The deposit insurance mechanism: Protecting depositors, bankrupting entrepreneurs

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The decision of the Central Bank to close 4 banks raised again the issue of the shortcomings in the deposit insurance mechanism. The fate of deposits of legal entities and entrepreneurs remains uncertain while physical persons with deposits in the bank rely on the state insurance mechanism, as a result of which some customers suffer as little as possible, while others suffer as much as possible. The reason why the latter lose their money is that the former have an unlimited advantage. All this makes it necessary to reconsider the deposit insurance mechanism.

How are deposits protected in Azerbaijan?

The deposit insurance mechanism was introduced in Azerbaijan in 2007. The legal basis for the implementation of the mechanism was established by the Law on Deposit Insurance adopted in December 2006. According to the law, the purpose of establishing a deposit insurance system is to prevent the risk of loss of funds deposited by physical persons in the case of the insolvency of banks and local branches of foreign banks.

The law obliges banks to protect deposits placed by physical persons, provided that the annual interest rate on those deposits does not exceed 10% in the national currency[1] or 2.5% in foreign currency. However, there are deposits that are nether covered by the insurance mechanism, nor protected by the state.

Unprotected deposits include the following:

- *Deposits attracted by branches of any local bank opened outside the territory of the Republic of Azerbaijan;*
- *deposits identified as a result of suspicious transactions as being connected to the legalization of criminally obtained money or other property, or terrorist financing;*
- *deposits established by a court decision to be due to the commission of a crime;*
- *seized deposits;*
- *funds in bank accounts opened by physical persons related to entrepreneurial activities;*
- *funds of physical persons under the authorized management of the bank;*

In the insurance case, i.e. the closure of a bank, the Deposit Insurance Fund pays compensation to the depositor. This Fund was established for the purpose of deposit insurance. According to the law, all banks and local branches of foreign banks that have a banking license to attract the deposits of physical persons are mandatory participants of the Fund. The Fund's insurance reserves are not limited to, but mainly come from, banks' membership and calendar fees.

According to the law, compensation for deposits in the national currency is paid in AZN, and for deposits in foreign currency in the currency of the deposits. As for the amount of compensation for protected deposits, one nuance should be taken into account. There are currently two mechanisms for deposit insurance. The first mechanism operates on the basis of the Law on Deposit Insurance, and according to the law, the amount of compensation is a maximum of 30,000 AZN. Some provisions of this Law, in particular the part related to the implementation of the compensation amount, were frozen in 2016. As a result of the 2015 devaluation, the second mechanism was launched by the adoption of the Law on Full

Deposit Insurance to prevent the flight of deposits in the case of the closure of banks. The conditions in this mechanism are the same as in the first mechanism, the main difference is that the compensation is unlimited, that is, 100% return. Although this law was adopted for 3 years in 2016, it was extended for another year in 2019 and 9 months in 2020. If the law is not extended on December 4, 2020, the full insurance mechanism will become invalid and the terms of the Law on Deposit Insurance will come into force again.

The 2016 mechanism of full deposit insurance was the right decision because at that time there was a mass flight of deposits due to the closure of banks, and this decision played an important role in creating stability in the deposit market. However, this mechanism cannot be long-term. Although it significantly prevents the flight of deposits and protects the funds of most depositors, it is not perfect; it can create difficulties for the banking sector in the long run and minimize the ability of entrepreneurs to recover the money they held in defunct banks.

What is missing in the deposit insurance mechanism?

Although the current mechanism supports protected depositors, it is generally not acceptable in the long run for the banking sector. Let’s look at the main shortcomings of the existing mechanism. The Deposit Insurance Fund is becoming the largest creditor of closed banks. When any bank closes, the protected deposits of physical persons who are customers of that bank are fully returned by the ADIF, and thus the Fund becomes a creditor of that bank. According to Article 82 of the Law on Banks, in the event of the bankruptcy of a bank, the funds of the main creditor, the ADIF, are returned first. The greater the bank’s protected deposit, the less other creditors have access to funds. The assets of the closed bank are distributed among the bank’s creditors on a rotating basis. Last on this list are unprotected deposits, deposits of legal entities and funds of entrepreneurs. For example, in the 4 banks whose licenses were revoked in May (Amrahbank OJSC, Atabank OJSC, NBCBank OJSC, AGBank OJSC), the total amount of protected deposits of the population is 686 mln AZN. According to the information provided by the banks themselves, by the end of 2019, the assets of 3 banks (Amrahbank OJSC, NBCBank OJSC, AGBank OJSC) amounted to 987.1 mln AZN. The assets of Atabank amounted to 532.1 mln AZN at the end of the third quarter of 2019 and decreased further by the end of the year. Thus, according to these 4 banks, their assets amounted to a maximum of 1.5 billion AZN by the end of 2019, and there is no doubt that the assets had decreased by the date of the revocation of their licenses by the Central Bank.[2]

Table 1. Information on the Banks' Capital

The names of the banks	**Information provided by the banks (in mln AZN)**		**Information provided by the Central Bank (in mln AZN)**	
	The amount of total capital	**The amount of funds required to restore the capital position**	**The amount of total capital**	**The amount of funds required to restore the capital position**
"Amrahbank" OJSC	8,9	41,1	(-) 77	127
"NBCBank" OJSC	58,6	Not required	(-) 24	74
"AGBank" OJSC	49,2	0,8	(-) 167	212
"Atabank" OJSC *	142,6	Not required	(-) 214	264
The total amount of funds required to restore the capital position	**–**	**41,9**	**–**	**677**

*** – As of October 1, 2019**

Source: ACB and Azerbaijan Bank Association

Based on the approach of the Central Bank (Table 1), it can be seen that the real amount of banks' assets is significantly smaller. It is obvious that banks are unable to fulfill their obligations. If 686 mln AZN of assets with a total negative capital of 428 mln AZN will be transferred to the ADIF for protected depositors, the chances of an entrepreneur or a legal person, which are last in the payment queue, to get their money back are in great question. For after the Fund takes its money, other creditors – *all costs and expenses incurred by the temporary administrator and liquidator, claims of bank employees in connection with injuries or deaths during working hours, mandatory payments to the state budget (taxes, compulsory state social insurance premiums and unemployment insurance premiums)* – come in turn. After this list, it seems impossible to compensate entrepreneurs and legal persons, including unprotected depositors, who are bank customers.

Another problem is the participation of the Fund, the main creditor, in the process as a liquidator. According to the relevant decisions of the Baku Court of Appeals, the ADIF was identified as the liquidator of Amrahbank OJSC, Atabank OJSC, NBCBank OJSC and AGBank OJSC. In addition to being a liquidator, the Fund is also a major creditor of the closed banks. The main task of the Fund is to return its own funds after depositors are compensated. In such a situation, the Fund becomes an interested party because in order to fulfill its obligations, it will prefer cheap and fast sales to save its own funds, rather than ensuring the real market value in the sale of movable and immovable property.

Banks are becoming more dependent on large creditors. The full deposit insurance mechanism ensures that deposits are not distributed among different banks, but are collected in one bank, thus increasing the dependence of banks on large depositors. When large depositors withdraw their funds from the bank for various reasons, the sudden withdrawal of large sums of money creates a liquidity problem for the bank.

The concentration in the savings market is deepening. The closure of banks as well as the public expectations that this process will continue encourage the population to invest in large banks. As a result, funds accumulate in the largest banks, further increasing their market share, while smaller banks face the threat of leaving the market because of the difficulty they have in attracting resources.

The legislation does not specify the date of the commencement of compensation. According to Article 28 of the Law on Deposit Insurance, within 7 calendar days after receiving a notification from the Central Bank on the occurrence of an insurance case, the ADIF announces in the media the place and time of the payment of compensation and publishes a notice. Here, the legislation does not specify the date of the payment of compensation, but rather the regulations for the announcement of compensation. The law only obliges the Fund to set a deadline for the payment of compensation (no later than 90 calendar days from the date of receipt of the depositor's application). Therefore, banks that have been closed over the past 10 years have usually implemented a time-consuming compensation payment process. For example, *Damirbank OJSC, Yunayted Kredit Bank OJSC,* and *Royalbank OJSC* began to pay compensations, respectively, 40, 35, and 18 days after the insurance cases. Although the insurance case in Atabank OJSC and Amrahbank OJSC occurred on April 28, 2020, the payment of compensations will begin 33 days later – after June 1. From this date, compensation will be paid for deposits up to the equivalent of 30,000 AZN. Only from July 1, the other deposits will be returned. The insurance case in the banks whose licenses were revoked last, *NBC Bank OJSC* and *AG Bank OJSC*, occurred on May 14, 2020. Compensation will begin on June 16, i.e. 32 days after the occurrence of the insurance case. From this date, compensation will be paid for deposits up to the equivalent of 30,000 AZN. Compensation for the other deposits will begin on 1 July.

How are deposits protected in other countries?

The deposit insurance system is applied in 146 countries around the world. In Europe, in 1994, the Directive of the

European Parliament and of the Council on Deposit Guarantee Schemes came into force. According to the document, each member state of the European Union must establish at least one deposit guarantee scheme. Financial and credit institutions licensed to conduct banking activities are prohibited from accepting deposits and opening customer accounts without being a member of one of these schemes. In the new version of the Directive on Deposit Guarantee Schemes amended in 2014, the amount of guaranteed deposits is set at the equivalent of 100,000 EUR. The amount of compensation is not limited to this. There are some deposits that are insured for a period of at least 3 months and a maximum of 12 months with a compensation of more than 100,000 EUR. These deposits include proceeds from the sale of private homes, social benefits related to the life of the depositor (disability, unemployment, death, pension, divorce, etc.), compensation for criminal injuries or insurance payments.

There are "limited" and "unlimited" countries with respect to the amount of compensation. While the vast majority of countries apply a limit, some do not. The unlimited compensation mechanism is usually applied temporarily during crisis years. For example, in 2007–2009, *Australia, Malaysia, Thailand, Hungary, Germany, Denmark, Ireland, Austria* and *Singapore* applied the temporary unlimited compensation mechanism. Currently, *Azerbaijan* and *Belarus* have an unlimited compensation mechanism. There are also countries that apply differential limits. In the *US* and *Canada*, the limits apply to a variety of accounts, including individual, joint, pension, and trust accounts. However, bank customers can be compensated by placing funds in other instruments in excess of the standard limit (250,000 USD in the US, 100,000 CAD in Canada).

In most countries, insurance only applies to the bank accounts and deposits of physical persons. This is especially true of the recently established insurance system. Moreover, the practice of gradually applying insurance protection to the accounts of small and medium-sized businesses is growing. Even in non-bank credit institutions (credit unions and cooperatives) in some countries, funds in investment accounts, deposits and insurance policies are covered by insurance.

In some countries (*Azerbaijan, Argentina, Indonesia, Kazakhstan*), high-interest deposits are also covered by insurance. In countries such as *Canada, Japan, Australia, Brazil* and *Singapore*, foreign currency deposits and accounts are not protected. Deposits and accounts in the currencies of non-EU countries in *Germany*, and non-European Economic Community countries in *France* are not protected.

One noteworthy point is related to the date of the insurance case because the date of compensation is determined after that decision. Prompt issuance of a decision confirming the occurrence of an insurance case also speeds up access to compensation. In the European Union, an insurance case is considered to have occurred when the competent authority recognizes that the credit institution is incapable of fulfilling its obligations to depositors. Such a decision must be made no later than 5 days after receiving confirmation from the competent authority that the credit institution is unable to fulfill its obligations. *In Brazil* and *the United States*, an insurance case is considered to have occurred from the moment the bank is closed by the regulator; in Canada, from the moment the Canadian authority declares that the control measures or decisions are not sufficient to restore the bank's operations. In *Argentina, Belarus, India, Indonesia, Kazakhstan, the Philippines* and *Russia*, the revocation of the license to conduct banking operations is considered an insurance case. In some countries, including *Azerbaijan, Armenia* and *Kyrgyzstan*, a court decision is required for an insurance case.

The timing of the start of compensation payments is also an important issue that allows the depositor to have quick access to their funds. According to the Core Principles for Effective Deposit Insurance System in force for EU countries, compensation must begin within 7 working days of the insurance case. One working day in the United States and Canada, three working days in Brazil, five working days in Argentina, and seven working days in *Australia, Hong Kong, South Korea* and *Singapore* have been set to restore depositors' access to their funds. In some countries, payments are made at the request of the depositor, not at the initiative of the insurance company. At the same time, there are restrictions on the start and end dates of payments. For example, in Turkey, it starts no later than 20 working days after the insurance case, and depositors can apply within 1 year. In Indonesia, payments start after 5 business days and end after 3 months.

Now let us look at the experiences of different countries. Deposit insurance in Russia is carried out by the Deposit Insurance Agency and compensation is paid in the national currency – rubles. Deposits in foreign currencies are returned at the rate of the Central Bank of Russia on the date of closure of the credit institution. Russia has been protecting the accounts of individual entrepreneurs since 2014 and legal persons with small businesses since 2019. According to a new bill, which is currently being read in parliament for the second time, the amount of compensation for insured deposits will be increased by 10 mln rubles (around 140,000 USD). The new amendment to the law expands the scope of insurance. If in the current legislation only escrow accounts opened for the purchase and sale of real estate as well as accounts opened on the basis of contracts on participation shares in construction were included in the insurance coverage, the list will be extended after the amendment. After the adoption of the bill, the proceeds from the sale of houses, inheritance, life and property insurance, social payments or subsidies, and payments on court decisions will also be recognized as insured deposits. At the same time, it will be possible to receive compensation of up to 10 mln rubles for accounts and deposits opened for the capital repairs of apartment buildings.

In Albania, the amount of compensation varies by credit institution. The amount of compensation in banks is 2.5 mln LEK (22,000 USD) while in Savings and Credit Associations (SCA) the amount is 2 mln LEK (17,500 USD). All deposits are converted into the national currency at the official exchange rate of the Central Bank on the day of the bank's closure. Deposits of physical persons and deposits of individual entrepreneurs are protected in Kazakhstan. The Deposit Insurance Fund of Kazakhstan insures all types of deposits in national and foreign currencies (all funds in bank accounts and payment cards). The amount of compensation varies depending on the type of deposit and currency: compensation in the amount of 5 mln tenge (11,900 USD) for any deposits in foreign currency, 10 mln tenge for deposits in the national currency (deposits, payment cards, bank accounts), and 15 mln tenge for savings deposits in the national currency. Payment for deposits in foreign currency is made in the national currency at the exchange rate on the date of revocation of the license. Deposits of physical persons and funds of individual entrepreneurs in Ukraine are insured by the Deposit Guarantee Fund and the maximum amount of compensation is 200,000 hryvnias (7,500 USD). In the UK, the Financial Services Compensation Scheme reimburses 85,000 pounds for deposits placed in banks, construction banks or credit unions. In the United States, deposits are insured by the Federal Deposit Insurance Corporation and the amount of compensation is 250,000 USD. Individual and joint deposits, pension savings, payments to employees, government accounts, and the deposits of corporations and associations, as well as profit-making and non-profit associations are also covered by insurance.

What Is to Be Done?

Other countries implement different mechanisms to address this issue. Insurance conditions in these countries are determined by a number of factors: level of income, level of concentration in the banking sector, the states of the economy and the banking sector, availability of funds in the Deposit Insurance Fund, availability of state support for deposit insurance mechanisms and so on. The deposit insurance mechanism is not perfect in any country, and the process is constantly evolving. Currently, the main trend is to expand the contingent covered by insurance, increase the amount of compensation and reduce the period of its issuance.

The deposit insurance mechanism in Azerbaijan has a 14-year history. During this period, the mechanism was able to return the funds of most depositors to their owners, and depositors protected in the last 4 years fully recovered their funds. However, granting unlimited preferences to protected depositors in the banking sector limits the rights of other bank customers and significantly reduces their chances of recovering their deposits in closed banks. Therefore, there is a need to improve the mechanism of deposit insurance.

The following suggestions can be considered to improve the deposit insurance mechanism:

1. Abandoning the full deposit insurance mechanism and applying a limit on the amount of compensation. For this, it is enough not to extend the validity of the Law on Full Deposit Insurance, which expires on December 4, 2020.

2. Increasing the amount of compensation for protected deposits. The amount of compensation can be increased from the current level of 30,000 AZN to at least 70,000 AZN.

3. Expanding the scope of protected deposits. As in foreign countries, current accounts of individual entrepreneurs and deposits of companies providing housing and communal services can be insured. At the same time, all funds on payment cards (salaries, social benefits, current accounts of entrepreneurs) can be insured to stimulate non-cash payments.

4. Continuation of the anti-dollarization policy. To encourage the population to deposit in the national currency, the annual interest rate for insurance of deposits in foreign currency can be reduced to 1%. Another step is to reduce the amount of compensation for foreign currency deposits.

5. Clarification and shortening of the compensation period. Legislation should specify the date for the commencement of compensation. At the same time, this period can be shortened to 5 calendar days.

6. Ensuring transparency in the cancellation process. It is important to include public representatives and experts in the liquidation commission, and to make the auction procedures transparent. The information should be posted in detail on the Fund's website

7. Ensuring transparency in the work of the Deposit Insurance Fund. The Fund must disclose detailed program and audit reports on its activities. At the same time, the statistical database on the volume of protected and unprotected deposits, currency structure, distribution of savings accounts, etc. should be disclosed.

Notes

[1] According to the decision of the Board of Trustees of the Azerbaijan Deposit Insurance Fund (ADIF), from June 1, 2020, maximum annual interest rate on protected deposits in the national currency is raised from 10% to 12%.

[2] One of the topics of discussion after the closure of the banks was the inaccuracy of their information on capital shortages. Although the banks said in their statements that there was no serious problem with the amount of capital, the Central Bank, citing completely different figures, announced that the capital of these banks fell to a negative level. Thus, now there are two different results about the real volume of assets due to the different methodology used by the Central Bank and the other banks for calculating assets.