N75), establishes a guarantee for the compensation of citizens' resources in Belarusian rubles by *banks created and registered in accordance with the legislation of the Republic of Belarus*. Currently article 121 is being amended and paragraph 2 will be removed from the legislation, in order to remove this contradiction.

Box 1. The Current Legislative Framework for Deposit Insurance

The 1998 Decree of the President	This Decree guarantees complete safety and repayment of foreign exchange accounts with the following six authorized banks: Belarusbank, Belagroprombank, Belpromstroybank, Belinvestbank, Belvnesheconombank, and Priorbank.
The resolution of the Board of the NBB, December 27, 2000, N 33.14, came into force on March 1, 2001	This resolution lays out the rules for the 1998 Decree. It lists the sources for the fulfillment of obligations, should compensation be needed for the foreign exchange deposit accounts in the six authorized banks. According to the resolution, authorized banks have to pay 0.1 percent of balances attracted to the Guarantee fund, in monthly contributions.
Article 121	Article 121 is the legal basis for coverage of all other deposits.
The Resolution of the Board of the NBB of March 29, 2001, N 75	This resolution lays out the rules for Article 121 of the Banking Code (March 29, 2001, N75). The resolution establishes a guarantee for the compensation of citizens' resources in Belarusian rubles by banks created and registered in accordance with the legislation of the Republic of Belarus. The resolution regulates the coverage for ruble accounts in all banks and foreign exchange accounts excluding the six authorized banks. It sets the rates for the monthly contributions to the Guarantee fund for various banks and sets the limit of compensation at 1000 US dollars. The payments to the guarantee fund are: (i) 0.1 percent if the level of deposits do not exceed the capital of the bank; (ii) 0.2 percent if the level of deposits exceed the amount of the own capital of the bank two times; (iii) 0.3 percent if the level of deposits exceed the amount of the own capital of the bank three times; and (iv) 0.1 percent for banks authorized to serve state programs.

II. Key Characteristics of the New Deposit Insurance Scheme

3. **The National Bank of Belarus is currently working on a new draft deposit insurance law.** The draft law has not yet been presented to the parliament. There is likely opposition to the new deposit insurance scheme from the two largest banks; Belarusbank and Belagroprombank currently do not pay insurance premiums and would need to start making significant contributions to the scheme. The Finance Ministry may also be critical of the law since it is expected to make the initial capital contribution to the fund.

4. **The new draft law aims to level the competitive playing field between the state-owned banks and their privately owned rivals.** The draft law is a clear improvement over the previous set of legislations that covers a very complex system of deposit insurance. The draft law does incorporate various best practices of a sound deposit insurance scheme such as mandatory membership and equal treatment of all banks:

- The draft law treats state and non-state owned banks equally and covers all banks and nonbank credit-and-financial organizations that are registered at the Reserve Corporation and hold a license by the NBB to attract individual's deposits (call, time, and escrow deposits).

- The draft law treats foreign and local currency deposits equally, hence reduces the incentives for dollarization.

- The draft law regulates relations of compensation of bank deposits of individuals by a specially created legal entity—the Reserve Corporation for Compensation of Bank Deposits.

- Membership of the Reserve Corporation is mandatory.

- The membership fee is 0.5 percent of the bank's own resources (capital) and quarterly contributions constitute 0.3 percent of the individual level of deposits by the banks. These quarterly contributions are high by international standards.

- The reserve of the Reserve Corporation will comprise of mandatory contributions of banks as well as investment returns. Shortfalls in resources of the reserve can be financed with loans to include those granted against guarantee of the NBB, as well as budget loans.

- Coverage limit: Full coverage up to 2,000 Euro equivalent and 80 percent coverage up to 5,000 Euro equivalent.

5. **There is wide variation in the coverage, organizational structure, and pricing of deposit insurance schemes around the world.** Recent research has analyzed the relation between the different design features and market discipline and financial fragility across countries. Box 2 assesses the proposed new deposit insurance scheme in Belarus against the best practices derived from this research.

Box 2. International Best Practices in Deposit Insurance vs the Draft Law for Belarus 1/

Best Practice	Belarus Draft Law
• Coverage: A class of creditors should be created that have incentives to monitor and thus discipline banks by being excluded from deposit insurance. By imposing a low coverage and/or co-insurance, large depositors are exposed to potential losses. Excluding interbanks deposits forces member banks to monitor each other carefully. Insider deposits should be excluded from coverage, so that management of banks participate in the losses of banks.	Maximum coverage is limited to EUR 5,000, this amount is high by international standards and may not be sufficient to prevent moral hazard. Commercial enterprise and interbank deposits are excluded.
• Membership: Voluntary schemes can give rise to adverse selection, where weak members stay in the scheme, while strong members leave. Compulsory membership is therefore recommended.	Compulsory membership
• Funding: Premiums assessed on the member banks minimizes moral hazard since banks have the incentives to minimize insurance losses. An exclusive funding by member banks, however, might not be possible, especially in times of systemic crisis, so that ex-post public back-up funding might be necessary.	Ex-ante premiums are assessed There is no ex-post contingent financing from member banks.
• Pricing: Determining and applying the actuarially fair premium helps avoid under pricing the deposit insurance scheme and thus failure of the scheme.	Premiums are high compared to international standards
• Premium structure: A flat premium—applied by most schemes around the world—implies a cross-subsidy from less risky to riskier banks. Theoretically, risk-adjusted premiums contribute to better risk pricing by banks and help avoid under-pricing the deposit insurance.	Flat premium. Calculation and application of risk-based premiums poses practical problems, and is not essential at this stage.
• Mandate: Deposit insurance schemes vary in the mandates they have, from narrow "pay box" schemes that pay out insured deposits after a bank has been closed to "risk-minimiser" schemes whose mandate might include supervision and regulation of its members and a role in bank failure resolution. The optimal mandate of the deposit insurer depends on the general structure of the safety net, other design features of the scheme and the general institutional and legal environment of the country. More important than the organizational arrangements of the safety net is the correct alignment of incentives.	Pay box
• An efficient system of supervision, prompt corrective action and early intervention rules is important for the success of deposit insurance. By carefully monitoring banks' risk taking and disciplining them accordingly, it can help reduce the moral hazard risk of deposit insurance and thus the risk of bank fragility. Intervening early in a failing bank before its capital turns negative helps reduce the cost of bank failures to the deposit insurer.	Improving the efficiency of supervision and closing banks that endanger the stability of the system prior to introducing a limited insurance scheme will be essential for Belarus.
• Equal coverage of foreign currency and local currency deposits.	Equal coverage

1/ For an overview, see Demirgűc-Kunt and Kane, (2002), "Deposit Insurance Around the Globe: Where Does it Work?", *Journal of Economic Perspectives*. 16(2).

6. **The envisioned changes in the deposit insurance legislation would constitute an important step forward in leveling the playing field between banks for deposit taking activities**. One of the most important steps in the draft law is that the annual contributions to the Reserve Corporation are to be made in equal proportion to the deposits a bank attracts and at an actuarial fair price by all banks, including the fully state owned banks. This would eliminate the current preferential treatment of state owned banks. The envisioned premium of a quarterly 0.3 percent of attracted deposits is high by international standards. A higher premium perhaps can be justified for a time while the Corporation builds up its resources from the currently low base. However, the intention should be to move to a more normal premium at an early stage.

7. **Belarusbank has a large concentration of small deposits and accounts for almost 65 percent of all household deposits.** Belarusbank almost exclusively holds very small deposits. The average size of deposits in Belarusbank is 29 U.S. dollars equivalent, compared to an average size of deposits in the authorized banks excluding Belarusbank and Belagroprombank of 1,680 U.S. dollars equivalent, and an average deposit in non-authorized banks, excluding Poisk bank,[2] of 2,295 U.S. dollars equivalent. Nevertheless, 76.3 million out of Belarusbank's 419.2 million households deposits are over 5,000 U.S. dollars equivalent.

8. **Therefore, reducing coverage from a full guarantee to 5,000 Euro for the largest two banks, while increasing coverage for the non-authorized banks would be expected to reduce the contingent liability of the government.** The envisioned draft law in principle represents presently about US$80 million reduction in these contingent liabilities (Figure 1, Table 1). While the government's contingent liability is expected to fall, the maximum coverage envisioned in the draft law of insuring deposits up to EUR 5000 [3] equivalent per individual per bank is still high relative to other CIS countries. It is also too high to address the moral hazard issues that are implicit in a blanket guarantee.

[2] Poisk Bank is excluded due to its current poor financial state.

[3] Per deposit account per bank up to EUR 2,000 equivalent in full and 80 percent of from EUR 2000 to EUR 5,000 equivalent; with maximum coverage per individual per bank EUR 5,000 equivalent.

Table 1. Distribution of Household Deposits By Size 1/

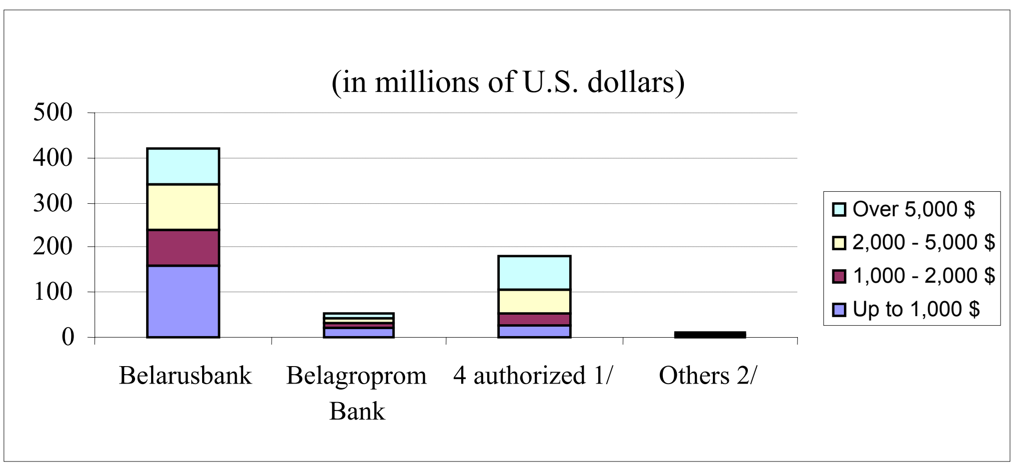
(Volume of deposits in millions of U.S. dollars)

	Belarusbank	Belagroprom	4 authorized 2/	Others 3/	Total
Up to 1,000 $	160.6	21.1	24.4	1.43	207.53
1,000 - 2,000 $	78.5	10.5	28.1	2.28	119.38
2,000 - 5,000 $	103.8	12.6	52.1	3.77	172.27
Over 5,000 $	76.3	11	73.9	4.51	165.71
	419.2	55.2	178.5	11.99	664.89

1/ Local and foreign currency deposits; NBB exchange rate as of 01.01.2003 (1,920 ruble/$).
2/ Belpromstroybank, Belinvestbank, Belvnesheconombank, and Priorbank.
3/ Includes 5 non-authorized banks. The deposit distribution in these banks is similar for all banks in this group, therefore the analysis can be expanded to cover all non-authorized banks.
Notes: The 11 banks that are reported in this table account for more than 95 percent of HH deposits.

Source: Belarus Banking Association

Figure 1. Distribution of Household Deposits By Size



III. Transition to a Limited Coverage Deposit Insurance Scheme

9. **Reforming a deposit insurance scheme, especially when it involves removing a blanket guarantee from one or more systemically important banks, raises the issue of how to achieve a non-disruptive transition.** Belarusbank alone accounts for almost 65 percent of all household deposits. Removing the blanket guarantee from Belarusbank and Belagroprombank without addressing the systemic liquidity problems in those banks could lead to a loss of confidence in the banking system. In particular, given the dominance of

Belarusbank in the retail market it may not be possible to withdraw the government guarantee over night, since this may prompt depositors to withdraw their money.

10. **The envisaged high coverage of the current draft law, EUR 5,000, may serve as a transition mechanism since it is close to a blanket guarantee.** Even though the coverage is high relative to average deposit size given the current liquidity problems in the two largest banks such a high coverage may help to limit panic among depositors. Currently the majority of small depositors are concentrated in Belarusbank and Belagroprombank. Therefore, the envisaged coverage comes close to a blanket guarantee for those banks. Such a high coverage may be appropriate while these banks are being reformed.

11. **It may be useful to look at the experiences in neighboring countries, both in regards to transition (Russia) as well as basic design (Ukraine).** It is important to remember though that the transition towards limited deposit insurance in both countries has been dominated by country specific problems. Russia for example has thousands of small banks and a number of insolvent banks. Cleaning up the banking system has been the most important part of Russia's transition. Ukraine introduced its deposit insurance scheme with limited coverage for all banks excluding its Savings Bank. In Belarus, in addition to the health of the financial system the dominance of Belarusbank in the retail market will impact the best transition model.

12. **Russia chose to transition to a limited insurance scheme in a step approach.** It is currently transitioning Sberbank from full government guarantee to limited guarantee. Sberbank accounted for 64.9 percent of all retail deposits as of September 1, 2003. The government announced that it will continue to provide unlimited coverage to Sberbank's existing deposits that were opened before November 1, 2004. New deposits will be covered according to the limit set by the new deposit insurance scheme. Further, the full state guarantee will only remain in force until January 1, 2007. Whether the transition will be successful remains to be seen, but the lessons learned from the current experience in Russia can be useful in planning the transition in Belarus.

13. **Ukraine has built a well run system for its deposit insurance scheme; however, did not address the issue of providing full coverage to its savings bank.** Ukraine introduced its deposit insurance scheme with limited coverage for all banks excluding its Savings Bank. Even though leaving the full coverage on the Savings Bank is a problem, the situation in Ukraine is significantly different than in Belarus; as of December 2001 only about 19 percent of all household deposits were in Ukraine's Savings Bank, compared to almost 65 percent in Belarusbank. Other than that Ukraine's deposit insurance fund is well run and transparent and could from an operational aspect serve as a model. Whether, deposits that are attracted by commercial banks are increasing in this system remains to be seen.

14. **Independently of whether Belarus chooses to follow a step approach or provide a blanket coverage while it reforms its banking system, it will be essential to address the current liquidity shortage.** The Government will need to exercise caution in sequencing the changes in deposit insurance with other banking sector reforms. If the insurance coverage is

lowered, it is necessary to either (i) put in place transitional arrangements to address potential concerns Belarusbank's and Belagroprombank's depositors may have while moving from full to partial coverage; or (ii) put Belarusbank and Belagroprombank on a sound financial footing prior to reducing coverage.

15. **Further Belarus could already require that all banks including the state owned banks start paying annual contributions towards an insurance scheme.** Currently, private banks are paying 1.2 percent in annualized contributions to the insurance scheme, which leads to a significant cost disadvantage vis-à-vis state owned banks. This practice allows the state owned banks to offer attractive interest rates, in addition to the competitive advantage they already have by being backed by a full state guarantee. Requiring state owned banks to pay the same fee would eliminate the current preferential treatment of state owned banks and is an important step forward in leveling the playing field between banks. This step can be implemented independent of the transition of state owned banks to a limited deposit insurance scheme.

16. **However, state owned banks due to their size would endanger the funds of the deposit insurance scheme.** One possible solution would be to require state owned banks to start paying annual contributions towards the insurance scheme, while at the same time keeping the funds that are put aside to bail out private banks and state owned banks separately. These funds would need to be kept separately until the large differences in size between state owned and private banks have diminished.