

# REIMBURSING DEPOSITORS

## Abstract

A basic function of all deposit insurance systems is to reimburse depositors promptly for the losses they otherwise would suffer in the event of an insured financial institution's closure. As a result, depositors are relieved of both the recovery-rate and time risks of a liquidation process up to the insured level of their deposits. Reimbursements to depositors—including the speed and convenience of such—vary across countries, and can affect public confidence in the deposit insurance system. This paper addresses the factors related to the reimbursement process, discusses the advantages and disadvantages of various approaches, and makes recommendations on appropriate guidance for deposit insurance systems.

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### **Conditions Necessary for an Efficient Reimbursement Process**

A number of conditions, including those involving legal and financial issues, must be in place for a deposit insurer to accomplish its reimbursement function efficiently—that is, to reduce the recovery-rate and time risks for depositors with insured deposits. Specifically, depositors need to know when and under what conditions the deposit insurer will start the reimbursement process.<sup>2</sup> Additionally, depositors need to know the coverage limits. Finally, the deposit insurer needs to have available adequate funding to fulfil its obligation to reimburse insured depositors.

### **Starting the reimbursement process**

A deposit insurer needs to know as soon as possible when an institution with insured deposits will be closed and whether depositors will need to be reimbursed. In many cases, the decision to close an institution rests with the supervisory authority, which will either suspend or withdraw the institution's license or charter. In other cases, the process to close an institution may be commenced by the supervisor or deposit insurer, but must be approved by a court.

### **Separating the reimbursement from the liquidation process**

It is advisable to separate the reimbursement process from the disposition of the assets of the closed institution even in cases where the deposit insurer also handles the liquidation of the institution. A clear separation of responsibilities can improve the speed and efficiency with which depositors are reimbursed and ensure that the appropriate focus is given to the necessary tasks. However, in many cases this will not be possible. For example, if no funds are available for reimbursement other than from the disposition of the failed institution's assets, the deposit insurer will not be able to separate its task from the work of the liquidator. In these cases, the deposit insurer will need additional authorities—for example, the ability to borrow for working-

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<sup>1</sup> The Subgroup on Reimbursing Depositors is comprised of representatives from Hungary (coordinator), Canada, Italy, Philippines, and the United States.

<sup>2</sup>Typically, the reimbursement process starts when deposits became frozen because of the unavailability of liquid assets or when the decision is made to close an insured institution.

capital purposes—in order to proceed with a timely reimbursement process.<sup>3</sup> The longer the period between the closure of an institution and the beginning of the reimbursement process, the greater is the likelihood that the public will lose confidence in the ability of the deposit insurer to meet its obligations.

### **Early access to data**

In addition, the longer the period between a closure and the start of the reimbursement process, the greater the risk that manipulation of the institution's data might occur. This could result in the inability of the deposit insurer to sort out depositors with legitimate claims from those seeking protection of funds that would otherwise not be insured. Granting a deposit insurer the authority to have access to, or control of, deposit data before closure would lessen the risk of manipulation. Legislative provisions in a number of countries allow the deposit insurer to prepare for closure and possible reimbursement at institutions that appear likely to fail.<sup>4</sup> In other countries the deposit insurer is restricted from doing this by strict secrecy rules. The deposit insurer also needs to have sufficient experience and advance information about the institution's data system(s) so as to speed up the reimbursement process.

### **Time frame for the reimbursement process**

Regardless of how a closure is handled, a deposit insurer needs a clear delineation of when to start and when to complete the reimbursement process. Depositors, too, need to know when they can expect to receive their funds.<sup>5</sup> If insured deposits will not be available immediately after an institution is closed, depositors need to know the time frame over which reimbursement will take place. This will help to reduce the loss of public confidence.

### **Reconciliation of accounts**

Determining who should be reimbursed and ensuring that insurance limits are respected are the most crucial and time-consuming steps in the deposit-reimbursement process. In order to carry out this function in a timely manner, the deposit insurer needs to have a clear understanding of the legal environment in which it operates, who is eligible for deposit insurance coverage, what products are covered, and the limits of that coverage. For example, the law has to define clearly the eligible persons—natural or legal, the trustee's rights to proceed depending on whether the authorisation is given before or after the closure, and the beneficiary's rights. The scope and

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<sup>3</sup> See the paper on funding for a discussion of the various sources of funding a deposit insurer may use to accomplish a timely reimbursement. See the paper on powers for a discussion of what authority a deposit insurer needs in order to accomplish a timely reimbursement of depositors.

<sup>4</sup> For example, in the United States, the Federal Deposit Insurance Corporation (FDIC), which insures bank and thrift deposits, generally is given at least 90 days' notice before the closure of a bank. If no financial institution can be found to assume the deposits during this period, the FDIC makes plans to pay depositors the full amount of their insured deposits. In Hungary the deposit insurer is authorised to examine the books of a bank if it appears likely to fail.

<sup>5</sup> For example, the European Union Directive requires that deposit guarantee schemes of member countries must be in a position to pay duly verified claims by depositors within three months of the date of an institution's failure.

level of coverage will vary, depending upon a country's decisions consistent with its public-policy objectives, and should be defined clearly in the law.<sup>6</sup>

Once the deposit insurer determines which depositors and what products are covered, it must determine the amount that should be reimbursed to each depositor. The deposit insurer needs to assess the amount in each deposit account at the time of the closure of the failed institution, determine whether the accounts are within the deposit insurance limit, and reimburse the depositors. The mechanics of this process are discussed below. However, there are a number of issues that must be determined before this process can begin.

### *Ownership rights and capacities*

In order to determine the amount that each depositor is owed and whether the amount falls within the coverage limit, the deposit insurer must understand the different ownership rights and capacities, if there are any, with respect to single accounts, joint accounts, business accounts, retirement accounts, and fiduciary accounts and how deposit insurance coverage is applied in these instances. In many countries the coverage limit is applied to the combined account statement of depositors with multiple deposits, regardless of the number of deposits, the currency, or the location.<sup>7</sup> In others, deposits held in different rights and capacities are insured separately.<sup>8</sup>

### *Interest payment*

In most countries interest on deposits is calculated up to the point of closure and paid first, along with the principal, up to the coverage limit. However, in many countries the interest payments on deposits considered to have "high" yields may be repudiated and reimbursement made only for the principal with some "reasonable" rate of interest. In addition, some countries exclude from coverage deposits considered to have extremely high yields.

### *Items in transit*

A complex issue involves the problem of incoming transfers and items in transit—monies received by the insured institution during the period after the withdrawal of its license or charter, but before the declaration of the unavailability of the deposits or the institution's closure. Before calculation of the amount to be reimbursed can take place, the deposit insurer must process these, preferably in accordance with some established rules that will minimise any disruption to the payments system caused by the institution's closure.

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<sup>6</sup> A separate paper addresses the issue of scope and level of coverage.

<sup>7</sup> For example, the European Union directive establishes that the coverage limit must apply to the aggregate of all deposits held by an individual at the same institution. With respect to jointly owned accounts, the Directive prescribes that the share of each depositor must be taken into consideration when determining the aggregate amount held by an individual.

<sup>8</sup> In the United States, for depositors who are individuals, the different rights and capacities—or categories of accounts—are single-ownership accounts, joint accounts, revocable trust accounts, irrevocable trust accounts, and retirement accounts.

### *Rules regarding set-off and collateral*

Two other important issues affecting the determination of the amount of reimbursement are the rules regarding set-off and collateral.<sup>9</sup> First, it must be decided whether the right of set-off applies. In this context, set-off refers to the right to reduce the amount of a deposit by the amount of a loan. Second, regulations regarding the status of deposit accounts used as collateral must be formulated. It generally is preferable to suspend payout of such deposits until their collateral status is cancelled. If the reimbursement and liquidation proceed separately, which they do in most countries, then close cooperation between the deposit insurer and the liquidator is necessary to handle the offsetting and collateral cases.

### **Funding the reimbursement process<sup>10</sup>**

As discussed above, in order to carry-out its mandate to reimburse depositors of failed institutions efficiently, a deposit insurer needs a source of funding. Access to funding varies widely around the world. In some countries, a fund is built up from the premiums paid by the institutions covered by deposit insurance. In other countries, a special assessment is made on the institutions covered by deposit insurance when a member of the group fails. Whatever the case, a deposit insurer must have funds available to meet its obligations.

### **Reimbursing Depositors—Elements and Procedures**

The payment of insured depositors in a deposit reimbursement is generally a time-consuming, labour-intensive, methodical process. To speed this process and enhance its efficiency, it is advisable for the deposit insurer to establish consistent administrative practices and procedures, which are readily accessible and can be followed by subcontractors as well as in-house staff. These practices and procedures should be set-out in a manual, periodically reviewed and updated, and supported by adequate computer capabilities.

In developing its administrative practices and procedures a deposit insurer should strive to set operational priorities, focus on depositors' expectations, and emphasise structure over individual functions. The operational priorities need to be aligned with the public-policy objectives of the deposit insurance system, taking into account the particular legal, economic, and cultural aspects of the country. In designing the reimbursement process, the needs and expectations of depositors should be taken into account. Each part of the reimbursement process must work together in a seamless fashion to ensure an efficient reimbursement process.

### **Administrative regulation of the reimbursement procedure**

The administrative practices and procedures should specify the necessary steps to ensure accuracy in the reimbursement of depositors. To determine the proper reimbursement amount, a deposit insurer has to review all the deposit-account records, apply the proper laws and regulations to each account, and prepare a combined account statement for depositors with multiple accounts. The account statements must then be balanced with the general ledger to

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<sup>9</sup> Depositor priority and set-off are discussed in a separate paper.

<sup>10</sup> See the paper on funding for a more detailed discussion.

ensure that they are accurate. Finally, a record must be kept of all reimbursements made to depositors for verification and auditing purposes.

### **Submission of claims by depositors**

When the verification and reconciliation of accounts cannot be accomplished through the failed institution's own records, submission of a claim form by the depositors may be required. This is an important consideration when designing the reimbursement process. In a number of countries, depositors must submit a claim—effectively proving ownership of an account—before the deposit insurer can process a reimbursement. This may be necessitated by the generally poor quality of data available at the time of an institution's closure, or by other considerations—such as bank-secrecy laws, that may prevent a deposit insurer from being able to identify depositors and their accounts accurately.<sup>11</sup>

In general, requiring the submission of claims is inconvenient to depositors, can delay the payout process, and may generate negative publicity for the deposit insurer. On the other hand, proceeding with the reimbursement process on the basis of poor-quality data may result in inaccuracy, a large number of complaints and additional losses for the deposit insurer.

### **Timing of reimbursement to depositors**

Coincident with the verification process is the decision regarding the timing of depositor reimbursement. This decision should reflect the objectives of the deposit insurer as well as the results of a comprehensive situational analysis, especially regarding the ability of the deposit insurer to gain access to the data necessary for deposit verification. In general, the deposit insurer will have the option of either a quick payout or a payout only after verification is completed.

A quick payout ensures that the time risk to depositors associated with an institution's closure is minimised, but it has the potential for inaccuracy, especially if the records are in poor condition. This option may generate complaints by depositors regarding the amount of reimbursement and may increase losses to the deposit insurer. To manage a quick payout efficiently, a high degree of cooperation between the deposit insurer and the supervisory authority is fundamental. The deposit insurer should have advance notice of an impending closure and should have access to the deposit records of the failed institution. The deposit insurer also must have the funds to reimburse depositors.

Alternatively, the deposit insurer may chose to make payment only after extensive deposit verification and proof of ownership. This option requires that all cheques, reconciliation tasks, and adjustments be completed before depositor reimbursement is made. This option can minimise the risk of error by the deposit insurer, but generally results in a protracted procedure that may result in the public's loss of confidence in the ability of the deposit insurer to meet its objectives on a timely basis.

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<sup>11</sup> For example, because of the bank-secrecy laws in the Philippines, the deposit insurer requires the filing of claims for verification purposes.

A possible solution to the above dilemma might be to advance a partial payment to insured depositors before all the steps necessary to ensure an accurate payout are completed.<sup>12</sup> Of course, this option presents trade-offs as well. Although an advance partial payment can mitigate panic and other disruptive effects—especially if a great number of the frozen accounts are used to pay wages or pensions—the procedure may require extraordinary measures and could increase the risk of making inaccurate payments. If this option is chosen, it is imperative to have a plan of action and systematic processes in place. Further, if this option is not properly integrated into the overall payout process, it may delay the normal reimbursement process. The approach selected must be country-specific and should take into account the tolerance levels and expectations of the public. A reasonable position on this issue would be to issue payments after best efforts to ensure accuracy and completeness are made.

### **Preparatory tasks for the reimbursement**

The actual reimbursement to depositors should occur after the deposit records or claims of depositors have been reconciled.<sup>13</sup> To begin, the deposit insurer must determine the end point of the institution's operations and reject any transactions after that point. Then the deposit insurer must identify depositors, determine insured and uninsured amounts, produce lists of deposits, and issue cheques or implement other means of payment.

The reimbursement procedure generally starts by downloading the institution's deposit information into the deposit insurer's processing systems.<sup>14</sup> Incoming transfers must be reviewed and a determination made of whether they arrived before or after the institution's closure. Transfers arriving after an institution's closure generally should be rejected and returned to the originating institution.

Next, the deposit insurer should draw up individual deposit statements showing principal and interest as of the closing date and then sort them to determine ownership. For depositors with multiple accounts, a combined account statement will need to be prepared. If the deposit insurance laws allow a depositor to increase the level of coverage by holding deposits in different rights and capacities, the combined statement will have to reflect any deposits held in a different right or capacity. Thereafter, the deposit insurer will have to sort out the excluded depositors, verify the rights of trustees and beneficiaries, and clarify any fiduciary relationships. The deposit insurer also will have to perform the interest calculations on deposits according to the statutory provisions. Once these steps are completed, the account statements should be posted to the general ledger and balanced to ensure accuracy.

Next, it must be determined if any deposits are to be set-off against outstanding loans or if any deposits are used either as collateral or backed up by collateral. These accounts will require special treatment according to the laws and regulations in effect.

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<sup>12</sup> For example, the Philippine Deposit Insurance Corporation may make advance payments for emergency needs.

<sup>13</sup> As discussed above, final verification may not be complete at this point if the decision has been made to go with a quick or a partial reimbursement of claims.

<sup>14</sup> This may require conversion of systems to ensure compatibility between computers. Paper-based records must be entered into the deposit insurer's system manually.

A subsequent consideration at this point is whether any insured deposits are held in foreign currencies. Again, depending on the laws and regulations of the deposit insurer, appropriate adjustments will have to be made. In many cases, this requires the deposit insurer to convert a deposit held in a foreign currency to the domestic currency at the appropriate exchange rate. In other cases, the deposit insurer will have to be prepared to pay the depositor in the foreign currency.

At this point the deposit insurer is prepared to reimburse insured depositors. The last step before reimbursement is the preparation of a settlements claim specifying the amount to be paid by the deposit insurer and to be claimed from the liquidator.

## **Reimbursement**

The reimbursement procedure can be simplified substantially if a healthy institution can be found to take over the insured-deposit accounts. Depositors benefit if the receiving bank's network overlaps that of the failed bank. If such an institution is not available, the deposit insurer must select a method of payment, such as employing a reimbursement agent that will issue cheques, cash or some other means of payment to insured depositors; mailing cheques; transferring funds to another institution designated by the depositor; issuing a debit card to insured depositors; or making a postal transfer.<sup>15</sup>

## **Communication and complaints**

Communication is crucial to the reimbursement process. Immediately following an institution's closure, the public should receive practical and accurate information about: when and how depositors can expect to receive their money (the reimbursement schedule), what depositors are expected to do in order to receive their reimbursement, and who depositors can contact for further information or clarification.

Frequent and regular updates regarding the proceedings, the latest reimbursement statistics, and any problems that would delay the process are advisable. Information can be disseminated through direct communication with depositors, press releases, the news media, advertisements, posters, the Internet, or any other available means.

Direct communication through letters or telephone calls may be necessary in order to notify depositors about the availability of their money, to request further documentation to qualify for insurance coverage, or to answer depositors' questions or complaints. In the experience of many deposit insurers, there generally are two types of complaints—those regarding coverage and those regarding the quality of service. Coverage questions must be dealt with through a legal investigation to decide whether the dispute is valid. Complaints regarding the quality of service should be handled expeditiously and with the utmost empathy. Handling such complaints may be easier and more efficient if the deposit insurer already has established service standards.

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<sup>15</sup> Another reason for asking depositors to contact the deposit insurer might be to support the selected method of reimbursement. For example, money can only be transferred to a requested deposit account, or a debit card must be handed over to the depositor, which is the case in Hungary.



## **Monitoring and follow-up**

Continuous monitoring of the reimbursement process is advisable so that adjustments may be made if necessary. For example, if the reimbursement process will take weeks or months to complete, special care should be taken so that the deposit insurer is not accused of giving some depositors or group of depositors favourable treatment.

Some follow-up tasks should be noted. Submitting the reimbursement process to an independent auditor may be advisable, especially if the regulations and supporting software did not undergo an audit before application. In some cases, the deposit insurer also will need to submit its claim as creditor of the closed institution to the liquidator in compliance with the subrogation rules specifying the amounts reimbursed and the indemnification obligation not yet settled. Finally, the deposit insurer may need to undertake some efforts to locate depositors whose reimbursement was unsuccessful during the normal process.

## **Preparations for the Reimbursement Process**

The reimbursement process will benefit not only from having adequate legal and financial elements in place, but also from undertaking preparations to ensure that information systems are in place and that human resources are identified who can handle the task.

## **Legal provisions**

Review of the experiences of past reimbursement cases is an important task and should include consideration of the adequacy of legal provisions. If such provisions are found to be lacking, then initiation of amendments to the law is advisable.

## **Improving the quality of bank records**

To facilitate the determination of the proper amount of insurance coverage, the implementation and enforcement of a requirement for high-quality standards in bank record keeping is very important. As long as the quality of a closed institution's records is sufficiently good, it is possible, in a reasonable period of time, to obtain a clear picture of the deposit insurer's obligations. In a number of countries, it is the role of the supervisory authority—as the proxy for the deposit insurer—to monitor the adequacy of the institutions' information systems. In other countries, this is the role of the deposit insurer. Regardless, it is important that the deposit insurer and the supervisory authority maintain a cooperative working relationship to ensure that the deposit insurer is aware of the need to take action, and that when the need arises the deposit insurer will be able to meet its objectives. If conditions are favourable for the revision of banking law, the imposition of standardised requirements might be appropriate. Such requirements might include a minimum list of identifiers—such as name and address—for depositors, trustees, beneficiaries, and other appropriate parties, and regular reconciliation of the information.

## **Developing information systems**

In a reimbursement scenario, deposit insurers may process many thousands of accounts. This must be done according to strict legal and administrative procedures and within very tight time frames. Information technology (IT) support is indispensable. Manual processing is not only slow, but also error-prone and resource-intensive. Proper IT support, however, must reflect the objectives of the deposit insurer and comply with the adopted priorities and special conditions of the country.

Newly established deposit insurance schemes can benefit from the accumulated experience of established deposit insurers. However, caution should be taken in applying other deposit insurers' technology, especially application software, as it may not directly relate to the legal environment or public-policy objectives of the country's deposit insurance scheme. Although lessons can be learned from how other deposit insurers developed their approaches, each deposit insurer requires a reimbursement process and an IT system that reflects the conditions in its country.

As noted above, part of the reimbursement process can involve downloading data from a closed institution into the deposit insurer's IT system. Regular and comprehensive examination of an insured institution's deposit-record-keeping system is important. Enforcement of record-keeping standards should be part of the supervisor's authority.

## **Human resources**

A deposit insurer will need to review whether it has adequate, experienced in-house staff to handle a deposit reimbursement. In many cases, the number of staff needed for a reimbursement will exceed the number of staff the deposit insurer needs to manage its day-to-day operations. The deposit insurer will need to decide whether to maintain a staff sufficient for what it considers a normal workload or whether it will outsource the function by employing independent contractors to handle reimbursements as they arise.

Recent technological developments have made reliance on internal staff an increasingly cost-efficient alternative. However, independent contractors may be able to provide a depth of expertise and quality of resources that would otherwise be unavailable to a deposit insurer.

## **Public awareness<sup>16</sup>**

Public confidence in the reimbursement process can be promoted by continuously disseminating information about how deposits are protected. Dissemination of such information in an easily understandable brochure and establishment of an unambiguous deposit register system, which lists protected products for each member institution, may contribute significantly to a smooth and efficient reimbursement process.

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<sup>16</sup> Public awareness is discussed in greater depth in the paper on that topic.

## Conclusions

On the basis of the experience of many deposit insurers a number of elements are necessary to achieve a successful reimbursement process. First, the deposit insurer needs to review its policies, practices and processes to ensure that they are up-to-date and can effect accurate reimbursements. Second, information systems and human and other resources need to be monitored and continually enhanced so that they can deal with the changing environment. Third, the public needs to be educated so that they understand how the reimbursement process works, including what is and what is not insured. Fourth, the expectations of depositors need to be managed to ensure that bank runs are reduced—the expectations of depositors should mirror what the deposit insurer is capable of delivering.

In addition, there should be a high degree of coordination between the supervisory authority and the deposit insurer to ensure that the deposit insurer will be prepared to handle the closure of an insured institution.<sup>17</sup> This includes development of a process to ensure that the quality of bank records is monitored and that record-keeping standards are enforced. Above all, a deposit insurer should design a country-specific system that depositors can rely upon.

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<sup>17</sup> It is assumed that the supervisory authority has the power to direct the closure of a troubled institution. If this function is handled by another authority, then there must be a high degree of coordination with that authority also.