

# Experience is the Best Teacher

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***Kazakhstan Deposit Insurance Fund recently conducted a comparative research analysis on the deposit insurance systems of the CIS countries<sup>1</sup>, which revealed several important and interesting trends.***

Above all, it has become evident that generally, the more cases of banks' forcible liquidation and ensuing insurance coverage payouts a certain deposit insurer has already gone through, the more sophisticated and advanced it becomes and the more mandates it begins or strives to obtain, especially those related to the partaking in the banks' forcible liquidation and the alternative methods of problem banks' resolution. This follows a simple logic: like many other entities deposit insurers learn much from their own experience. Thus, only after dealing in practice with several cases of bank failures, understanding many inconveniences of the insolvent bank's forcible liquidation and experiencing certain problems while discharging their main obligations on insurance coverage payouts do they begin to realise that alternative bank resolution methods might be more convenient and less costly for all parties to implement.

For example, the comparison of deposit insurers from the Asia-Pacific Regional Committee (APRC) of the International Association of Deposit Insurers<sup>2</sup> with the post-Soviet deposit insurers showed that, in general, Asian deposit insurers possess a wider scope of mandates and more advanced and sophisticated functions and tools than those of deposit insurers

in the CIS countries. This is due mainly to the fact that, by and large, through their history Asian deposit insurers have faced a lot more cases of bank failures followed by forcible liquidations and insurance coverage payouts than their counterparts from the CIS. Firstly, this is simply because Asian deposit insurers have generally longer histories of operation than the post-Soviet insurers that were founded not earlier than 1998 shortly after the CIS countries gained their independence. Secondly, Asian countries suffered much more from different crises, the most important among which was the Asian financial crisis at the end of last century. In the post-Soviet countries no regional crisis of such magnitude has ever occurred yet.

Thus, the APRC financial authorities have learned from their experience and realised the necessity and importance of improving the national deposit insurance systems and the need to extend the powers of deposit insurers in various aspects, especially in the optimisation of the problem bank resolution process. They understood well that these steps will contribute much to counteracting the impact of future financial crises and will help deposit insurers efficiently fulfil their main mission of one of the key Financial Safety Net players – to maintain the financial stability of their countries. As a result, deposit insurers of such countries as Malaysia, South Korea, Taiwan and Vietnam have already reached the highest stage of development and became "risk-minimisers" with a very broad range of mandates and appropriate tools to assess and manage risks. Most of other Asian deposit insurers now possess "paybox with extended powers" mandates. On the contrary, most of the CIS deposit insurers merely represent "paybox" systems with mandates limited mainly to accumulating incoming premiums in a special reserve and then reimbursing depositors in case of a member-bank's forcible liquidation.

As for the implemented methods of insurance coverage payout, they do not differ much between the APRC and CIS countries and are rather diverse in both regions.

However, in APRC countries direct payouts of insurance coverage to the depositors of a forcibly liquidated bank is the least favoured method for problem bank resolution" (forcibly liquidated banks rarely reimburse the depositors themselves, this function is usually exercised by an agent bank or the deposit insurer). Purchase and Assumption and Bridge Bank are considered the most efficient methods and, consequently, are most used in practice. Due to the fact that these bank resolution methods avoid triggering of the payout process, insurers of only half of the Asian countries have any experience in conducting payouts to date. Moreover, in some of these countries the exact starting period of insurance coverage payouts is not even specified in legislation.

Furthermore, unlike in the CIS countries where the liquidation commission generally is in charge of forming the failed bank's depositors register, the APRC deposit insurers themselves become responsible for exercising the function. Also, in six countries – members of the APRC (Hong Kong, Indonesia, Singapore, Taiwan, the Philippines and Japan) deposit insurers are equipped with special software, which can automatically download all the information required to compile the depositors' register from the bank's automatic banking information system (ABIS). Thus, the deposit insurers do not have to conduct regular on-sight investigations to ensure the correctness of the depositors' register prepared by the bank.

Finally, in several APRC countries (e.g. Malaysia, South Korea and Japan) in certain cases it is possible to partially

<sup>1</sup> The comparative research analysis included deposit insurance systems of 10 CIS countries (Armenia, Azerbaijan, Belarus, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, Ukraine and Uzbekistan). The analysis was carried out on the occasion of the 4th Annual Meeting and Seminar of the Eurasia Regional Committee of the International Association of Deposit Insurers hosted by the Kazakhstan Deposit Insurance Fund on September 12-13, 2011 in Almaty.

<sup>2</sup> 15 countries-members of the Asia-Pacific Regional Committee include: Australia, Azerbaijan, Hong Kong, India, Indonesia, Japan, Kazakhstan, Malaysia, the Philippines, Russia, Singapore, South Korea, Taiwan, Thailand, and Vietnam.

reimburse the failed banks' depositors prior to the official beginning of the payout period, while no deposit insurer of CIS countries is authorised to do so.

The comparison of those CIS deposit insurers who have already gone through a process of insurance coverage payouts with the ones who have no such experience revealed the same trend. Only 3 CIS countries – Kazakhstan, Russia and Ukraine—have so far actually reimbursed the failed banks' depositors. In fact, the Deposit Insurance Agency of Russia (dealt with 109 bank failures) and the Kazakhstan Deposit Insurance Fund (dealt with 3 cases of banks' forcible liquidation) represent the most advanced deposit insurance systems in the Eurasian region, "payboxes with extended powers" and possess such complex mandates as participation in the failed bank's receivership process, liquidation commission and creditors' committee, control over the correctness of the insured depositors' register compilation by member-banks, and participation in the country's Early Warning System along with the financial regulator.

As for the Deposit Guarantee Fund of Ukraine (DGFU), which has gone through 26 payout cases but still possesses quite limited "paybox" mandates, at first glance it seems to be an exception to our established "rule". However, DGFU has already gained control over the depositors' register and initiated a range of important reforms aimed at upgrading its mandate from a simple "paybox" to a "paybox with extended powers". A draft law has been prepared with the assistance of the World Bank and USAID, which shifts the problem bank resolution and liquidation mandates from the National Bank of Ukraine to DGFU, introducing the receivership concept and the least-cost principle criteria in the process of selecting a bank resolution method. DGFU also strives to create a full-fledged secondary market for bank assets in Ukraine to facilitate the implementation of alternative problem bank resolution methods.

Among the remaining seven CIS deposit insurers who have never had to exercise their main function of conducting payouts, yet only the Agency for Guaranteed Compensation of Bank Deposits of Belarus has managed to reach the stage of "paybox with extended powers". Nevertheless, it still lacks such an important mandate as participation in the Early Warning System, which both the Deposit Insurance Agency of

Russian Federation and the Kazakhstan Deposit Insurance Fund possess. The other six deposit insurers from Armenia, Azerbaijan, Kyrgyzstan, Moldova, Tajikistan, and Uzbekistan still represent the "paybox" system.

Following the Asian and developed countries' example, seven countries in the CIS region have realised that the problem banks' forcible liquidation and ensuing insurance coverage payouts are not always the best solution to the bank's insolvency and, therefore, already stipulated alternative bank resolution methods (Purchase and Assumption, Bridge Bank, Open Bank Assistance, etc.) in their legislation. However, few of them had either sufficient time elapsed since introduction of these legislative amendments or enough courage and competence to implement these alternative bank resolution methods in practice. For instance, in the legislation of Kazakhstan, Kyrgyzstan, Moldova, Russia, Ukraine, and Uzbekistan, Purchase and Assumption method may be used along with the problem bank's forcible liquidation. However, only Russia, Ukraine, and Uzbekistan have so far tested this method in practice. Also, although the Bridge Bank resolution method is already provided for in the legislation of Kazakhstan and Kyrgyzstan, it has not been actually used yet. Finally, under the national banking legislation, the governments of Kazakhstan, Moldova, Russia, Tajikistan and Ukraine can apply the Open Bank Assistance resolution method in certain cases. Nevertheless, only Kazakhstan, Russia and Ukraine have so far actually injected capital in problem banks.

Finally, the aforementioned comparative research analysis also made obvious the fact that those CIS countries that already have experience in conducting forcible liquidations of failed banks often cannot efficiently implement the alternative problem bank resolution procedures in practice for several reasons. Firstly, it is because the secondary market for bank assets in the CIS countries is either absent or underdeveloped. The biggest issue, however, is most likely the absence of a methodology to assess bank's certain assets, in particular, intangible assets and loan portfolio. Unfortunately, in these countries the legislation has not been developed in this direction yet.

Therefore, one of the major current challenges for the post-Soviet deposit insurers is to comprehensively prepare for smooth implementation of these alternative problem bank resolution methods when necessary. Deposit

insurers of the CIS countries will need, among other measures, to thoroughly study and compare the current local legislation and standards on assessment of banks' intangible assets and loan portfolio with the international best practice in this area, and then, on the basis of this analysis, to develop and put forward before the Central Bank and the financial regulators their proposals on necessary improvements. In addition, there is a need to standardise approaches to the problem bank's assets assessment.

### MOST ADVANCED DEPOSIT INSURERS IN THE CIS

#### Deposit Insurance Agency (Russian Federation)

*Throughout the seven year-history of the Deposit Insurance Agency, 109 bank failures have taken place in Russia. As a rule, the insurance coverage was paid out to depositors either through an agent bank, or through the deposit insurer itself. However, the Deposit Insurance Agency has also used the Purchase and Assumption and the Open Bank Assistance resolution methods (thrice each), 12 times provided financial support to the investors in problem banks and once issued a loan to a bank under the reorganisation process.*

#### Deposit Guarantee Fund of Ukraine

*The Deposit Guarantee Fund of Ukraine faced 26 cases of bank failures. The country's legislation provides for all of the main methods for problem bank resolution, except for the Bridge Bank one. In addition to the direct insurance coverage payouts, the Purchase and Assumption method has also been used twice in Ukraine.*

#### Kazakhstan Deposit Insurance Fund

*Throughout its history, the Kazakhstan Deposit Insurance Fund has exercised its main function of reimbursing depositors three times. It is worth noting that, unlike in cases of the Deposit Insurance Agency of Russia and the Deposit Guarantee Fund of Ukraine, when failed banks usually had less than 50 thousand insured depositors, the Kazakhstan Deposit Insurance Fund had to deal with a rather large number of insured depositors in two cases: there were about 164 thousand depositors in the failed "Nauryz Bank Kazakhstan JSC" and 267 thousand in "Valut Tranzit Bank JSC". In addition, the fact that in both of these banks the depositors' register was incorrectly formed has also aggravated the complexity of the payout process.*

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