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PROBLEM BANK RESOLUTION METHODS AND PAYOUTS OF INSURANCE COVERAGE TO DEPOSITORS OF FORCIBLY LIQUIDATED BANKS:

COMPARATIVE ANALYSIS OF DEPOSIT INSURANCE SYSTEMS IN CIS COUNTRIES

Research Paper

Prepared by the Eurasia Regional Committee

International Association of Deposit Insurers

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I. INTRODUCTION

During the global financial crisis, government measures aimed at stabilizing the economy and protecting the most vulnerable sections of the population were the main priorities of government policy in many countries. According to international practice, the role of the deposit insurance system significantly increases during a period of economic instability. In fulfilling their main mission to protect depositors' interests, i.e. from the loss of their savings in bank deposits in the event of a bank failure, deposit insurers should identify an optimal method of problem bank resolution together with the regulatory bodies, and effectively perform payouts of insurance coverage to depositors of forcibly liquidated banks. Clearly, public confidence in the banking sector and the stability of a country's financial system as a whole depend on the effectiveness and promptness with which such goals are achieved. For this reason, the Fourth seminar of IADI's Eurasia Regional Committee (EARC IADI)) focused on these issues, which became extremely topical after a drastic increase in bank failures during the recent period of financial turbulence.

The purpose of the present research is to provide an overview and analysis of the functioning of deposit insurers in CIS countries, including those that are not members of EARC IADI. In total 10 countries (hereafter "respondent countries") participated in the research: Azerbaijan, Kazakhstan, Russia and Ukraine (IADI members), Armenia and Kyrgyzstan (observers of EARC IADI), and Belarus, Moldova, Tajikistan and Uzbekistan.

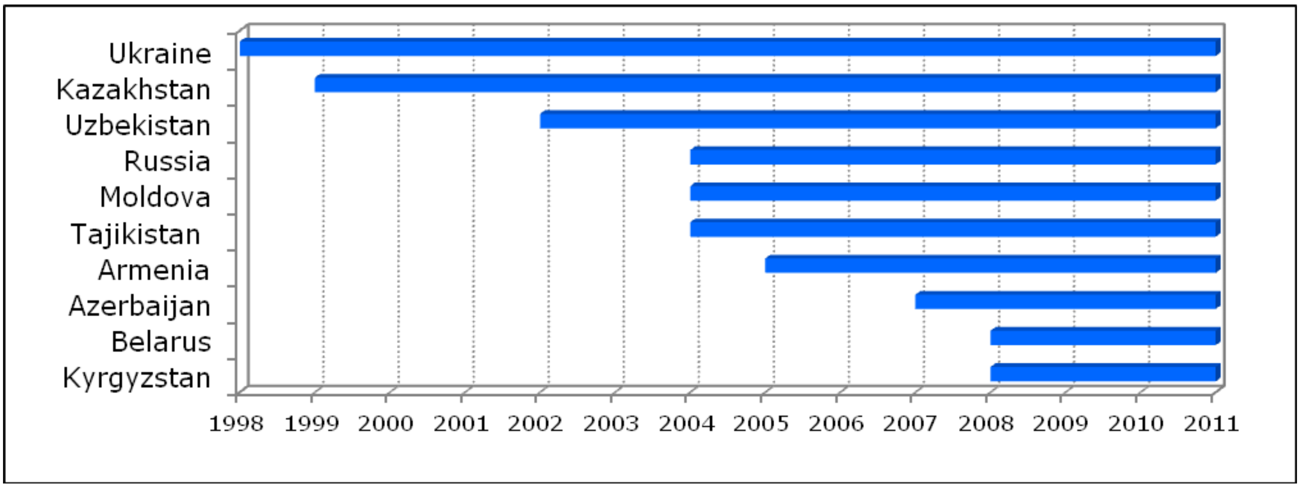
The main issues considered in the present comparative analysis relate to the general principles of deposit insurer activities, such as funding, scope of mandate, and objects of insurance, as well as problem bank resolution methods applied in the event of bank failures, insurance coverage payout procedures in the event of the problem bank's forced liquidation, etc. The Kazakhstan Deposit Insurance Fund (KDIF) prepared and circulated among CIS deposit insurers a special survey covering all these issues.

II. MAIN FUNCTIONAL FRAMEWORKS

A. Organizational form

In the CIS region, the first deposit insurance systems (DIS) for individuals' deposits were established in Ukraine in 1998 and in Kazakhstan in 1999. Nowadays, bank deposits are insured in most CIS countries *(see Figure 1)*. Among the respondent countries, only the deposit insurers of Azerbaijan, Tajikistan and Uzbekistan are non-governmental organizations, while in other countries insurance of individuals' deposits is provided by public companies or institutions on behalf of the State.

Figure 1. Year of Deposit Insurer's Establishment



One of the main aspects of a deposit insurer's activity that supports banking sector stability is its efficient cooperation with other financial safety-net players.

> A framework should be in place for the close coordination and information sharing, on a routine basis as well as in relation to particular banks, among the deposit insurer and other financial system safety-net participants. Such information should be accurate and timely (subject to confidentiality when required). Information-sharing and coordination arrangements should be formalized. ***Principle 6 – Relationships with other safety-net participants, Core Principles for Effective Deposit Insurance Systems, IADI***

The existence of agreements and/or memoranda of cooperation and information-sharing between the deposit insurer and the financial regulatory entities (e.g. central bank, financial supervision entity, etc.) plays a crucial role in this area. According to the survey deposit insurers in all the respondent countries have entered into such agreements with the central bank. In addition, the Deposit Insurance Agency of Russia (DIA) successfully collaborates with the Banks' Association and the Ministry of Internal Affairs, KDIF with the Association of Financiers of Kazakhstan, the Belarussian Deposit Insurer with the Ministry of Finance, and the Armenian deposit insurer with the Banks' Association and the Ministry of Finance.

B. Main functions

> A deposit insurer should have all powers necessary to fulfill its mandate and these powers should be formally specified. All deposit insurers require the power to finance reimbursements, enter into contracts, set internal operating budgets and procedures, and access timely and accurate information to ensure that they can meet their obligations to depositors promptly. ***Principle 4 – Powers, Core Principles for Effective Deposit Insurance Systems, IADI***

The analysis revealed four main functions which are inherent to deposit insurers of all respondent countries without exception: payout of insurance coverage to the depositors of forcibly liquidated banks, selection of an agent bank for making payouts, formation of a special reserve for payouts, and asset investment management. In Azerbaijan, Moldova, Tajikistan, Uzbekistan and Ukraine, the deposit insurer controls entry into and exit from the deposit insurance system. Moreover, the Deposit Guarantee Fund of Ukraine (DGFU) has the authority to change a member bank's membership status from "permanent" to "temporary" if the bank does not fulfill capital adequacy and solvency requirements, or if there is a suspension of operations related to the acceptance of deposits from individuals, or if the bank breaks a law or DGFU norms. In that case, individuals' deposits newly attracted by the bank are not covered by the DGFU's insurance. In Azerbaijan, Belarus, Kazakhstan, Kyrgyzstan, Russia and Ukraine, the deposit insurer has the authority to inspect the accuracy of the depositors' register set up by the bank, or may initiate such inspections by financial regulators. When a member bank's license to conduct banking operations is withdrawn and the bank is determined to be insolvent, deposit insurers' representatives in Belarus, Kazakhstan and Russia are entitled to take part in the bank's Committee of Creditors – its temporary administration and liquidation commission. Representatives from the deposit insurers of Azerbaijan and Kyrgyzstan also can participate in the problem bank's liquidation process by joining the insolvent bank's Committee of Creditors.

Of all the deposit insurers of the respondent countries, only ADIF and KDIF may establish maximum recommended interest rates on individuals' deposits. In addition, KDIF determines and manages the risks connected with member banks' operations through a differential premium system based on the calculation of member banks' financial indicators. On the other hand, only the DIA is authorized to participate in the problem bank's resolution process, together with the regulatory authorities, to the extent of conducting receivership and liquidation procedures with regard to problem member banks as well as providing financial support to problem banks or their investors, etc.

In international practice, deposit insurers are divided into three main categories depending on the scope of their mandates:

(1) Paybox – system with limited basic powers (bank premium collection and deposit insurance coverage payout);

(2) Paybox with extended powers – additional mandates usually include participation in the problem bank resolution process;

(3) Risk minimizer – the most advanced type of deposit insurance system, able to manage its own risks (ability to exert supervisory authority).

According to the research analysis, eight out of ten respondent countries' deposit insurers operate as a "paybox" system, while the deposit insurers of Russia and Kazakhstan have a wider mandate.

C. Membership and members

In all respondent countries, membership of a deposit insurance system is compulsory for all banks to which the regulatory authorities have granted a license for attracting and maintaining individuals' deposits.[1] Compulsory membership of the DIS for all financial institutions that attract insured deposits is also recognized in the IADI Core Principles for Effective Deposit Insurance Systems, as this helps avoid "adverse selection" of banks for DIS membership and, as a consequence, equally distributes the financial burden between all member banks via regular premiums, as well as helping to accumulate an adequate amount of special reserves for faster payouts of insurance coverage. In addition to the traditional commercial banks, the deposit insurance system of Kyrgyzstan includes one Islamic bank, while in Tajikistan micro-credit/deposit organizations are also DIS members.

As of May 1, 2011, according to the survey the largest number of DIS members was observed in Russia – 905 member banks. Ukraine took second place with 169 permanent DIS members and 6 temporary members. Among other respondent countries, the total number of DIS members varied from 15 to 43 banks.

D. Deposit insurance objects and deposit coverage limit

In respondent countries, deposit insurance is aimed at individuals' deposits, which include term deposits, conditional deposits (except in Russia), call deposits, current accounts (except in Uzbekistan) and card accounts. In Armenia, Azerbaijan, Belarus, Kyrgyzstan, Moldova and Tajikistan, banks' joint accounts are also covered by deposit insurance. Deposits of individual entrepreneurs are subject to insurance in Armenia and Kazakhstan. Legal entities' bank accounts are not covered by deposit insurance in any of the respondent countries.

Deposit insurance can cover either the full amount of the deposit (blanket guarantee), or can be limited, i.e. there is a fixed deposit coverage limit per one depositor, and usually per institution. Limited deposit coverage is more popular in international practice, and is recommended by IADI in one of its Core Principles for Effective Deposit Insurance Systems. Among the respondent countries, "blanket" or unlimited deposit insurance coverage is provided by the deposit insurers of Belarus and Uzbekistan. Limited coverage amounts used in other respondent countries vary from USD 520 (Moldova) to USD 38,000 (Azerbaijan). In all respondent countries, the deposit coverage limit is the same for deposits in domestic and foreign currency, except in Armenia, where deposits in foreign currency are protected up to USD 5,400 (equivalent to the official coverage limit in domestic currency), and deposits in domestic currency are protected up to USD 10,800 (equivalent to the official coverage limit in domestic currency).

[1] In Ukraine membership is compulsory for all banks, with one exception: the State Saving Bank of Ukraine, which is a public joint-stock company.

In the event of a member bank's forced liquidation, the deposit insurer pays out deposit insurance coverage to the bank's depositors. In Belarus, Kazakhstan, Tajikistan and Uzbekistan, deposit insurance covers the main balance placed on deposit, within the deposit insurance coverage limit, excluding accrued interest. Thus, the deposit insurers of these countries, in fulfilling their main function of protecting public interests through deposit insurance and coverage of individuals' losses in the event of a bank's forced liquidation, do not bear any responsibility for covering depositors' investment risk, following the principle that any accrued interest on deposits is depositors' investment gain and, therefore, the risk of its loss should be borne by the depositors themselves. In the event of a member bank failure in Armenia, Azerbaijan, Kyrgyzstan, Moldova, Russia, and Ukraine, deposit interest is also subject to the DI's insurance.

In addition, reimbursement of foreign currency deposits in respondent countries is carried out only in domestic currency, except in Azerbaijan and Belarus, where payouts are also made in foreign currency.[2]

Table 1. Deposit insurance coverage *(in USD[3])*

№	Respondent countries	Deposit coverage	Insurance of deposit interest	Experience in coverage payouts
1	Belarus	blanket	no	no
2	Uzbekistan	blanket	no	no
3	Azerbaijan	38,000	yes	no
4	Kazakhstan	34,355	no	yes
5	Russia	25,455	yes	yes
6	Ukraine	18,750	yes	yes
7	Armenia	10,800 (domestic)	yes	no
	Armenia	5,400 (foreign)	*yes*	no
8	Kyrgyzstan	2,138	yes	no
9	Tajikistan	1,553	no	no
10	Moldova	520	yes	no

E. Fund formation

A deposit insurance system should have available all funding mechanisms necessary to ensure the prompt reimbursement of depositors' claims including a means of obtaining supplementary back-up funding for liquidity purposes when required. Primary responsibility for paying the cost of deposit insurance should be borne by banks since they and their clients directly benefit from having an effective deposit insurance system. ***Principle 11 – Funding, Core Principles for Effective Deposit Insurance Systems, IADI***

[2] In Azerbaijan, the DI pays out deposit insurance coverage in foreign currency if the deposit was denominated in US dollars or euros. In other cases, reimbursement is exclusively in domestic currency.

[3] Exchange rates as at May 1, 2011.

Generally, regular mandatory premiums paid by member banks are the main sources of funding for a DI special reserve for insurance coverage payouts in respondent countries. In all CIS countries except Russia and Kazakhstan, new member banks are required to pay one-time entrance premiums upon joining the deposit insurance system. Moreover, in most respondent countries (except Armenia and Uzbekistan) fines paid by member banks for incomplete or late fulfillment of their liabilities to the DI are another source of DI special reserve funding.

The DIs of all respondent countries except Belarus, Russia[4] and Uzbekistan collect additional premiums from member banks in certain cases, including to redress a shortfall in the special reserve. For example, in Kazakhstan an additional premium is transferred by member banks to KDIF as a one-time payment in the event of a shortfall in the special reserve for payouts, while extraordinary premiums are paid by member banks in order to pay off the loans, and accrued interest thereon, granted by the central bank to KDIF to cover the special reserve shortfall. The amount of additional premium paid by a member bank should not be greater than double the regular mandatory premium paid by that bank in the previous quarter, while the annual amount of the extraordinary premium to be paid should not exceed the annual amount of the regular mandatory premium actually paid by the member bank.

In all respondent countries except Kazakhstan, DIs use a unique flat rate for calculating premiums to be paid by member banks *(see Table 2)*. In Armenia, where the premium rate is equal to 0.05% of the daily indicator of total individuals' deposits attracted over the reporting quarter, a minimum premium amount also exists, i.e. USD 2,500 per year (equivalent to the official coverage limit in domestic currency). KDIF uses a differential premium system for calculating member banks' premiums. According to this system, the member bank's premium depends on the classification group to which it was assigned on the basis of the total score calculated using financial and other indicators. In general, the BATA differential premium system uses five classification groups with the following regular premium rates: "A" – 0.04%, "B" – 0.08%, "C" – 0.11%, "D" – 0.19% and "E" – 0.38% of the member bank's total insured deposits.

Table 2. Member banks' premiums

№	Respondent countries	Premium rate	Calculation basis
1	Armenia*	0.05%	Daily indicator of the total amount of deposits attracted over the reporting quarter
2	Azerbaijan*	0.125%	Average daily amount of insured deposits over the quarter
3	Belarus*	0.3%	Balance of the attracted insured deposits
4	Kazakhstan*	0.04%-0.38%	Total amount of insured deposits

[4] In Russia, bank premiums may be collected at higher rates, but within 0.3% of the total amount of insured deposits and for no more than for two quarters in 18 months.

5	Kyrgyzstan**	0.2%	Total amount of individuals' and legal entities' deposits
6	Moldova*	0.25%	Total amount of insured deposits
7	Russia*	0.1%	Total amount of insured deposits
8	Tajikistan*	0.5%	Average balance of insured deposits over previous quarter
9	Uzbekistan*	0.5%	Average balance of insured deposits over the last month of the reporting quarter
10	Ukraine***	0.25%	Total amount of attracted deposits, including accrued interest

*charged per quarter.
**charged per year.
***charged twice a year.

For all DIs in respondent countries, an additional source of special reserve funding besides regular premiums is income from the DIs' asset investments. Moreover, in all respondent countries with the exception of Tajikistan and Uzbekistan, income from the liquidation commission received during the recovery of the deposit insurance coverage amount paid by the DI to the liquidated bank's depositors also represents a source of funding for the special reserve for payouts. Such policy complies with IADI's Core Principles for Effective Deposit Insurance Systems since, in order to recover its expenses, the DI should have a share in profits from the realization of the failed bank's liquidation mass: "the deposit insurer should share in the proceeds of recoveries from the estate of the failed bank. The management of the assets of the failed bank and the recovery process should be guided by commercial considerations and their economic merits".

According to the survey there are also other sources of funding for the special reserve in the respondent countries. In Kazakhstan, a 50% share of KDIF's authorized capital accounts for the largest portion of the DI's special reserve – it is included in the special reserve's funding sources under the current legislation. To emphasize, the share of authorized capital in KDIF's overall special reserve amount significantly expanded during the financial crisis in 2008, as a result of the sevenfold increase of the deposit coverage limit (from 700,000 to 5 million tenge). The amount of authorized capital to be included in the special reserve for payouts is decided by KDIF's shareholders, and may vary from 0 to 50%.

One of the major sources of special reserve funding for the DIA is a contribution from the Russian government, while an initial one-time contribution from the Kyrgyzstani government amounting to 76% of the special reserve's funding target accounts for a significant portion of the Kyrgyzstani DI's reserve. In Ukraine, the DIF's reserve includes funds initially paid in by the central bank in the amount of 20 million hryvnia, as well as its special contributions representing the surplus of its estimated income over estimated expenses (during the crisis), loans, and income from deposits placed with the Central Bank of Ukraine (during the crisis); in Moldova, it is funded by loans, donations, budget subsidies and other sources. In Belarus, the DI's special reserve includes 80% of the central bank's income.

Measures stipulated in the legislation of the respondent countries in the event of a DI reserve shortfall are shown in *Table 3.*

Table 3. Measures stipulated in respondent countries' legislation in the event of a DI reserve shortfall

№	Measures to be taken	Armenia	Azerbaijan	Belarus	Kazakhstan	Kyrgyzstan	Moldova	Russia	Tajikistan	Uzbekistan	Ukraine
1	Levying additional premiums on DIS members	✓	✓	-	✓	✓	✓	-	✓	-	✓
2	Borrowing/contribution of the shortfall amount from the central bank and/or other financial regulators	✓	✓	✓	✓	-	-	✓	-	✓	✓
3	Borrowing/contribution of the shortfall from the Ministry of Finance and/or state budget	-	✓	✓	-	✓	✓	✓	✓	✓	✓
4	Bond issuance	✓	✓	-	-	-	-	✓	-	-	-

III. DEPOSIT INSURANCE COVERAGE PAYOUT PROCESS

A. Problem bank resolution methods

In the event of problems arising with a member bank's solvency, international practice suggests four main problem bank resolution methods:

1. Forced liquidation and payout of deposit insurance coverage to depositors;
2. Purchase & assumption (P&A);
3. Bridge bank;
4. Open bank assistance (OBA).

Forced liquidation of member banks is stipulated in the legislation of all the respondent countries, and this procedure is the most likely to be actually applied in the event of a bank failure *(see Table 4)*. In seven out of 10 respondent countries' legislation, alternative methods of problem bank resolution are provided for. For example, in Kazakhstan, Kyrgyzstan, Moldova, Russia, Uzbekistan and Ukraine, the P&A procedure can be applied instead of the more common forced liquidation and payout to depositors.

Except in Belarus and Russia, the central bank of each respondent country is the entity that determines the problem bank resolution method and bears all the responsibility for its implementation. In Belarus, all these functions are exercised by the court. In Kyrgyzstan, problem bank resolution is jointly carried out by the agency for bank reorganization and debt restructuring and the central bank, while in Tajikistan it is conducted by the court together with the central bank. In Russia, the appropriate problem bank resolution method is selected either by the court (in cases where it declares the bank's bankruptcy or liquidation) or by the DIA together with the Central Bank of Russia (in the event of the bank's restructuring or P&A).

Table 4. Problem bank resolution methods stipulated in legislation

№	Respondent countries	Forced liquidation	P&A	Bridge bank	OBA
1	Armenia	✓	-	-	-
2	Azerbaijan	✓	-	-	-
3	Belarus	✓	-	-	-
4	Kazakhstan	✓	✓	✓	✓
5	Kyrgyzstan	✓	✓	✓	-
6	Moldova	✓	✓	-	✓
7	Russia	✓	✓	-	✓
8	Tajikistan	✓	-	-	✓
9	Uzbekistan	✓	✓	-	-
10	Ukraine	✓	✓	-	✓

B. Definition of bank failure

For each DI of the respondent countries the main trigger for it to carry out its principal function – reimbursement of deposit insurance coverage – is a member bank failure; the definition of this event varies significantly from one DI to another, and includes:

- *Withdrawal of license to conduct all or specific banking operations:* Belarus, Moldova, Russia, Tajikistan, Ukraine, and Uzbekistan;
- *Bank's non-fulfillment of its liabilities to depositors:* Armenia and Azerbaijan;
- *Court's decision on the problem bank's forced liquidation: Armenia,* Azerbaijan, Kyrgyzstan, Kazakhstan, and Tajikistan.

C. Generation of depositors' register

In the event of a bank failure, it is crucial to swiftly determine the total amount of the DI's liabilities on payout of deposit insurance coverage, which implies that the forcibly liquidated bank has previously prepared a depositors' register. In most respondent countries, the depositors' register is established by the liquidated bank itself. In Kazakhstan, Moldova, and Ukraine, the depositors' register is prepared by the bank's liquidator; in Kyrgyzstan, by the agency for bank reorganization and debt restructuring. In Russia, the DIA participates in generatinggenerates the depositors' register together with the failed bank (within the framework of the problem bank's management by its acting administration appointed by the Central Bank of Russia).

The periods within which the DIs of respondent countries gain access to the depositors' register of a forcibly liquidated bank are shown in the table below.

Table 5. Period within which DIs gain access to the depositors' register of a failed bank

№	Respondent countries	Period
1	Armenia	Within 10 days after the bank failure
2	Azerbaijan	After the bank failure
3	Belarus	Within 3 working days after the failed bank's receipt of the central bank's notification about the banking license withdrawal
4	Kazakhstan	No later than 20 working days after the appointment of the problem bank's temporary administration (before the beginning of the bank's forced liquidation)
5	Kyrgyzstan	Within 15 calendar days after the bank failure
6	Moldova	Within 5 days after the bank failure
7	Russia	After the bank failure
8	Tajikistan	Within 5 days after the bank failure
10	Ukraine	Within 20 working days after the appointment of the bank's liquidator
11	Uzbekistan	After the bank failure

Furthermore, it should be emphasized that the depositors' register generation procedure can be accelerated if the DI is authorized to inspect, the accuracy of such a register prior to the official announcement of the bank failure. Such authority exists in Belarus, Kazakhstan, Russia and Ukraine. The process of inspecting the correct preparation of the depositors' register by member banks is fully automated only in Belarus and Russia. For example, in Russia special software has been developed for use by the DIA during bank inspections, and by member banks for self-assessment of their compliance with the DIA's requirements in this area. Maintenance of the depositors' register in Kazakhstani banks is automated and generated in their Automated Banking Information System (ABIS). In Ukraine, only the process for inspecting the depositors' list provided by the liquidator to the Ukrainian deposit insurer is automated.

D. Start and end of the payout process

When a bank failure takes place, it is essential to ensure prompt, accurate and complete payouts of deposit insurance coverage to the depositors of the forcibly liquidated member bank, in order to maintain public confidence in the deposit insurance system and the financial system as a whole. Since the period between termination of a bank's operations due to withdrawal of its banking license and enactment of the court's decision on the bank's forced liquidation can be rather long, the DI's readiness to promptly reimburse depositors is crucial. In general, a country's legislation should specify a maximum period within which its DI should start insurance coverage payouts. In four out of ten respondent countries, this period does not exceed 15 days after the bank failure *(see Table 6)*. In Belarus, the maximum term for deposit insurance payouts is one month after the date of the depositor's application to the DI to receive deposit insurance coverage. A liquidated bank's depositors in that country have the right to apply to the DI immediately after the bank failure.

Table 6. Periods within which DIs should start insurance coverage payouts

№	Respondent countries	Maximum period for starting insurance coverage payouts
1	Armenia	Within 30 days after the bank failure
2	Azerbaijan	Within one year after the day of the first publication of notification about the start of insurance coverage payouts
3	Belarus	Within 30 days after receiving the depositor's application to receive a deposit insurance coverage payout
4	Kazakhstan	Within 14 working days after the bank failure
5	Kyrgyzstan	Within 60 calendar days after the bank failure
6	Moldova	Within 11 days after the bank failure
7	Russia	Within 14 days after the bank failure
8	Tajikistan	Within 15 days after the bank failure
10	Ukraine	Within 60 days after the liquidator's appointment
11	Uzbekistan	Within 13 days after receiving the depositor's application to the DI and all appropriate supporting documents from the bank's liquidation commission

It is worth emphasizing that, in Belarus, Kazakhstan, Kyrgyzstan, Moldova and Tajikistan, the DI can postpone the start of insurance coverage payouts in emergency cases, e.g. a shortfall in the special reserve for payouts or legal proceedings over the problem bank. In such cases, terms for payouts may increase by up to three months after the date of submitting an application to the DI in Belarus, up to 45 calendar days from the date of bank failure in Kazakhstan, up to 60 more days or for an indefinite period in special emergency cases in Kyrgyzstan, and up to 30 days from the date of bank failure in Moldova.

In some of the respondent countries, deadline for the end of insurance coverage payouts to the depositors of forcibly liquidated banks is also legally stipulated. For example, in Azerbaijan the DI should end the payout process within one year from the date of the announcement of a payout; in exceptional cases this period may be extended up to five years. In Armenia, depositors' right to apply for insurance coverage expires after one year, in Belarus two years from the date of the bank failure, and in Ukraine three years from the date of the bank's liquidation. In Kazakhstan, the DI stops all payouts of deposit insurance coverage one year after the date of the liquidated bank's inclusion in the state register of legal entities, but no earlier than five years after enactment of the court's decision on the member bank's forced liquidation. In Russia, deposit coverage payouts continue until the court decides that the liquidation procedures for a problem bank have been completed.

E. Payout methods

> The deposit insurance system should give depositors prompt access to their insured funds. Therefore, the deposit insurer should be notified or informed sufficiently in advance of the conditions under which a reimbursement may be required and be provided with access to depositor information in advance. Depositors should have a legal right to reimbursement up to the coverage limit and should know when and under what conditions the deposit insurer will start the payment process, the time frame over which payments will take place, whether any advance or interim payments will be made as well as the applicable coverage limits. ***Principle 17 – Reimbursing depositors, Core Principles for Effective Deposit Insurance Systems, IADI***

Payouts of deposit insurance coverage via an agent bank is the most common payout method, stipulated in the legislation of all respondent countries *(see Table 7)*. Agent banks are selected based on the following main criteria: degree of financial soundness, compliance with regulatory bodies' prudential norms and standards, development of their branch network, total amount of assets, prior experience in deposit insurance coverage payouts, absence of overdue payments to the state budget, etc.

In Azerbaijan, Kazakhstan, Kyrgyzstan, Moldova and Russia, deposit insurance coverage can also be directly reimbursed by the DI itself (usually after expiration of the agreement between the DI and the agent bank). In addition, Kazakhstan, Moldova, and Russia stipulate the use of the national postal operator for insurance coverage payouts in their legislation.

Table 7. Coverage payout methods stipulated in the respondent countries' legislation

№	Responding countries	DI	Agent bank	Postal transfer	Liquidated bank
1	Azerbaijan	✓	✓	-	-
2	Armenia	-	✓	-	✓
3	Belarus	-	✓	-	-
4	Kazakhstan	✓	✓	✓	-
5	Kyrgyzstan	-	✓	-	-
6	Moldova	✓	✓	✓	-
7	Russia	✓	✓	✓	-
8	Tajikistan	-	✓	-	-
9	Uzbekistan	-	✓	-	-
10	Ukraine	-	✓	-	-

F. Deposit insurance coverage payouts

The present section considers experiences of three countries - Russia, Ukraine and Kazakhstan – which cover all stages of deposit insurance coverage payouts in practice.

The DIA's experience

The DIA has been operating for almost eight years. The organization has experienced 109 bank failures, including 84 cases of deposit insurance coverage payouts to depositors carried out by an agent bank, 22 cases of reimbursements directly conducted by the DIA itself, and three cases of using P&A as an alternative problem bank resolution method.[5] Most bank failures (105 out of 109) involved less than 50,000 insured problem bank depositors, who were reimbursed by the DIA. The main problem confronting the DIA during the deposit insurance coverage payout process was incorrect depositors' registers generated by the problem bank (including deletion of accounts data). In addition, the DIA has uncovered several cases of fraud: setting-up of fake deposits; splitting of insured deposits exceeding the deposit coverage limit into several smaller deposits, each with amounts less than the deposit coverage limit; transformation of uninsurable liabilities to legal entities into insurable liabilities to individuals; and other instances of fraud. It should be emphasized that, during the crisis period in Russia in 2007-2009, there were three cases of capital injections into problem banks (OBA alternative resolution method). In addition, the Russian state also provided financial support (loans) to the investors of problem banks 12 times, and gave loans to the problem banks themselves.

[5] As of May 1, 2011.

Based on its longstanding experience with resolving problem banks, the DIA has identified the following advantages and disadvantages of problem bank resolution methods in Russia.

- OBA

Advantages:

1) The existing legislation on bank resolution allows contributions to the problem bank's authorized capital to be made in a simplified way and, taking into account the difficult financial standing of problem banks, it makes it possible to significantly improve their financial soundness in the shortest possible time.
2) Injections of capital into the problem bank by a state company with a strong business reputation, such as the DIA, positively affects the bank's financial standing due to the strengthening of public confidence in it and, as a consequence, increases the inflow of deposits.

Disadvantages:

1) The DIA's acquisition of a capital share in a problem bank makes it necessary for the DIA's representatives to intervene in the banks' management board activity, its budget process and an operations which infringe upon established prudential requirements, and also to limit the bank's activities when necessary. Thus, the DIA has to take responsibility for managing credit institutions.
2) If a significant volume of capital is injected into a problem bank, an imbalance can occur between the value of the bank's net assets and the DIA's contribution. This may cause difficulties for the further sale of the DIA's shares to the interested investors.

- P&A

Advantages:

1) Transfer of the problem bank's assets and liabilities into the assuming bank is carried out based on the book value. In the event of the bank's bankruptcy, such assets are sold at their liquidation value. The difference between the book and liquidation values may be up to 90%.
2) Prevention of major bank runs because all the terms and conditions of servicing creditors remain the same with the assumption of the problem bank's liabilities.
3) Maintenance of the problem bank's branch network, which is transferred to the assuming bank at market value.
4) Opportunity for the problem bank's personnel to avoid huge layoffs.
5) Reduction in the DIA fund's expenses.

According to the DIA, there are no disadvantages to using the P&A method of problem bank resolution.

❖ *Provision of financial support to investors in problem banks*

Advantages:

1) No capital injection from the state (nationalization) is necessary
2) The main risks of the problem bank restructuring are borne by the investor
3) Credit risk is minimized by receiving collateral on the loans provided
4) Preservation of the problem bank's business.

Disadvantages:

Continuous monitoring of the investor's activities (with a view to minimizing the DIA's reputational risks, among other reasons) is required.

In addition, according to the DIA, a more active use of the P&A resolution method could be one of the promising directions to pursue when amending the legislation on the problem bank resolution process. The DIA believes that it would be expedient to provide for the transfer of the problem bank's assets and liabilities to more than one assuming bank at a time, to establish rules on – and the amount of – the special premium payment to the assuming banks in cases where the value of the assumed problem bank's liabilities exceeds the value of the assets received, and to establish the possibility of repurchasing from the assuming bank any of the transferred problem bank's assets/property that are of inappropriate quality.

In addition to the proposals on the legislation amendments, the DIA has also started to develop new internal documents regulating activities relating to problem bank restructuring, and continues to review and revise existing documents. In particular, the program of activities aimed at implementing the DIA's development strategy in 2011-2012 envisages the preparation of the following internal regulations:

1) methodological recommendations on the quick assessment of problem banks' asset quality;
2) special methodology on the description of assets offered for transfer within the P&A operations framework, which will enable potential buyer institutions to make informed and quick decisions on their participation in the P&A;
3) rules on the use of electronic portals as a means of selling a problem bank's assets received by the DIA during the restructuring process.

The DGFU's experience

The Deposit Guarantee Fund of Ukraine (DGFU) was established in 1998, and has so far dealt with 26 bank failures resulting in insurance coverage payouts to the depositors of forcibly liquidated member banks. In 24 of these cases, the total number of insured depositors eligible to receive reimbursement from the DGFU was less than 50,000. While reimbursing the failed banks' depositors, the DGFU also faced the problem of incorrect depositors' registers generated by the problem banks.

Ukrainian legislation stipulates all major problem bank resolution methods, with the exception of the bridge bank. However, apart from forced liquidation, only the P&A method has so far been implemented in practice – twice by the National Bank of Ukraine. In order to improve the effective implementation of problem bank resolution procedures, the DGFU is seeking the mandates of temporary administrator and liquidator for problem banks, as well as the establishment of a fully developed secondary market for bank assets. With the purpose of improving the Ukrainian financial safety net, which would obviously imply, among other measures, institutional strengthening of the DGFU along with the extension of the scope of its powers in the area of problem bank resolution, the DGFU has developed a concept for reform and adoption of the new mechanism for dealing with problem banks.

The KDIF's experience

Since its establishment in November 1999 and over the whole period of KDIF's operation, there have been three cases of forced liquidation of problem banks. The total number of insured depositors was 2,300 for Komirbank JSC, 164,000 for Nauryzbank Kazakhstan JSC, and 267,000 for Valut-Transit Bank JSC. The main problems which KDIF had to deal with during the deposit insurance coverage payout process (this was initially carried out via agent banks and after three years directly by KDIF itself) were incorrect depositors' registers generated by the problem banks and a shortfall in the special reserve for payouts.

During the period of financial uncertainty (2007-2009) in Kazakhstan, the National Welfare Fund, Samruk-Kazyna, injected capital totaling USD 3 billion into three large and two medium-sized banks.

According to KDIF, problem bank resolution methods have the following main advantages and disadvantages:

- *Forced liquidation*

Advantages:

1) Depositors can receive their deposit insurance coverage within the deposit coverage limit shortly after the enactment of the court's decision on the problem bank's forced liquidation.

Disadvantages:

1) The liquidation process may be delayed for an indefinite period of time.
2) Low liquidation value of the problem bank's assets, or their loss.
3) High administrative expenses.

4) Incomplete settlement of accounts with the problem bank's creditors.

❖ *Capital injections by the state (OBA)*

Advantages:

1) State injections of capital into the problem bank help improve its financial standing within the shortest possible period of time.
2) State injections of capital strengthen creditors' confidence in the problem bank and contribute to an increase in funds inflows to the problem bank.

Disadvantages:

1) The state assumes some responsibility for the problem bank's operations as its shareholder (reputational and financial risks).
2) The need for operational management of the bank and regular monitoring of its financial standing by the state, which requires large amounts of capital investment in the problem bank by the state, and recruitment of a large number of staff to exercise these functions.
3) Risk of moral hazard ("too big to fail" issue) in systemically important banks.

❖ *Bridge bank*

Advantages:

1) The bridge bank can conduct common banking and other operations stipulated in the Kazakhstani legislation under the license granted by the authorized regulatory body

Disadvantages:

1) If there are no potential buyers for the bridge bank's shares, the term of operation of the bridge bank may be delayed indefinitely.
2) Lack of experience in establishing bridge banks in Kazakhstan.

❖ *P&A*

Advantages:

1) P&A operations are carried out prior to the enactment of the court's decision on the problem bank's forced liquidation, which minimizes the expense for the KDIF's special reserve for deposit insurance coverage payouts.
2) High probability that the problem bank's branch network can be preserved.
3) Retention of the problem bank's existing depositors, as they are "transferred" to the assuming bank along with the problem bank's assets.

Disadvantages:

1. No experience in carrying out P&A operations in Kazakhstan.
2. Absence of potential buyers for the problem bank's assets and liabilities may delay the term of the P&A operation.
3. Risk of the repurchase of poor-quality assets.
4. Risk of court proceedings with the banks' creditors due to the (in their opinion) incorrect assessment of the bank's assets.

KDIF thinks that, in order to increase the effectiveness of problem bank resolution procedures, it is essential to improve the existing Kazakhstani legislation in the following directions:

1. Development of the methodology for assessing the problem bank's intangible assets to be transferred to the assuming bank, including its loan portfolio, to be applied while conducting the P&A operations.
2. Development of the markets for banks' assets and debt liabilities.

IV. COMPARISON OF DEPOSIT INSURERS IN CIS AND APRC COUNTRIES[6]

APRC IADI is the Asia-Pacific Regional Committee of IADI. It currently numbers deposit insurers from 15 countries among its members, namely: India (1962), the Philippines (1963), Japan (1971), Taiwan (1985), South Korea (1996), Australia (1998), Vietnam (2000), Malaysia (2005), Indonesia (2005), Hong Kong (2006), Singapore (2006), Thailand (2008), as well as Azerbaijan, Kazakhstan and Russia, which were excluded both from the APRC and the respondent countries for the purposes of this comparison.

First of all, DIs in APRC countries generally possess broader powers than those in CIS countries. For example, in Malaysia, South Korea, Taiwan and Vietnam, DIs have achieved the most advanced stage of development: the "risk minimizer". The main reason for this difference is the absence of experience in deposit insurance coverage payouts in the majority of respondent countries. In fact, the latter have rather limited and basic mandates, which mostly involve setting up the special reserve and deposit insurance coverage payouts to insured depositors in the event of a bank failure. Moreover, APRC countries have gone through many more cases of bank failure (especially during the Asian financial crisis) than their counterparts in the CIS. This

[6] In 2009 KDIF prepared comparative research on deposit insurers in APRC member countries. As the issues of the 2009 research and the present research are analogous, this section gives a brief general comparative summary of these two regions' deposit insurers.

enabled them to realize that it was essential to drastically improve their deposit insurance systems as one of the key financial safety-net players, and also to greatly extend their powers in order to more efficiently fulfill their mission – maintaining financial system stability – as well as to optimize the problem bank resolution process.

In general, payouts of insurance coverage to liquidated bank's depositors is the least-used problem bank resolution method in the APRC region, and only half of the APRC countries have experience in this area. The most effective and commonly used problem bank resolution methods are P&A and bridge bank. That is why the legislation of several APRC countries does not even stipulate exact terms for the start of the deposit insurance coverage payout process.

Unlike in respondent countries, the DIs in the majority of APRC countries are required to prepare a depositors' register themselves upon the announcement of a bank failure. Furthermore, in about half of the APRC countries (Hong Kong, Indonesia, Japan, the Philippines, Singapore, and Taiwan) DIs are equipped with special software which allows automatic downloading of all the data needed to generate the depositors' register from the bank's automated banking information system (ABIS). An additional advantage of having such software is the elimination of the need for regular member bank inspections by the deposit insurers in some APRC member countries.

Just like in most respondent countries, the DIs of the majority of APRC countries should reimburse depositors exclusively in domestic currency, irrespective of currency of the original deposit. On the other hand, in a number of APRC countries (e.g. Japan, Malaysia, and South Korea) it is possible to partially reimburse depositors before the official start of the payout process in certain cases, while such provision is not stipulated in any of the respondent countries' legislation.

The deposit insurance coverage payout methods in use are almost the same in both APRC and respondent countries. For example, the DIs of Indonesia and South Korea usually prefer to use an agent bank for payouts. Meanwhile, in the Philippines the DI itself pays out the insurance coverage, and in India payouts are carried out via the problem bank's liquidator. A similar variety of deposit coverage payout methods is also used in CIS countries.