

# CLAIMS AND RECOVERIES

## Abstract

The capacity to manage the assets and liabilities of a failed bank is an essential part of all effective safety-net systems. In the broadest sense, it involves disposing of the bank's assets and resolving the bank's liabilities for the benefit of creditors with *bona fide* claims against the bank. This paper considers the major objectives, organisational and resource requirements, and strategies of the claims-and-recoveries function that arise after a failure-resolution strategy has been adopted.

The optimal strategy for effectively and efficiently managing the claims-and-recoveries function is situational, and reflects different economies, safety-net structures, insolvency regimes, and financial, legal and political systems. However, the claims-and-recoveries function is subject to common management processes. These include a feedback loop of analysis, planning, and execution. In addition, effectiveness and efficiency likely are best achieved through decisive control and commercial practice rather than reliance upon legal rights or bureaucratic procedures.

## CLAIMS AND RECOVERIES

The capacity to manage the assets and liabilities of a failed bank is an essential part of all effective safety-net systems.<sup>1</sup> In the broadest sense, it involves disposing of the bank's assets and resolving the bank's liabilities for the benefit of creditors with *bona fide* claims against the bank. This paper, which was prepared by the Subgroup on Claims and Recoveries, considers the major objectives, organisational and resource requirements, and strategies of the claims-and-recoveries function that arise after a failure-resolution strategy has been adopted.<sup>2</sup>

In bank failures, claims take several forms.<sup>3</sup> In the context of insolvency proceedings, for example, creditors file claims. Claims also may encompass matters such as legal actions by or against the insolvent bank, or costs and outlays from financial assistance provided to the bank by the deposit insurer or another safety-net participant. Recoveries on these claims are typically derived from the disposition of the bank's assets, payments by borrowers, and proceeds from legal actions, including claims against directors, officers, auditors and other third parties.

The organisation(s) that actually performs the claims-and-recoveries function varies across jurisdictions, and reflects country-specific developments beyond the scope of this paper. In most cases, the deposit insurer will have, at a minimum, a mandate to advance its claims to recover on deposit insurance payments and possibly other costs. Thus, irrespective of whether a deposit insurer is responsible for resolving claims or disposing of the failed bank's assets, it is likely to have an interest in understanding and possibly influencing the claims-and-recoveries process in order to achieve its goals.<sup>4</sup>

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

<sup>2</sup> See the paper on failure resolution, which describes the main issues relating to the resolution of troubled banks.

<sup>3</sup> Definitions of bank failure tend to be country-specific. In this paper, bank failure may be considered to have occurred when one or more of the following circumstances obtain: the institution's liabilities exceed its assets, it has been placed in administration or liquidation, or it has voluntarily sought to wind-up its affairs.

<sup>4</sup> There is considerable variation in the claims-and-recoveries role played by deposit insurers and other safety-net participants. Where deposit insurance payments are made upon the liquidation of a bank, the deposit insurer usually is subrogated to the rights of the insured depositors, and is likely to file and actively manage the claim arising from the deposit insurance payment. In some instances, deposit insurers have broader roles in risk-minimisation or recovery processes, for example as lender, creditor, or possibly as receiver. In other cases, these functions are the responsibility of other entities, including central banks.

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### **Objectives of the Claims-and-Recoveries Function**

In most countries, claims and recoveries typically involve at least some of the following objectives: (i) maximisation of recoveries from the assets of the failed bank; (ii) minimisation of the costs associated with the failed bank's liabilities and those arising from the failure resolution; (iii) determination of the most cost-effective strategies; (iv) contribution to financial-system stability; (v) timely and equitable payment to creditors; and (vi) contribution to system discipline by such measures as instituting legal action against errant officers, directors, auditors, and other parties.

Some objectives may conflict with other objectives. For example, a mandate to return assets to market promptly may be conditional upon minimising adverse economic effects. Similarly, pursuing professional-liability actions for system discipline may be subject to considerations regarding the financial benefits of reaching early compromise. Ideally, such trade-offs are considered and agreed upon in the development of the claims-and-recoveries function in order to facilitate consensus and coordination on, and commitment to, the necessary action steps and priorities involved in dealing with a failed bank.

### **Conditions Precedent**

A number of factors affect the performance of the claims-and-recoveries function. As with any bankruptcy process, bank-insolvency resolution requires clear and enforceable priority-of-claim rules. These establish seniority of various classes of claimants, including depositors' claims. Also important are bank-liquidation and asset-disposition procedures, open-marketing and effective conveyance processes, and an effective and transparent judiciary with expertise in the liquidation of banks.

The powers provided to the organisations responsible for performing the claims-and-recoveries function also have considerable effect on overall performance. These powers include control over the assets, contract rights, and privileges of the failed bank. The ability to allow or disallow claims, stay litigation, enforce or repudiate certain contractual obligations, and challenge fraudulent transfers, affect the performance of the claims-and-recoveries function. Finally, fiduciary responsibilities may limit the ability of those performing the claims-and-recoveries function to fulfil other responsibilities and goals.

### **Strategies for Management of the Failed Institution's Assets and Liabilities**

Although the precise nature of the claims-and-recoveries strategies vary from country to country, in each case the strategies should be consistent with (i) the objectives of the safety net, (ii) the economic and legal environment in which claims-and-recoveries activities are conducted, and (iii) the organisational form and resources

available. In the absence of a country-wide political consensus on the steps to be undertaken, claims-and-recoveries activities may be lengthy, inefficient and ineffective.

The benefits of explicit rules and procedures for handling various aspects of the claims-and-recoveries function may be particularly significant in enhancing credibility, increasing market discipline, prompting action, and thereby minimising costs arising from delay. For example, regularly updated memoranda of understanding among participants in the financial safety net help protect the claims-and-recoveries function from political interference.<sup>5</sup> In the event of a failure, explicit policy statements that authorities will not protect creditors and shareholders beyond pre-specified commitments, also may help manage expectations.

By contrast, discretion may be beneficial in certain circumstances in order to achieve public-policy objectives, such as financial-system stability. Discretion also may be useful in providing a degree of flexibility that otherwise may be lost when too many aspects of the claims-and-recoveries function are made explicit.

### **Organisation and Resources for the Claims-and-Recoveries Functions**

The determination of whether the claims-and-recoveries function should be performed by public, private, or hybrid organisation(s) is country-specific. However, it may be guided by an evaluation of which form is expected to be more efficient and effective in handling claims and recoveries, and by rigorous application of commercial criteria with incentives for efficiency. Likewise, the choice of outsourcing or developing the internal capacity to fulfil the functions of the claims-and-recoveries function may be facilitated by a consideration of the frequency, scale, and cyclical nature of projected failures, and the mandates and objectives of the deposit insurer and other safety-net participants.<sup>6</sup>

The identification and development of the capabilities and skills involved in claims-and-recoveries activities are ongoing processes. In most countries, professionals are drawn from the insolvency, accounting, banking, real-estate, information-technology and legal professions. Although projecting staffing requirements for future failures is problematic, it is important that those responsible for the claims-and-recoveries function have both the funding to remunerate and access—internally or through standby arrangements with external suppliers—to professionals capable of dealing with projected failures. Inadequate funding will lead to delay and increased costs.

### **Planning Claims-and-Recoveries Activities**

Business plans are a key element of the claims-and-recoveries process. They provide a strategic framework within which financial and non-financial performance

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<sup>5</sup> Coordination between safety-net participants is the subject of a paper on interrelationships.

<sup>6</sup> A more comprehensive review of this subject, as it pertains to deposit insurance systems, may be found in the paper on structure and organisation.

information is developed and evaluated. Plans articulate the strategy for maximising the recovery of assets (including litigation) on a net present-value basis; for employing effective resources in the liquidation; and for establishing benchmarks for assessing performance. The goal is efficiency and consistency, with reliable estimates based on timely, verifiable information and assumptions.

Ideally, business plans should be updated regularly and cover all major areas of the claims-and-recoveries function, including claims processing, asset management and disposition, and forensic-litigation management. To address large failures and/or multiple failures, it also is essential to develop contingency plans that mobilise the resources of internal staff and contractors, as well as coordinate activities of the safety-net participants.<sup>7</sup>

### **Maximising Recoveries from Asset Management and Disposition**

Asset management and disposition is typically the most visible and the most expensive activity of the claims-and-recoveries function, and usually has the greatest effect on recoveries. To ensure that appropriate strategies are adopted, it is important to evaluate the assets, in much the same manner as the medical procedures of a hospital emergency ward, where victims are first classified for treatment on a priority basis.

On this basis, healthy or performing (“good-bank”) assets may be separated from nonperforming (“bad-bank”) assets. The good bank may be retained as part of a “going-concern” solution, or otherwise marketed as soon as possible, as they have no “upside” potential. The disposition of the bad bank may be more problematic in the event of a large overhang of similar assets, such as unsold real estate, held by other banks and market participants. In such circumstances, the bad bank may be “worked out” under professional management with a mandate to maximise recoveries, after operational and financial costs, precisely because there is an “upside.”

Efficient and effective asset-management strategies reflect the type and quality of assets being realised, and include tools to validate valuation assumptions employed in the asset valuation/appraisal process and business plans. Risks relating to interest rates, market fluctuations, particular asset-disposition strategies, and asset-specific and legal issues need to be identified, evaluated, quantified, managed or hedged. Use of discounted cash-flow analysis or another appropriate valuation technique is required to ensure that approaches to claims and recoveries recognise the time value of money, as well as the risks associated with hold *versus* sell decisions. Consideration also might be given to the estimated value of the assets to potential purchasers, each of whom values the assets differently because of different plans and different financing costs.

Once the assets have been examined and categorised, the timing and method of disposition may be considered in light of the nature of the assets being disposed of

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<sup>7</sup> For an elaboration on this point, see the paper on interrelationships.

and the condition of the markets into which they are being sold, with a view to such objectives as maximisation of recoveries on a net present-value basis. Other considerations may have to be balanced against such objectives, including environmental implications or legislatively mandated policy requirements.

Selling assets at resolution or immediately thereafter has the advantage of returning assets to the market quickly, as well as replenishing the deposit insurance fund and minimising government involvement with the assets. These advantages should be considered against the risk of lower recoveries and potential resistance from creditors who stand to benefit from a more lengthy realisation process.

It is vital to maintain the value of those assets that cannot be sold immediately, or that have been selected for longer-term workout, through clear asset-management procedures. Even performing loans tend to lose value unless managed actively. Clearly, the risks of holding for later sale and the availability of skilled asset-management practitioners need to be factored into any application of this approach. As well, internal information and operations systems and procedures will be required to catalogue and track the assets.

Transparency and access to information are key factors in asset management and disposition, since marketing the assets to qualified and interested potential purchasers is likely to stimulate competition and thereby increase recoveries. The quality of information available to potential purchasers has an important bearing on prices, so effort is needed to arrange information in as orderly and complete as possible a manner to generate greater buyer interest and thereby maximise value.

### **Marketing methods**

There is a wide range of methods for marketing the assets of failed banks, including (i) asset-by-asset sales on a commercial basis; (ii) auctions; (iii) portfolio sales; (iv) securitisation; (v) workout/ restructuring; and (vi) equity partnerships:

- i. On the premise that retail prices are higher than wholesale, it may be better to sell certain assets individually, particularly nonperforming assets where the security interest has been realised. This permits their sale as appropriate with a marketing program tailored to the asset in question. The purchaser may be the end user who is often more willing to pay a higher price than the “middleman” in a bulk sale. One potential downside to an asset-by-asset sale is higher transaction costs.
- ii. Auctions by outcry or sealed written bids—including tender bids and expressions of interest—have been utilised to facilitate bulk or individual-asset sales, sometimes with enhancements such as seller financing, representations and warranties. The advantages of auctions, which can significantly accelerate the speed of recoveries, should be considered against the risks of few bidders and low bids.

- iii. Marketing assets that have been combined into pools may facilitate quick sale, generate market-value returns, and significantly reduce both the assets under administration and the resources required to manage the assets. As is the case with auctions, consideration should be given to the risks of few bidders and low bids.
- iv. Securitisation involves packaging similar assets and selling portions with rights to cash flows identified by contract, in some cases with credit enhancements. As is the case with portfolio sales, securitisation may be advantageous in enhancing asset recovery values and expediting asset sales. To date, the application of securitisation has been most effective in well-developed markets with existing markets for asset-backed securities.
- v. Asset-management companies can serve as rapid asset-disposition vehicles for bundling and securitising or portfolio sales, and as longer-term restructuring or workout agencies to deal with nonperforming assets. They also enable a consolidation of skills, resources, and uniform workout practices within one agency, thereby providing efficiencies in recovering maximum possible value.
- vi. Equity partnerships have been an effective method of disposing of portfolios of underperforming, nonperforming, and owned real estate. In these joint ventures, the agency responsible for recoveries provides the assets and financing, and the partners/investors contribute equity and assume responsibility for management and disposition of the partnership's assets.

In some instances, the method of marketing may be enhanced with vendor take-back (seller) financing and limited guarantees. Seller financing may be particularly advantageous in dealing with hard-to-sell assets, but should be part of a well-thought-out exit strategy. Guarantees against loss—as well as related put agreements by which a buyer has the option of returning assets for a refund within a specified period of time—may be of assistance in completing a transaction. Although guarantees have the disadvantage of creating contingent liabilities, such disadvantages can be mitigated by limiting their duration and total value.

Factors affecting asset management and disposition performance include general economic conditions, the quality of the assets of the failed bank, depth of secondary markets, assets subject to competing creditor claims, and litigation or other proceedings that complicate realisations. Similarly, the ability to market assets promptly may be problematic where a failure is sudden, such as failure caused by a rapid lack of liquidity, where failure occurs across multiple jurisdictions, or where an asset-valuation review and pricing of assets cannot be accomplished in advance of failure.

The absence of specialised human resources for the handling of insolvency issues, including distressed assets, is a challenge for many countries. Contracting out tasks

relating to claims and recoveries raises the “principal-agent” risk that the agent will not act in the principal’s interest, resulting in below-expectation returns. Where practical, this risk may be addressed explicitly with measures to align the interests of the agents with those of the deposit insurer or other relevant safety-net participant.

Measures designed to align interests include negotiating incentive plans with receivers or other entities to increase the probability that net realisations will be in the upper range of projections, measured on a net present-value basis. Other measures may specify that the liquidation of assets will be completed by a specific date, that the liquidation management will focus on the need to minimise costs, and that existing management expertise will be retained to completion of the plan.

### **Maximising Recoveries from Claims and Litigation**

Claims and litigation advanced against other parties by the failed bank or relevant safety-net participants represent a potentially important asset on which recoveries may be realised. In some cases, these activities also are an important tool in fostering greater discipline in the financial-services sector. For these reasons, potential claims should be identified and investigated carefully to determine the appropriateness and potential for recovery (cost/benefit) before being pursued. Consideration of whether to pursue an action might include an analysis of the possible defenses, counterclaims, or claims-over that may be made by the defendants. Once commenced, activities may be refined or curtailed at appropriate times.

Among the more important claims pursued are professional-liability claims. These arise in circumstances where the deposit insurer, failed bank, or another safety-net participant has suffered damages, and there is information that raises a reasonable case of negligent or wilful misconduct or wrongdoing by directors, officers, or auditors, or by other relevant parties. In cases of fraudulent or otherwise patently egregious behaviour, the results of an investigation also may raise the possibility of potential criminal proceedings—typically pursued by the state as opposed to a deposit insurer or other safety-net participants.

### **Minimisation of Liabilities**

In addition to depositor claims, failed banks typically have a number of liabilities, such as environmental problems associated with real estate or businesses owned by the bank, indemnifications or other guarantees, off-balance-sheet liabilities, and claims against the failed bank.

The claims-and-recoveries function likely will require that claims against the failed bank are resolved in a fair and cost-effective manner. This will involve notifying potential claimants of the claims process, reviewing and resolving asserted claims, distributing dividends to proven claimants, and transferring unclaimed dividends to the appropriate state authority.



The resolution of claims against a failed bank can add significantly to the cost and duration of a liquidation. Such claims may involve a creditor taking security before failure of a bank; higher ranking or priority claims;<sup>8</sup> multi-jurisdictional insolvency issues; complications arising from a parent/affiliate pursuing significant claims; and reviewable transactions entered into before failure resolution.

A particularly important source of cost and delay arises from litigation instituted by creditors, shareholders, or other claimants and plaintiffs against the failed bank or the agency that performs the claims-and-recoveries function. This is the negative side of the possibility of realising recoveries from litigation, and a crucial aspect of liability management for those charged with handling claims and recoveries. For this reason, it is advisable to conduct regular evaluation of the claims in order to quantify appropriate reserves, estimate the potential liability exposure, and consider alternative means for resolution.

### **Measuring Performance and Managing Knowledge**

One of the key strategies to be applied to the claims-and-recoveries function is the creation of a framework to measure and credibly demonstrate performance, as well as promote continuous learning. Performance measurement is likely to focus on such criteria as the least-cost criteria of resolution, as well as on the quality of management processes, including performance against management's plans, and performance against quantitative and qualitative industry standards.<sup>9</sup>

To be meaningful, performance measures reflect the country-specific claims and recoveries' objectives, the institutional framework, and characteristics of the bank failures. Moreover, precisely because the claims-and-recoveries function is country-specific, it is important to ensure that the knowledge and experience gained be both captured and disseminated. In particular, an analysis of each bank failure may be beneficial in providing guidance for future liquidations and thereby potentially reducing costs to both the safety net and other creditors.

### **Conclusions**

The effectiveness of the claims-and-recoveries function depends on understanding the problems, matching appropriate strategies with goals and country-specific conditions, and the level of commitment to achieve such goals. Above all, careful planning and analysis need to be complemented by decisive action and the discipline of commercial practice.

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<sup>8</sup> Creditor ranking is discussed more fully in the paper on depositor priority.

<sup>9</sup> Qualitative benchmarks might include performance in closure of the bank, management of cash, claims processing, and litigation. Quantitative benchmarks likely would focus on such issues as speed of asset disposition, yield on asset realisations, overhead costs, and the net present value of recoveries/losses.

- The claims-and-recoveries function benefits from clear and enforceable priority-of-claim rules, and well-developed bank liquidation and asset-disposition procedures supported by the legal system. Uncertainty or inequality of treatment of creditor groups may jeopardise confidence in the financial system, with attendant costs.
- Coordination among safety-net participants plays an important role in contributing to the efficiency and effectiveness of the claims-and-recoveries function. Where those functions are not consolidated in the hands of the deposit insurer, memoranda of understanding among financial safety-net participants becomes even more critical in facilitating coordination.
- Once a bank has failed, liquidation of its assets should be pursued on the basis of the economic merits. Other considerations—such as concern for system-wide stability, or a determination to pursue professional-liability actions to enhance business standards of conduct—may introduce conflicting objectives and pose trade-offs that will need to be addressed.
- Success depends upon sufficient organisational, funding, and human resources to conduct efficient and effective claims-and-recoveries activities. These resources should be consistent with the structure of the financial-services sector, and with the frequency and cyclical nature of failures. Inadequate funding can lead to delay in completing asset dispositions or claims-resolution activities, and to a significant extent increases in costs.
- Plans are a key element of the claims-and-recoveries process. Plans articulate the strategy for maximising the net present-value recovery of assets; ensure the employment of effective resources in the liquidation; and establish benchmarks for assessing progress and performance.

Regular review and reporting to stakeholders on the efficiency and effectiveness of claims-and-recoveries activities provide a feedback loop for identifying steps to strengthen supervision and standards of bank management, and, to validate or revise practices relating to claims and recoveries as well as failure-resolution methodologies.