Sophisticated Discipline in a Nascent Deposit Market

Increases in real interest rates by poorly capitalized banks result in fewer deposits

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Depositors may penalize banks for undertaking excessive risks, performing poorly or otherwise jeopardizing the value of their assets. By withdrawing funds or requiring deposit rate premiums from less stable institutions, the depositors' actions have the potential to increase allocation efficiency and mitigate moral hazard. But this discipline only materializes if depositors possess both the willingness and ability to monitor their banks.

When depositors are experienced and mechanisms for disseminating financial information are reliable, this is not as much of a concern. However, in settings in which these features are under-developed, such as in Russia, the ability to discipline banks has been open to question.

Short History of Liberalized Deposit Markets

Russians' experience with liberalized deposit markets has been brief. In the early 1990s hundreds of private commercial banks entered its new, largely unregulated, deposit market. At that time bank deposits, particularly those of households, were held almost exclusively by the state savings bank. But lax entry policies contributed to the quick development of a competitive market for deposits. By early 1994, on the back of heavy advertising and relatively high interest rates, private banks had captured over half of the household deposit market. The era's mix of liberalized deposit rates, naive depositors and over-burdened regulators proved dangerous. A system-wide liquidity crisis in 1995 led to bankruptcies of some of the country's largest private retail banks. Their failures followed by only a year the collapse of several high-profile pyramid schemes, the largest of which contributed to the loss of savings of up to ten million Russians.

The image problem of private banks was furthered by the macroeconomic crisis of 1998, when the Russian government devalued the ruble and defaulted on its bond obligations. Because of their exposure to hard currency liabilities and ruble-denominated assets, including government securities, a number of banks were driven into insolvency. Again, many of the largest players on the retail market proved unable (or in some cases, unwilling) to meet their obligations to depositors.

Developed Capacity to Discipline

Drawing on a database from the pre-deposit-insurance stage of Russia's transition, we investigate depositors' ability to monitor and discipline private, domestic banks. Our data allow us to distinguish depositors by legal status — i.e., non-bank firms, banks or households — which may convey information about willingness and ability to impose discipline. Relative to households, for instance, firms might either have better access to or more appreciation for the financial information released by banks. Inter-bank deposits may be less sensitive to risk than the deposits of households or firms, since a relatively high percentage may represent stocks of short maturity, whose value is less threatened by the risk of institutional failure.

The results of our estimations show that even though the deposit market in Russia is young and the supporting institutional and informational infrastructure is relatively immature, the country's depositors have developed the capacity to identify and discipline weaker banks. Banks' net deposit inflows, specifically, are highly sensitive to bank capitalization, liquidity and changes in loan quality, particularly after the 1998 crisis.

Yet, our evidence for price discipline — when depositors "demand" higher deposit rates from less stable institutions — is weak. The absence of price discipline may, however, be interpreted as a subtler, more sophisticated form of discipline exhibited by depositors if they view the deposit rate as a signal of bank stability. So viewed, banks cannot necessarily expect to increase the net inflow of deposits by raising deposit rates. More than just compensating for observable risk, raising rates may carry the suggestion of additional — unobserved — bank risk.

Our estimations indeed show that after a certain point, increases in real interest rates produce negative returns with respect to deposit attraction. This effect is particularly pronounced for poorly capitalized banks.

If depositors are confident in a bank's ability to meet deposit withdrawals, on the basis of its capital-assets ratio, they are more apt to view its rate increases as coincident with increases in the expected return on their deposits, and increase their supply of deposits accordingly. But a bank, which has already given depositors reason for suspicion due to its lower capitalization, does not have the same ability to translate the rate increase into a corresponding inflow of deposits.

Bank size has little effect on the results: both large and small banks are subject to depositors' sophisticated discipline, with large banks enjoying a higher switching point (11% vs. 5% for smaller banks), above which increases in real interest rates produce negative returns.

Conclusion

Russian depositors were effectively forced to become relatively quick learners and sophisticated discipliners during the 1990s. However, as Russia moves forward with the introduction of widespread deposit insurance, it will face real costs in terms of reduced market discipline and subsequent moral hazard incentives.

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