International Association of Deposit Insurers

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Dealing with Parties at Fault in a Bank Failure and Fraud in Deposit Insurance

Guidance Paper

Prepared by the Research and Guidance Committee

International Association of Deposit Insurers

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Executive summary and proposed additional guidance

This paper examines existing international approaches and practices in the area of dealing with parties at fault in a bank failure and fraud in deposit insurance. It considers various aspects of investigating and prosecuting actions and omissions that contributed to bank losses and failures, and thereby promoting regulatory and market discipline, increasing recoveries from failed banks' assets and protecting deposit insurance funds' resources.

According to the Financial Stability Forum, "Claims and litigation advanced by the failed bank or the receiver/liquidator against directors, officers, auditors and other parties related to the bank failure are potentially important assets. These claims may result in significant recoveries and may serve as a tool for fostering discipline in the banking sector".[1]

It is typical for jurisdictions to have in place legislation and other regulations that allow various court and out-of-court actions to be brought against culpable and potentially culpable persons to recover damages resulting from their misconduct or fraudulent actions, as well as administrative and enforcement actions intended to mitigate risks, prevent unsafe and unsound practices, and remove irresponsible persons from the banking sector. A number of jurisdictions have tightened regulation for senior managers in banks or are in the process of implementing such reforms. For example, Ireland, Spain, the Netherlands and Ukraine have introduced amendments to their laws that establish stricter requirements for bank directors and managers (fitness and probity standards, whistle-blower regime, increased penalties, personal liability, etc.). The British government has recently replaced its "Approved Persons Regime" with the new "Senior Managers Regime", which will allow regulators to take enforcement actions against persons guilty of misconduct and introduce a new criminal offense covering reckless conduct leading to the failure of a bank.[2]

Effectively investigating the causes of bank failures and bringing actions against persons/entities whose misconduct contributed to the losses of a failed bank are important issues for many deposit insurance agencies, especially those who act as the bank resolution authority (in the capacity of receiver, liquidator, bankruptcy trustee, etc.) or are otherwise involved in managing or supervising bank bankruptcy/liquidation proceedings. All deposit insurers could benefit from recovering additional funds from the failed bank's assets and thus mitigating deposit insurance fund losses. It is particularly important in light of the recent international initiatives that propose using the resources of deposit insurance funds for resolution funding.[3]

Depending on their mandates, deposit insurance agencies and other financial safetynet participants as well as law enforcement agencies and courts can play their respective roles in investigating and prosecuting actions/omissions that contributed to the losses of a failed bank – based on the legislation and other regulations, interagency agreements (MOUs, etc.) and/or internal rules that govern their specific responsibilities and powers.

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[1].Financial Stability Forum. Guidance for Developing Effective Deposit Insurance System. September 2001, p. 37.

[2] See, for example, Clifford Chance: There May be Trouble Ahead: UK Government moves to tighten regulation for senior managers in banks. Briefing note. October 17, 2013.

[3] See, for example, EU Directive2014/59/EU on recovery and resolution of banks and investment firms (): http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:32014L0059

During the recent financial crisis, a number of jurisdictions enhanced the mandates of their deposit insurance agencies and increased their involvement in the implementation of various resolution tools. For such deposit insurers, it became even more important to have in place effective arrangements for coordinating their efforts with other relevant government bodies, bank supervisors and, in some cases, creditors and other interested parties, as timely and efficient investigation and litigation against culpable persons may directly influence their losses and, as a result, the safety of the deposit insurance fund's financial resources.

Current guidance on dealing with parties at fault in a bank failure is provided by the Key Attributes of Effective Resolution Regimes for Financial Institutions issued by the Financial Stability Board[4]and the IADI Core Principles for Effective Deposit Insurance Systems. Core Principle 12 states that "The deposit insurer, or other relevant authority, should be provided with the power to seek legal redress against those parties at fault in a bank failure". To be in compliance with Core Principle 12, the guidance suggests practices including: investigation of conduct of parties responsible for or who contributed to the failure of a bank by a responsible body; imposing sanctions and/or redress against persons that are culpable for the failure of a bank.

Proposed additional guidance:

1. Every jurisdiction should have legislation and other regulations that govern investigation and liability of persons at fault in a bank failure. The legislation should indicate: the types of misconduct subject to investigation; the types of liability, which should be dependent on the severity of misconduct and the damage caused by any misconduct; the range of persons that can be held liable for wrongdoing; and limitation periods.

2. The legislation/regulations should clearly specify the areas of responsibility, powers and obligations of relevant government and non-government agencies with regard to conducting investigations and bringing legal actions against parties at fault in a bank failure, as well as the sources of funding for such actions

3. A deposit insurer that is involved in bank liquidation proceedings should have the ability to influence the course of the investigation and bring legal actions against potentially culpable persons, as well as follow up the effectiveness of court and out-of-court prosecution and recoveries from such legal actions.

4. If the deposit insurer acts in the capacity of a resolution authority, it should have internal rules and processes that govern the investigation of bank failures and their causes, and the initiation of legal actions against responsible persons. It is good practice to have MOUs with other relevant agencies (bank supervisor, public prosecutor's office, investigating authorities, police, etc.) that specify the respective rights and responsibilities. The agencies involved in investigation and prosecution of wrongful actions that contributed to bank failure should have formal and/or informal arrangements for sharing information about their findings in a timely manner. They should have continuing authority to investigate and prosecute "parties at fault" notwithstanding the successful resolution of a bank.

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[4].Financial Stability Board. Key Attributes of Effective Resolution Regimes for Financial Institutions. October 2011.

5. It is recommended to have criteria for evaluating the feasibility of investigating and initiating legal actions (both in and out of court) against potentially culpable persons. Such criteria may include economic criteria (such as cost-efficiency), political criteria (criminal actions, social danger, importance for maintaining market/regulatory discipline, etc.) and/or other criteria (environmental, etc.).

6. In some jurisdictions, senior officials of depository institutions are obligated to have insurance policies that cover liability of directors and officers for their wrongful acts. In this case, the deposit insurer or other agency responsible for investigating bank failures should pay due attention to this potentially important source of recovery of damages.

7. It is good practice to publicize instances where persons at fault in a bank failure or losses/damage to the bank or its creditors have been held to account. It serves as a warning to other bankers/bank counterparties, contributes to strengthening the authority of the agency authorized to initiate prosecution of culpable persons, and establishing appropriate judicial practices.

8. The deposit insurer should have internal procedures for the timely identification of fraudulent claims, the right to refuse insurance payouts when claims result from fraud and to bring legal actions against fraudulent persons for committing fraud and/or participating in such fraudulent actions.

I. Introduction and purpose

The effectiveness and efficiency of investigations into the causes of bank failures, and legal actions to recover damages from persons whose misconduct resulted in losses at a failed bank, can directly influence the sustainability of the deposit insurance system and preservation of the deposit insurance fund's resources. Bringing legal actions against persons and/or entities that are culpable for the failure of a bank can encourage more responsible behavior by bank directors and officers, their external and internal auditors, appraisers and other related parties. This, in turn, increases the stability of the banking system and decreases the probability of bank failures and losses for the deposit insurer in connection with bank failures and resolutions.

While jurisdictions usually have legislation and other regulations governing the investigation and prosecution of actions that cause losses/damage to legal entities and/or their creditors, as well as administrative, civil and criminal actions against culpable and potentially culpable persons, such laws and regulations vary substantially among countries. These differences relate to the types of misconduct subject to sanction and/or redress, the range of persons that can be brought to responsibility, the grounds for bringing court and out-of-court actions, and the role played by various government and non-government bodies/agencies, including deposit insurers. At the same time, there are a number of common issues and best practices that can be utilized by relevant authorities to improve the efficiency of their operations in this specific area.

The Key Attributes of Effective Resolution Regimes for Financial Institutions issued by the Financial Stability Board is a substantial step forward in unifying national resolution regimes and ensuring their compatibility and consistency. As regards the theme of this paper, the Attributes state that the resolution authorities should have at their disposal a broad range of powers, which should include powers to "Remove and replace the senior management and directors and recover monies from responsible persons, including claw-back of variable remuneration".[5]The draft Assessment Methodology for the Key Attributes, which was published in August 2013, contains the following provision in its explanatory note 3.2 (i):

"The power to recover monies may include investigation and pursuit of claims against a responsible person by any of the following:

(i) the resolution authority;

(ii) another agency or authority (for example, the supervisor or regulatory authority);

(iii) judicial authorities; or

(iv) other governmental disciplinary or enforcement bodies.

Monies may be recovered directly from the individual or from any available professional liability insurance. Claims might include claims for damages in civil or criminal proceedings. The responsibility of a person for the failure of the firm should be determined in accordance with the jurisdiction's law."[6]

It is worth mentioning that such a power is of significant importance for all deposit insurers (and other relevant authorities), including those that are not designated to act as the resolution authority, because this potentially allows them to recover more funds from the assets of banks subject to resolution. The EU Directive2014/59/EU on recovery

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[5]Financial Stability Board. Key Attributes of Effective Resolution Regimes for Financial Institutions. October 2011, p. 7.

[6]Financial Stability Board. Assessment Methodology for the Key Attributes of Effective Resolution Regimes for Financial Institutions. Consultative Document, August 28, 2013, p. 45.

and resolution of financial institutions[7] contains a special section (Title VIII: Penalties) regulating the administrative sanctions that should be imposed by resolution authorities and competent authorities against persons and/or entities for breach of the provisions of the Directive. A trend towards strengthening sanction regimes has been observed in many countries, including the UK, Ireland, France, Russia and the Netherlands.

Taking into account the importance of efforts aimed at the investigation and adequate prosecution of actions and/or omissions that contributed to a deterioration of the financial condition of a bank and thereby caused it to fail, the International Association of Deposit Insurers (IADI) included in its Revised Core Principles for Effective Deposit Insurance Systems a principle devoted to this particular issue: Principle 12 states that "A deposit insurer, or other relevant authority, should be provided with the power to seek legal redress against those parties at fault in a bank failure".[8] Additional guidance is contained in the essential criteria that are used for assessing compliance with Principle 12:

1. "The conduct of parties responsible for, or contributing to, the failure of a bank (e.g. officers, directors, managers, owners), as well as the conduct of related parties and professional service providers (e.g. auditors, accountants, lawyers and asset appraisers), is subject to investigation. The investigation of the conduct of such parties may be carried out by one or more of the following: the deposit insurer, supervisor or regulatory authority, criminal or investigative authorities, or any other professional or disciplinary body, as applicable.
2. The relevant authority takes the appropriate steps to pursue those parties that are identified as culpable for the failure of the bank. The culpable parties are subject to sanction and/or redress. Sanction or redress may include personal or professional disciplinary measures (including fines or penalties), criminal prosecution and civil proceedings for damages.
3. The deposit insurer, or other relevant authority, has policies and procedures in place to ensure that insiders, related parties and professional service providers acting for the failed bank are appropriately investigated for wrongdoing and for possible culpability in a bank failure."

The purpose of this paper is to take stock of existing approaches and practices in investigating the causes of bank failures, identifying actions and persons that contributed to a deterioration of the financial condition of a bank and thereby caused it to fail, establishing grounds, and bringing various enforcement and administrative, civil and criminal actions against parties at fault in bank failures. It also examines some recent international and national initiatives intended to improve market and regulatory discipline in the banking sector, and enhance the relevant capabilities of deposit insurers and/or other government and non-government bodies related to prevention and prosecution of misconduct and frauds resulting in damage to failed banks, their creditors, deposit insurers and other parties concerned.

This paper draws on the results of the two surveys conducted by the Subcommittee[9] in 2012, presentations delivered at the seminar in Moscow, Russia (May 2013), as well as research and publications on the related issues. The first survey

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[8] BCBS-IADI: Core Principles for Effective Deposit Insurance Systems, BIS, June 2009, p. 16.

[9] The IADI Research and Guidance Committee's Subcommittee on dealing with parties at fault in a bank failure and fraud in deposit insurance consisted of representatives from the deposit insurance agencies of Russia (Chair), the Czech Republic, Hungary, Indonesia, Japan, Kazakhstan, Korea, Mexico, Poland, the Philippines, Romania, Taiwan, Trinidad and Tobago, Ukraine and the US.

contained questions on the legal basis for investigating and prosecuting actions that contributed to bank failures (the Subcommittee received responses from 27 deposit insurers). The second survey was devoted to practices for preventing and combating fraud in deposit insurance (25 responses).

The remainder of the paper is organized as follows. Section II discusses the issues related to investigating the causes of bank failures. Sections III to V examine practices for bringing administrative/enforcement, civil and criminal actions, respectively. Section VI considers existing practices in the area of preventing and combating fraud in deposit insurance, and is followed by a concluding section.

II. Investigation of reasons for bank failures

Thorough investigation of the causes for a bank becoming non-viable and failing is an essential element of every liquidation/bankruptcy procedure. The quality of the investigation and validity of the evidence identified and reported will affect the success of further actions against culpable persons and recovery of damages from them. Therefore, before seeking recovery from culpable or potentially culpable persons, it is necessary to conduct a rigorous investigation of whether they breached their duty to, and the extent to which they caused losses to, the failed institution.

In general, the investigation program is guided by the legislative provisions that establish liability of culpable persons in committing/not preventing specific illegal actions. The range of aspects investigated includes identification of the major causes of bank difficulties/failure; detection and analysis of transactions with the assets and liabilities of the bank (including off-balance sheet items) that resulted in losses and/or damage to the bank and/or its creditors; assessing the legitimacy of decisions taken and their compliance with regulatory requirements and internal rules; identification of the persons in charge of authorizing or executing specific transactions; and evaluation of the feasibility and cost-efficiency of initiating legal actions.

The major objectives of such an investigation include collecting evidence in relation to: transactions and actions/omissions that ultimately resulted in the deterioration of the bank's financial position, incurring losses; violation of laws or other regulations; and identification of persons that committed, authorized or contributed to illegal actions/wrongdoings.

Other tasks that investigators typically face include determination of the size of the damage to the bank/its creditors, identification of possible sources from which to recover damages, and identification of persons that are liable for the damage (directors, senior officers, employees, insurers, auditors, appraisers, etc.). Based on the results of this investigation, it should be possible to determine the most effective recovery strategy (in-or out-of-court enforcement, etc.).

A number of different factors can influence the possibility of recovering damages from culpable persons. Among them are: existing legal system and judicial practices; legal qualification of specific actions as offenses; legislative norms that regulate liability and limitation periods for various types of wrongdoing; sufficiency of evidence, terms of contracts between the bank and potentially culpable persons and insurers (Directors and Officers (D&O) liability insurance, fidelity bond insurance); the possibility to locate the culpable person and ability to seize his/her assets in order to recover damages, etc.

In many jurisdictions, the agencies responsible for assessing the reasons for a bank's failure on the basis of such assessments evaluate the feasibility of initiating legal actions (for example administrative, civil or criminal actions) and/or recovering damages. In some cases, they assess the cost-efficiency of such legal actions, but this is not always relevant. In particular, in some circumstances cost-efficiency is considered less important than political, legal or social criteria. Examples of such criteria may include the social implications of wrongdoing, the need to prevent similar offenses by other bankers/persons, etc.

The length of an investigative process can vary depending on the size of the failed institution, the availability of documents and other evidence, and the complexity of the misconduct.

It is good practice to jurisdictions to have in place legislation that establishes the fiduciary duties, qualification requirements and standards of behavior for bankers (directors and officers);types of offenses and types of responsibility for specific wrongdoings/negligence/complicity; limitation periods for every type of offense; the powers and responsibilities of various agencies involved in investigating the causes of bank failure and malpractice; and in- and out-of-court procedures for recovering damages and prosecuting culpable persons.

The success of an investigation depends in substantial measure on the powers and qualifications of investigators, as well as on the timing of the investigation. The earlier the investigation begins, the greater the chance of collecting sufficient evidence, including from persons that worked or are still working for the bank. It also allows the safety and availability of documents and bank databases to be ensured. Typically, when an investigation is delayed and starts after the bank closure, it is more difficult to obtain the necessary evidence of wrongdoing. Moreover, in such cases the problem of limitation period expiry can arise.

For agencies in charge of investigating the causes of bank failure, it is important to have the possibility to assign/hire qualified experts capable of conducting both economic/accounting (financial) and legal (civil and criminal) analysis of documents and other data on transactions/actions that took place before the bank closure by the competent authority. Therefore, it is also important to have a system of education and professional training for the staff members involved in conducting such investigations, analyzing the results/findings and preparing/initiating legal actions against potentially culpable persons. When investigating certain specific transactions, it may be feasible to hire third parties that specialize in those areas of legislation/legal procedures. Such outsourcing of the investigation is feasible where bank failures occur only rarely, but in any case it requires the clear identification of objectives and the existence of effective controls over such third-party experts.

Moreover, it is useful to have detailed manuals/handbooks that govern the investigation, the collection of evidence, the documentation of investigation results, the management of investigation processes, the analysis of findings/evidence, and the decision– based on the available evidence –whether or not to initiate further legal actions.

If the deposit insurer itself is responsible for conducting the investigation of transactions/wrongdoing that contributed to the bank failure, it is useful to ensure its close cooperation with investigating bodies, the public prosecutor's office, and other law enforcement agencies. This allows timely information sharing and prompt commencement of civil or/and criminal court procedures on the basis of collected evidence of crimes. Moreover, to conduct such investigations, the investigators often need access to information that is protected by tax and banking secrecy provisions, etc. The agency responsible for investigating bank failures can obtain such information based on its statutory powers/rights, otherwise it will have to request such information from other relevant government bodies (either in each individual case or on the basis of relevant MOUs). When deciding whether to bring claims against failed institution insiders, the investigating agency also may conduct employee interviews and a review of the factual circumstances underpinning the alleged misconduct. For example, the FDIC's investigatory process involves interviews and sworn testimony of the officers and directors, which the FDIC uses to build a record to support its claim.[10] A very interesting practice that deserves further dissemination exists in the KDIC. It envisages an exchange of personnel between the deposit insurer (acting as the resolution authority) and the Public Prosecutor's Office (see Annex 1).

There are some benefits to granting the deposit insurer the power to investigate bank failures. They include: the deposit insurer is directly influenced by the recoveries from a failed bank's assets as it shares the proceeds from the bankruptcy estate with other creditors; it typically has staff members experienced in banking (in many cases law enforcement agencies do not have such specialists); it has fewer grounds for conflicts of interest (bank supervisors can be less motivated to thoroughly investigate the bank failure in cases of regulatory forbearance that contributed to the bank's misconduct/irresponsible behavior), etc.

In cases when bank failures are rather frequent, the agency in charge of investigating and prosecuting actions that contributed to bank failures can establish a dedicated department/division, consisting of experts in banking, finance and law. This department is authorized to conduct analysis of actions/transactions that caused losses to the bank, study documents of the bank, interview former/existing bank employees/counterparties, and collect the evidence of misconduct which is necessary for initiating legal/enforcement actions against potentially culpable persons and recovering damages (including civil and criminal lawsuits). Examples of deposit insurance agencies that have such dedicated investigation departments are the Federal Deposit Insurance Corporation (FDIC), the Deposit Insurance Corporation of Japan (DICJ), the Korea Deposit Insurance Corporation (Korea), the Philippine Deposit Insurance Corporation (PDIC), the Indonesia Deposit Insurance Corporation (IDIC), the Turkish Savings Insurance Fund (TMSF), the Nigeria Deposit Insurance Corporation (NDIC)and the Deposit Insurance Agency of Russia (DIA Russia).

In jurisdictions where insured depository institutions typically carry Directors and Officers liability insurance, it is important to determine those persons who are covered by such insurance, which actions/omissions are included in the coverage, and any time limitations on such coverage.[11] As practice shows, in jurisdictions where such D&O insurance is widespread, recoveries from such insurance policies can be an important source of funds for the estate of liquidated banks.

In cases when the deposit insurer is not primarily responsible for investigating the reasons for a bank failure, it is good practice to involve its specialists in conducting expert economic appraisals when needed. In addition, a major focus for deposit insurers is the investigation of cases of fraud involving the illegitimate payment of insurance to a person not covered by deposit insurance protection or in excess of the established coverage limit. This will help to decrease deposit insurance fund expenses and to limit the occurrence of such illegal actions if, such investigations result in adequate measures being taken, such as non-payment of insurance to depositors whose claims result from fraudulent actions.

Another important issue that should be properly addressed is the sources of funding for the investigation. The legislation should clearly determine who pays for conducting the necessary expert appraisals, assessments, and investigations. The investigations can be funded from the failed bank's estate, from the budget of the

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[10] 12 U.S.C. §1818 (n); 12 U.S.C. §1821 (d) (2) (I).

[11] For more detailed information about Director and Officer liability insurance see, for example, http://www.agcs.allianz.com/assets/PDFs/risk%20insights/AGCS-DO-infopaper.pdf.

investigative body (if such expenditures are allowed and budgeted for) or from the state budget (the latter is more typical for criminal cases).

It is good practice to have a predefined format for documenting and summarizing the results of the investigation. One example of this are Material Loss Reviews, which summarize the results of investigations conducted by the FDIC's Independent Office of the Inspector General to determine the reason and nature of losses to the deposit insurance fund. These can be found at http://www.fdicig.gov/mlr.shtml.

Practices in investigating the circumstances of bank failures

The results of the survey conducted in 2012 as part of the preparatory work for this paper allowed approaches and practices to be identified that are utilized in various jurisdictions when responsible agencies conduct an investigation of the causes of a bank failure and the circumstances, transactions and actions that contributed to the losses of a failed bank.

Not all jurisdictions have special legislation that requires the investigation of the reasons for a bank failure. Countries that have such provisions include Hungary, Japan, Korea, Russia, Turkey and the USA. For example, the Russian federal law "On insolvency (bankruptcy) of credit organizations" (Article 50.21 (11)) states that the bankruptcy trustee is obligated to"… identify evidences of intentional and fictitious bankruptcy as well as circumstances that constitute grounds for bringing legal actions set forth in Article 14 of this federal law". In other cases, such as Mexico, the legislation contains no specific provision that clearly specifies the mandate of financial authorities to investigate the causes that contributed to the failure of a bank in resolution, when there is no evidence of irregularity or suspected regulatory infringement, or a complaint filed by an interested party concerning a fact that constitutes a criminal offense or unlawful action.

The responses to the questionnaire show that, in a majority of jurisdictions, responsibility for investigating the causes of a bank failure lies with bank supervisors (52%) and law enforcement agencies (48%). Only 26%of respondents indicated that deposit insurers are authorized to conduct such investigations,[12] including deposit insurance agencies from Japan, the Philippines, Korea, Turkey and Russia.

Slightly more than half of the respondents stated that such investigations are governed by the Banking Act, 33% indicated the Criminal Code and only 26% the Deposit Insurance Act.

In the majority of countries, the time period covered by such investigations was not specified. In jurisdictions that responded to the survey, it differs quite a lot and depends on the nature of the offenses.

Sixty-one percent of respondents stated that their cooperation with law enforcement agencies in the course of investigating bank failures is based on the relevant provisions of legislation, and 39% indicated that they have MOUs with such agencies.

In half of jurisdictions, such investigations are funded from the investigating body's resources, while 29% of respondents mentioned government resources and 23% the assets of the failed bank itself.

More than two thirds of respondents pointed out that investigations usually start during the process of bank resolution. However, in half of the jurisdictions that responded to the survey, including Hungary, the Philippines, Taiwan and the USA, such investigations can also start prior to resolution.

[12]When they act in the capacity of receiver/liquidator/bankruptcy trustee/financial administrator.

Forty-one percent of respondents, including Romania, Japan, Russia and the USA said that their jurisdiction's responsible authorities have internal rules for conducting investigations.

Only 26% of deposit insurers that responded stated that they are the primary agency responsible for investigating the causes of a bank failure. They include Korea, Russia, Turkey and the USA. Fifty-nine percent of respondents indicated that they can provide relevant data or financial expertise to other agencies that are primarily responsible for such investigation.

III. Civil administrative actions

Key concept: **Civil administrative actions**– actions that a regulatory authority or a deposit insurer (when acting in its supervisory/regulatory capacity) can take against a problem institution in order to reverse negative trends or operational results. Available actions could include: 1) removal and prohibition of culpable financial institution officials from the industry; 2) an order to the financial institution that it cease and desist from the conduct in question; 3) an assessment of civil money penalties against the institution or an individual concerned; 4) asset freezes. Civil administrative powers in some countries can include the power to issue subpoenas during the investigative and/or formal hearing stages of the action. Some civil administrative actions can also be commenced against culpable individuals after a financial institution's failure.

In the majority of cases, administrative sanctions are used by the bank supervisor (and in some cases by the deposit insurer, especially when it has a mandate of "risk minimizer", for example, as sanction for violating rules that govern the payment of premiums or noncompliance with deposit insurance law) to deal with action by depository institutions and/or their directors and/or officers. In this case, administrative measures are an integral part of a system of prompt corrective actions, which is designed to encourage safer and sounder business practices at the relevant bank, and its compliance with the regulatory requirements. The severity of such sanctions usually depends on the seriousness of the identified deficiencies or wrongdoing, and they are aimed at stopping wrongdoing in the institution's business practices and its management actions and/or decisions, and/or at restoring the safety and soundness of the institution.

The most widespread administrative sanctions include: imposing limitations on specific operations/activities; prohibiting dividend payments; fines/civil money penalties for noncompliance with regulatory requirements; terminating membership in the deposit insurance system; temporary or lifelong removal from managerial positions in banks, etc. For example, the Monetary Authority of Singapore intends to enhance its power to issue prohibition orders against any persons who are not fit and proper, prohibiting them from conducting banking business.[13]

In the majority of jurisdictions, the powers to bring civil administrative actions are held by the bank supervisor, and the deposit insurer has limited authority to bring civil administrative actions against banks or bankers, although they can be brought after consultation with the primary supervisory authority.

The main objectives of civil administrative actions that are brought against directors, officers and/or other affiliated parties of the institution are: elimination of deficiencies in the bank's operations; prevention of the recurrence of deficiencies or irresponsible behavior; removal from the banking industry of discredited persons; prosecution of persons whose actions/negligence have contributed to the bank failure;

[13] Monetary Authority of Singapore: MAS' power to issue prohibition orders under the Banking Act, Consultation paper, P012 – 2013, October 2013.

and, ultimately, enhancing market and supervisory discipline as well as ensuring the fitness and probity of bank directors and officers.

As the majority of such administrative sanctions are outside the scope of this paper, it focuses mainly on civil administrative actions that are or can be brought against responsible persons affiliated with failed depository institutions. They typically include the removal of culpable bank officials from the banking industry and the recovery of monies from responsible persons, including claw-back of variable remuneration.

The results of the Subcommittee's survey show that the most common grounds for bringing civil administrative actions against former bank directors and employees are the following: identification of evidence of violation of laws and/or regulations; failure to submit documents and information, or submission of falsified documents/information; breach of fiduciary duties, including abuse of authority; deficiencies in the institution's management, including risk management practices; other actions/omissions that result in a financial loss to a bank or an improper personal financial gain to the party at fault.

Civil administrative actions are typically brought against directors, officers and other employees of depository institutions. In rare cases, civil administrative actions can be brought against auditors and appraisers for actions that impeded the identification of problems that a bank had faced, or caused a delay in implementing the necessary recovery and/or resolution strategies.

The main advantages of civil administrative actions are that they are more prompt and typically do not require consent of third parties (such as courts, law enforcement agencies, bailiffs, etc.). Taking this into account, they should be governed by clearly defined rules and procedures as well as criteria that allow their implementation with due impartiality and reasonableness.

An important factor that helps to achieve the objectives of administrative sanctions is public disclosure of information about their imposition. In contrast to other types of personal liability, which need approval from courts and thus are typically public, civil administrative actions are brought by the relevant authority independently – on its own. It is good practice to publish information about imposing administrative sanctions, especially when they envisage removal from office or from the banking/financial industry (where feasible).

Practices in imposing administrative sanctions

As the survey results show, in two thirds of jurisdictions that responded to the questionnaire, bank supervisors are authorized to bring civil administrative or enforcement proceedings against bankers.[14] At the same time,27%of deposit insurers also have such powers, including those in Australia, Quebec, Japan, Turkey and Russia.

Two thirds of respondents cited the failure to comply with banking supervision requirements as a ground for bringing civil administrative and enforcement proceedings; 42% mentioned a breach of statutory duty or performing unauthorized and unsafe operations; and 35% cited conducting banking business to the detriment of the interests of depositors.

All respondents mentioned directors, CEO, CFO, Chief Lending Officer and Chief Credit Officer as persons against whom civil administrative proceedings can be brought in connection with losses sustained by a failed bank. Others include other senior executive officers, bank employees, internal and external auditors, and appraisers.

[14] The figure includes sanctions against officers of operating banks (not only those that have failed).

Example: FDIC (United States): Prohibition from further banking employment (12 U.S.C. §1818 (e))

FDIC must establish 3 elements to obtain a lifetime industry-wide ban from banking against a Respondent. Each element can be established in two or more ways.

1. "Misconduct"
   - An institution-affiliated party (IAP) has violated a banking law or regulation; a cease and desist order; or written agreement between the bank and a federal banking agency; or engaged in unsafe or unsound practice; or breached fiduciary duty.
2. "Effect"
   - Personal gain to the IAP; or
   - Institution loss; or
   - Prejudice to the interests of the depositors; and
3. "Culpability"
   - Personal dishonesty by the IAP; or
   - Willful or continuing disregard by the IAP for the safety
   - and soundness of the institution

IV. Civil court proceedings

Key concept: **Civil court proceedings/lawsuits** are legal actions between two or more parties where compensation and/or injunctive relief is sought for the alleged damage caused.

Civil liability of parties at fault in a bank failure is usually based on the Civil Code, Bankruptcy Code and/or other laws that regulate the fiduciary responsibility of directors, officers and other relevant persons for violation of laws/regulations and wrongdoing that resulted in losses to a legal entity or its counterparties.

In general, civil liability claims include torts, negligence, strict liability torts, and vicarious liability.[15] All these claims are complex and contentious and often require many years and substantial investments in investigation and litigation before any actual recovery is realized.

Civil proceedings are brought against one or more defendants to recover monetary damages. In the case of persons whose actions/omissions contributed to a bank failure, such actions are typically initiated by the receiver/liquidator of the failed bank, its shareholders or the deposit insurer. Other entities that can bring civil lawsuits include the bank supervisor, the central bank and law enforcement agencies. Usually a lawsuit

[15] John S. Dempsey: Introduction to Private Security, Wadsworth, Cengage Learning, 2011, p. 112. http://books.google.ru/books?id=S3rFr5gWKQUC&printsec=frontcover&dq=inauthor:%22John+S.+Dempsey%22&hl=ru&sa=X&ei=WK4AUpvFC4G04ASfxICwDw&ved=0CEEQ6AEwAg#v=onepage&q&f=false .

on any particular claim is filed only after attempts at resolution through settlement are made.

For example, the FDIC places the investigated parties on notice that it may seek to recover losses from them. The so called "demand letters" requesting payment of civil money damages may be sent to former directors and officers and other potentially culpable persons, as well as to the director and officer (D&O) insurance carrier (based on the D&O liability insurance policy covering claims arising out of alleged errors in judgment, breaches of duty, and wrongful acts related to their organizational activities). These demand letters are not filed by the FDIC with any court, posted, or otherwise made publicly available[16] but their effect is quite significant, as out-of-court settlements allow the avoidance of costly and protracted litigation and result in greater recoveries.[17]And it is important to note that even if it does not pursue a claim against these parties, the information the FDIC gathers may be used in other enforcement efforts and shared with other agencies.[18]

Another example is the DICJ, which, along with its subsidiary (Resolution and Collection Corporation - RCC), has claimed about JPY 133 billion (around USD 1.3 billion) in total in its 127 civil liability pursuit cases in Japan since 1995.

The deposit insurer, especially if it faces losses resulting from a bank failure or acts in the capacity of the receiver or liquidator (or the resolution authority),can be a plaintiff in civil proceedings initiated for the purpose of recovering its own losses or losses that the failed bank has borne. In various jurisdictions, legislation (usually the Civil Code or Bankruptcy Code) establishes different time periods prior to a bank closure for possible challenges to transactions/actions/omissions and other wrongdoing committed during this period (limitation period). Because of this, those involved in preparing and filing civil actions in court should pay due attention to the limitation periods attributable to particular offenses.

The results of the survey by the Subcommittee show that the most frequent offenses which constitute grounds for bringing civil court actions include:

- Actions that caused material losses or moral damage;
- Breaches of fiduciary duty;
- Negligence/gross negligence;
- Granting of loans in breach of the law and internal procedures; and
- Failure to comply with requirements of the legislation.

Because civil court actions are intended to recover damages, to initiate such actions it is necessary not only to identify the specific violation of law and the persons whose actions/negligence are subject to judicial scrutiny, but also the scale of the damage as well as the cause-and-effect relationship between the action/non-action and the damage that it caused. Often, determining the scale of the damage is a quite difficult task, which requires substantial time, highly qualified investigators and the processing of large volumes of information both available in the bank itself and kept by some third parties (registries, depositaries, tax authorities, etc.).In such cases, some jurisdictions provide, as an alternative, the possibility of bringing civil court actions based on the concept of "subsidiary liability" (liability which is imposed on another party if the party that is primarily liable does not meet its obligation[19]).

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[16]12 C.F.R. §308.147.

[17]Such settlements can, however, come in for some criticism from the media, and even legislators. See, for example, http://www.forbes.com/sites/halahtouryalai/2013/03/12/is-the-fdic-protecting-banks-from-bad-press/.

[18] See: http://www.jdsupra.com/legalnews/fdic-bank-failure-litigation-understand-08203/.

[19] See Lucas Bergkamp, Barbara Goldsmith: The EU Environmental Liability Directive: A Commentary, Oxford University Press, 2013, p. 156.

For example, Russian legislation contains specific provisions relating to the subsidiary liability in bankruptcy cases, which relates to the additional responsibility of some persons at fault in the bank failure and bankruptcy. The subsidiary liability is not directly linked to any specific actions (such as transactions or contracts) that caused material losses to the legal entity, and is not calculated based on the size of these losses. In fact, it is the responsibility for the set of activities, carried out during the specified period of time, which contributed to the bankruptcy of the institution. The size of such liability is determined on the basis of the total amount of creditors' claims that have not been met in the course of liquidation proceedings from the bankruptcy estate of the debtor.

For filing civil suits based on any available grounds, it is important to have in place the statutory prescribed range of fiduciary duties that directors and officers owe to the bank which, in case of their violation, can serve as grounds for initiating civil court proceedings against them.

One of the recent global trends is the implementation or revision of requirements for bank directors and officers. The majority of jurisdictions have so called fitness and probity regimes, which set out the requirements for persons who perform designated senior management functions. For example, in 2011 the Central Bank of Ireland introduced its Fitness and Probity Standards. These place an ongoing obligation on regulated financial service providers to ensure that persons carrying out certain functions remain fit and proper. Similar requirements were introduced in Russia in October 2013 – they relate to the business reputation of members of the governing bodies of depository institutions.[20]Also in October 2013, the UK government proposed amendments to the Financial Services (Banking Reform) Bill[21]that make significant changes to enforcement processes in cases involving senior managers of banks.

The range of persons that can be defendants in civil court actions varies among jurisdictions, but typically it includes directors, senior officers, employees, internal and external auditors, appraisers, attorneys, brokers and securities underwriters, etc.

It should be noted that the strategies and grounds for bringing civil court actions against different categories of defendants may vary substantially. Because of this, the evidence and incriminating documentation should be compiled individually for each potentially culpable person.

Deposit insurers that act in the capacity of a resolution authority can set up special departments that are in charge of preparing legal actions, filing with the courts and supporting the claims in court proceedings. In specific cases, it can be useful to outsource some parts of these functions, especially when special expertise is needed for proving somebody's culpability.

An important consideration is whether information about civil court actions and offenses should be made public. In the majority of jurisdictions, court hearings and court records are public unless otherwise ordered by the court.

It is worth mentioning that defendants in many cases are quite successful in avoiding responsibility for their misconduct in contributing to a bank failure. Indeed, many law firms provide advice on how to do this.[22] Among the most common actions identified in the course of preparing this paper are:

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[20] The relevant amendments to Article 11.1 and Article 16 of the Federal Law On Banks and Banking came into force on October 2, 2013.

[21]https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/245794/Annotated_Clause_-_Senior_Managers_and_Banking_Standards.pdf.

[22] See, for example, http://www.aba.com/aba/documents/specialoffer/bankdirectorManual.pdf or http://www.alston.com/Files/Publication/37d2104c-0d8c-4fcb-9a36-

- Falsifying financial statements/other bank records
- Removing or destroying bank documents and/or electronic databases
- Concealing damage/losses through off-balance sheet transactions/other refinancing mechanisms that replace bad assets with other bad assets
- Providing misleading or incorrect information to supervisors/other relevant parties
- Deflecting responsibility by raising allegations of contributory or comparative negligence on the part of supervisors/other governing bodies or third parties.

Other actions of this kind include the use of offshore companies with organizational structures, financial conditions or business operations that cannot be easily examined/verified; asset transfers to trusts, family members, etc.; and relying on laws that insulate from liability, and claiming that actions/omissions were within the bounds of business discretion/judgment which absolves them from liability.

In some jurisdictions (such as Australia, Canada, Colombia, Singapore and the USA), it is common practice for financial institutions to insure their directors and officers against liability (D&O liability insurance).[23] And in many cases, it could be a more preferable option for the resolution authority (or other responsible agency) to seek a pre-litigation settlement from the carriers of such insurance, instead of filing civil actions in courts.

Annex 2 contains a summary prepared by the FDIC: "Overview of Director and Officer Liability Insurance and Fidelity Bonds as Potential Sources of Recovery for FDIC Professional Liability Claims."

2ef32c68b9e8/Presentation/PublicationAttachment/11008cc6-b669-450c-b2e2-3255b72939b5/Gill_Kanaly_Hartley_Long_RBFS_Final.pdf.

[23]Some jurisdictions do not allow this kind of insurance. For example, s140(1) of the Malaysian Companies Act 1965 renders void any provision exempting a director or officer from or indemnifying him against any liability attached to them under any law, for negligence, default, breach of duty or trust. Due to the broad language in which this provision is formulated, it has been interpreted to restrict the ability of a company to purchase D&O insurance for its directors or officers in relation to liability owed to the company.

A common view in Malaysia is that allowing the company to do so could lead to a decline in the standard of care by directors and officers who are duty bound to protect the company's interests. The Malaysian Corporate Law Reform Committee (CLRC), in its review of the Companies Act, had recommended that this prohibition in s 140(1) be retained. The CLRC had commented that the intention of s140 is to prevent a director or officer from being exempted from any liability arising from a breach of duty in advance of the occurrence of such breach. It also commented that D&O insurance in relation to any potential breach of duty owed towards the company has the effect of exonerating the directors and officers for liability towards the company, and undermines the principle that they are accountable to the company.

Example: FDIC (US): Professional Liability Program

The purpose of the FDIC's Professional Liability Program is to recover damages on professional liability claims for FDIC receiverships and hold accountable directors, officers, and professionals who cause losses to insured financial institutions that later fail and are placed in FDIC receivership. The Program's existence also enhances industry awareness of sound corporate governance standards. The most frequent grounds for bringing civil actions against the former directors and officers of the failed institutioninclude:

- Negligence/gross negligence
- Failure to exercise due care
- Breach of fiduciary duty
- Lack of loyalty to the institution and
- Knowing violation of or disregard for laws and regulations.

Professional liability suits generally are pursued if they are both meritorious and expected to be cost-effective.

As receiver, the FDIC has three years to file suit for tort claims and six years for breach-of-contract claims from the time the institution is closed. If state law permits a longer time, the state statute of limitations is applied.

From January 1, 2009, through December 10, 2013, the FDIC authorized suits in connection with 131 failed institutions against 1,058 individuals for D&O liability. This includes 84 filed D&O lawsuits (13 of which were fully settled and 1 of which resulted in a favorable jury verdict) naming 628 former directors and officers. The FDIC also has authorized 56 other lawsuits for fidelity bond, insurance, attorney malpractice, appraiser malpractice, accounting malpractice, and RMBS claims. In addition, 87 residential mortgage malpractice and fraud lawsuits are pending, consisting of lawsuits filed and inherited.

V. Criminal proceedings

Key concept: **A criminal prosecution** occurs when the appropriate government authority brings charges against an individual (or corporation) because they stand accused of committing an act that is classified as a crime by statute. If convicted, the individual may be incarcerated and ordered to make restitution to the victim; or ordered to pay a fine and/or complete some sort of community service; or any combination thereof. The threshold of proof is higher in criminal cases than in civil cases. A civil case may be pursued along with a criminal case for the same wrongdoing, although in some countries problematic legal issues may arise (called parallel proceedings issues) when criminal and civil cases are pursued at the same time instead of consecutively.

There is a distinction between civil and criminal liability. "Criminal liability can be described as damages from criminal dispositions which impact the society while damage from civil dispositions impacts individuals. The penalty which follows criminal dispositions is punishment as prescribed by the law, while the penalty which follows civil liability is a financial compensation".[24]

In recent years, under the influence of the global financial crisis and a large number of bank failures, many jurisdictions have intensified their efforts to initiate criminal cases against bankers at fault in bank failures. For example, from 2005 to 2013 (December 1), the Russian Deposit Insurance Agency, acting in the capacity of bank liquidator (bankruptcy trustee),filed 299 criminal actions against former bank owners and senior officials (including 105 for intentional bankruptcy, 104 for criminal misappropriation/abuse of authority and 32 for attempts to misappropriate funds from the deposit insurance fund). In total, 40 criminal sentences were awarded, including 4 in 2013. In Japan since 1995, the DICJ has accused former managers of failed banks with committing a breach of trust in 38 cases.

In December 2013,the United Kingdom enacted the new Financial Services (Banking Reform) Act 2013,[25]which contains special provisions regulating the criminal prosecution of persons for committing offenses that contribute to the failure of a bank. Annex 3 contains an extract from this Act (Part 4: "Conduct of persons working in financial services sector"). In January 2014, Mexico's Credit Institutions Law (LIC) was amended to include, among other things, additional crimes considered as "serious" according to the Mexican Code on Criminal Procedures.

Efficiency of criminal prosecution in substantial part depends on the comprehensiveness of the existing legislation and law-enforcement practices. The laws (especially the Criminal/Penal Code) should contain clear criteria and action/non-action that can constitute grounds for bringing criminal cases against culpable persons/entities. At the same time, it is important to have a well established criminal court system and effective investigative and prosecuting agencies. Their coordinated work is necessary for ensuring timely identification of crimes, collection of adequate evidence, filing legal actions and their impartial consideration by the courts. Criminal prosecution of bankers responsible for losses/damage that contributed to bank failures is one of the toughest and most effective instruments for influencing the behavior of bank directors and officers as well as other relevant persons. It can also facilitate better market and regulatory discipline in the banking industry.

The majority of jurisdictions have, in their criminal codes, provisions that can serve as the basis for initiating criminal cases against individuals and/or entities for financial and/or other crimes that they commit or have committed in the past. Taking into account that criminal proceedings are intended for prosecuting culpable persons, the severity of criminal punishment to a large degree depends on the seriousness and social danger implications of the specific offense, as well as the need to prevent similar occurrences in the future.

Criminal sentences can vary from probation and community service, up to detention. For example, in the USA after the savings and loan crisis, over 1,800 bank insiders were prosecuted between 1990 and 1995, resulting in more than 1,000 officers, directors, and other officials being sent to prison.[26]In Japan, a bank representative director was sentenced to a 3-year jail term in 2008 for committing an aggravated breach of trust in connection with the bank's failure, which is one of the most severely punished cases in the country (see Annex 4).

The respondents to the Subcommittee's survey listed the following as the most common offenses and grounds for bringing criminal cases against parties at fault in bank failures: criminal misappropriation/theft of funds/property (34%); criminal breach of

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[24]http://www.hadefpartners.com/News/pageid/120-137/default.aspx?mediaid=258.
[25]http://www.legislation.gov.uk/ukpga/2013/33/pdfs/ukpga_20130033_en.pdf.
[26] See Jean Eaglesham, "U.S. Sets 50 Bank Probes", Wall Street Journal, November 17, 2010, A1.

trust (26%); bookkeeping in breach of the law (26%); fraud/cheating (22%); misrepresentation (19%); and criminal conspiracy (15%). Other grounds that were mentioned include granting loans in breach of the law and internal procedures; fictitious or intentional bankruptcy; replacement of liquid assets by illiquid assets, etc.

The majority of respondents (70%) cited law enforcement agencies as parties that can bring criminal actions against parties at fault in a bank failure. Other persons/entities that can act as plaintiffs in criminal cases include the bank supervisor (37%), the receiver/liquidator/bankruptcy trustee (33%) and the deposit insurer (22%).

In practice, in the majority of cases when the entity responsible for investigating the bank failure discovers evidence of criminal offenses, it is obligated to submit its findings to whichever law enforcement agency (investigative agency, prosecutor's office, etc.) is authorized to verify evidence and file criminal cases before the court. The deposit insurer, especially if it also acts as the receiver/liquidator/bankruptcy trustee, can provide assistance to the law enforcement agencies and courts in the form of necessary expertise or advice, gathering evidence of crimes and, in some situations, educating courts and investigative agencies in specific areas of banking business/circumventions.

The most frequent defendants in such criminal cases typically are directors and officers of the failed bank, other "institution-affiliated parties", mortgage originators/brokers and, in more rare cases, third-party contractors such as attorneys, appraisers or auditors.[27]

It is quite common for criminal court proceedings to be public. It is also good practice for bank supervisors and/or deposit insurers to follow such criminal convictions and use this information to promote responsible behavior among bankers and bank owners.

VI. Fraud in deposit insurance

Key concept: **A fraud in deposit insurance** is action/actions that cause or can cause illegitimate payment of insurance to a person not covered by deposit insurance protection or in excess of the established coverage limit.

Some deposit insurance agencies occasionally face various types of fraudulent actions committed by bank employees and/or other persons who attempt to obtain deposit insurance in violation of existing rules and coverage limits. This problem can be especially relevant in situations where deposit insurance coverage is not provided to certain categories of depositors, such as specific types of legal entities, bank insiders or parties affiliated with the bank or its officers or directors.

In this case, the deposit insurer can face a number of challenges relating to the need to segregate non-covered deposits and covered deposits in a timely manner when preparing for payouts, and the more difficult challenge of identify fraudulent or fake deposit claims that were artificially created on the eve of the bank failure or in the course of preparing the register of insured liabilities.

Based on the results of the survey conducted by the Subcommittee, the following types of insurance fraud can be distinguished.

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[27] Examples of actual criminal prosecutions in the US can be found in http://www.jonesday.com/files/Publication/4c78cf38-5bda-43f7-a6d2-7843accdc86f/Presentation/PublicationAttachment/b5a905ef-902a-4509-927e-d0ab07b58c57/Criminal%20Actions%20Against.pdf.

a. *Substitution of a deposit owner* (replacement of uninsured depositors with insured ones). For example, bank employees can record an artificial transfer of funds from the uninsured account of a legal entity to the insured accounts of natural persons, or from the uninsured account of an insider to the insured account of some other person prior to the bank closure.
b. *Splitting the amount/deposit in excess of the established coverage limit* and transferring uninsured parts of the deposit to the insured accounts of other persons (or insured accounts of the same person in cases where coverage is provided based on different categories of ownership rights, such as joint accounts, trust accounts, etc.). This type of fraud also requires assistance from the failed bank's employees.
c. *Inclusion of fake depositors/deposits in the register of insured deposit liabilities* or non-inclusion of depositor liabilities to the bank subject to set-off. This kind of fraud can be committed by the agency/person in charge of compiling the register and submitting it to the deposit insurer for the execution of payouts to insured depositors.
d. *Recording of fake deposits in the failed bank's books* in order to obtain deposit insurance with the aim of misappropriating funds from the deposit insurance fund. This can be done by the bank's employees or its appointed administrator/bankruptcy trustee.

In addition, some respondents cited actions such as:

e. Making false (non-existent or exaggerated) claims with forged documents or assuming the identity of someone else for the purpose of obtaining deposit insurance protection.
f. Non-recording in the bank's books of deposits received from eligible depositors (aimed at, for example, avoiding the payment of premiums to the deposit insurance fund or stealing such depositors' money).

The types of insurance fraud mentioned above may be interpreted differently depending on the applicable legislation. Some deposit insurers regard them as intentional acts of deception with a view to personal gain (Malaysia Deposit Insurance Corporation, MDIC). In Mexico, the LIC establishes certain specific actions committed by directors, managers, or any other employees of a bank, and which can affect its stability and solvency, as criminal offenses and subject to penalties (i.e. mismanagement; false reports or false statements; loans to insiders that disregard statutory requirements; excessive market or other financial risk or adverse market conditions that caused serious financial problems). Additionally, relevant provisions of the Criminal Code governing "generic fraud" can also be applied or, as is the case in Russia, there can be "attempted larceny or misappropriation of money" from the deposit insurance fund. In addition, some respondents stated that the execution or attempted execution of offenses such as cheating, forgery, malicious mischief and/or misrepresentation are regarded as possible grounds for legal action against persons involved in such fraudulent activities.

Sometimes it is very difficult to unambiguously interpret a specific fraudulent action as falling within the purview of the exact legislative norm. In such cases, the investigators need to have deep knowledge of legislative provisions that regulate the prosecution of various types of offense/fraud. But in many situations it is even more important to know the law-enforcement practices, especially those related to how the courts interpret various types of illegal and fraudulent actions aimed at the illegitimate/groundless obtainment of deposit insurance coverage.

As the survey results show, in the majority of cases deposit insurance fraud falls within the purview of criminal law. At the same time, it is also feasible to consider other types of legal action against persons that are culpable for such offenses, including commencement of civil litigation to recover payments made to them from the deposit insurance fund (if any).

The main factors that may encourage insurance fraud are quite diverse and multi-faceted. They include the above-mentioned exclusion of some groups of depositors from coverage; impunity for such kinds of action; inadequate public awareness about legal responsibility for such offenses; unjustified delays in closing a bank (which may provoke such fraudulent actions/offenses).

Based on the experience of the deposit insurance agencies that responded to the survey, a number of arrangements for preventing deposit insurance fraud can be recommended. Among them are:

- Establishing requirements for DIS member banks' IT systems and especially their databases on deposits, periodic examination of accuracy of recording in banks' books of information related to deposits (and, where set-off is used, depositors' liabilities to the banks);
- Implementing marks or labels ("red flags") that help to promptly identify eligible deposits;
- Implementing the "Single Customer View[28]" approach;
- Granting the deposit insurer the authority to investigate transactions with deposit accounts, including operations with non-insured deposit accounts prior to a bank closure;
- Granting the deposit insurer the authority to refuse the payment of deposit insurance to depositors whose claims are considered to be fraudulent;[29]
- Implementing a policy of public awareness, including active efforts to explain which actions are subject to prosecution as illegal, and disclosure of actual offenses, etc., so as to promote market discipline and responsible behavior on the part of bank employees and depositors;
- Effectively prosecuting culpable persons whose actions contributed to/facilitated the deposit insurance fraud.

Other arrangements for preventing deposit insurance fraud that were mentioned by some respondents include using purchase and assumption transactions (P&A) instead of direct payouts,[30] and minimizing the exclusions from deposit insurance coverage (but the latter can sometimes contradict the political reasons for excluding specific categories of depositors, e.g. financial institutions, government bodies, directors, officers, insiders and affiliated parties, etc.).

The survey results show that the majority of deposit insurers have never faced the problem of fraudulent actions aimed at obtaining deposit insurance coverage for ineligible persons or in excess of the established coverage limit. Only four deposit insurers said that they have dealt with deposit insurance fraud cases (Turkey, the Czech Republic, Russia and Hungary).

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[28]A **Single Customer View** is a single, consistent view of an eligible claimant's aggregate protected deposits with the relevant firm. However, thisview excludes accounts where the eligible claimant is a beneficiary rather than the account holder, or where the account is not active. Seehttp://fshandbook.info/FS/glossary-html/handbook/Glossary/S?definition=G2656.

[29] For example, Canada's deposit insurer, the CDIC, has no specific laws or regulations in place to facilitate the prevention of deposit insurance fraud. However, the *CDIC Act* provides that it must only pay "the person that in its opinion appears to be entitled to be paid in respect of the deposit".

[30] As compared with check payment – in the case of a P&A transaction the depositor would have to present him/herself (likely with identification) to a bank in order to withdraw the insured funds.

As regards the number of deposit insurance frauds, in Turkey and the Czech Republic specific types of fraud were identified at one bank, in Hungary at two banks, and in Russia at 52 banks. In the case of Russia, these frauds related involved about 6,000deposits/accounts and the total amount of fraudulent deposit claims reached RUB 3.7 billion (more than USD 110 million). Due to the effective investigation of all cases of insurance fraud and legal (both in- and out-of-court) actions, DIA Russia's actual payouts to such ineligible depositors were less than 10%of this amount.

Annex 5 contains extracts from DIA Russia's internal regulations, which govern its efforts to identify and investigate deposit insurance fraud.

VII. Conclusion

One of the visible characteristics of the recent financial crisis was the large number of bank failures in various jurisdictions. And it is widely recognized that in many cases improper behavior by bankers and bank-affiliated parties contributed significantly to the deterioration of national financial systems.

The crisis encouraged more coordinated action at both national and international level, aimed at improving the resilience of banks and ensuring more cautious risk-taking policies. A number of jurisdictions have initiated improvements to their banking supervision and resolution regimes, strengthening existing deposit insurance systems and introducing new powers in relation to fitness and probity for bank directors and officers and their responsibility for wrongdoing.

The stability and financial sustainability of any deposit insurance system are directly influenced by the effectiveness of the legal system and its ability to ensure the recovery of funds from a failed bank's estate. That is why it is so important to have in place both legislation and adequate law-enforcement practices which allow assets that were lost by any failed bank to be recovered prior to its closure, where such losses are due to irresponsible and/or unlawful actions by its former managers and directors.

Thorough investigation of all causes and actions that contributed to a bank failure, as well as effective legal action of different types against persons at fault in the bank failure, help to improve market discipline, ensure the recovery of embezzled funds and the more complete satisfaction of claims by the failed bank's creditors, including the deposit insurer's claims. This, in turn, can decrease the financial burden on DIS member institutions that are required to pay premiums to the deposit insurance fund.

Another important mechanism that can minimize the deposit insurance fund's losses is prevention and fair prosecution of fraudulent actions that are aimed at misappropriating funds from the deposit insurance fund.

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Annexes

Annex 1. Exchange of Personnel and Data Sharing in the KDIC (Korea)

	KDIC (Korea Deposit Insurance Corporation)	Prosecution Service
Exchange of Personnel	**Sending 15 staff members** who have expertise in financial institution examinations	**Sending investigation experts** 3 prosecutors and 7 investigators
Data Sharing	**Sharing facts giving rise to suspicion &related information**	**Sharing of investigation records** related to the employees of a failed financial institution

Annex 2. Overview of Director and Officer Liability Insurance and Fidelity Bonds as Potential Sources of Recovery for FDIC Professional Liability Claims

I. Introduction

When an FDIC-insured financial institution fails, the FDIC is appointed as receiver ("FDIC-R"). The FDIC-R takes steps to maximize the assets in the receivership, which include recovering on claims against professionals who provided services and caused losses to the failed financial institution. After an institution's failure, the FDIC-R investigates the existence of such professional liability claims and pursues claims that are both meritorious and expected to be cost-effective. Whether a claim is expected to be cost-effective often depends on the availability of insurance coverage. An overview of two of the primary forms of insurance for professional liability claims – director and officer ("D&O") liability insurance and fidelity bond coverage – is provided below.

II. D&O Liability Insurance

D&O liability insurance is payable to, among others, the former directors and officers of a failed financial institution, as indemnification for losses or payment of defense costs that result from a third-party claim for wrongful acts in the performance of their duties for the institution. Fraudulent and intentionally illegal acts are not covered under a D&O insurance policy, but rather coverage extends to allegations of "wrongful acts", as defined under the policy, such as certain acts, errors, omissions, misstatements, or neglect while acting for the institution. In addition, D&O liability insurance usually is written on a "claims made" basis, meaning that the insurance policy will provide coverage for covered claims that are made against the insured directors and officers during the applicable policy period, regardless of when the conduct giving rise to the claim occurred.

The FDIC-R pursues claims, where appropriate, against an institution's former directors and officers that are frequently covered by D&O liability insurance. Such claims may allege that the former directors and officers were negligent, grossly negligent, and/or breached their fiduciary duties to the institution, for example by violating loan policies, underwriting requirements, and/or prudent lending practices, which caused loss to the institution.

While D&O liability insurance often provides coverage for FDIC-R claims, it does not always. D&O liability policies vary widely in wording and the scope of coverage provided. Exclusions in a particular policy may restrict the scope of coverage and, in recent years, the FDIC has noted an increase in exclusionary terms or provisions contained in the D&O liability policies of failed financial institutions. When certain exclusions apply, directors and officers may not have insurance coverage for claims brought against them by the FDIC-R.

In addition, even when there is coverage for FDIC-R claims, the amount of such coverage varies widely and depends on the policy limits purchased by the institution pre-failure. Ordinarily, the policy limits are depleted by payments by the insurer in attorneys' fees and costs to defend the directors and officers against the FDIC-R's claim. This depletion of the policy's limits by defense costs reduces the amount of insurance recoverable by the FDIC-R.

III. Fidelity Bonds

Whereas D&O liability insurance protects directors and officers from third-party claims alleging wrongful acts in the performance of their duties for the institution, fidelity bonds protect the institution itself from losses caused by a variety of threats, including intentional employee dishonesty, robbery, forgery or alteration, and counterfeit money. The FDIC-R succeeds to the institution's claims as an insured party under a fidelity bond.

The FDIC requires all newly chartered banks to obtain sufficient fidelity bond coverage as a condition of granting deposit insurance. Additionally, Section 18(e) of the Federal Deposit Insurance Act (FDI Act) provides that the FDIC may require such coverage, and if it is not obtained, may contract for such protection and add the cost to the bank's deposit insurance assessment. However, such action would only be taken in rare instances, such as when a bank is able to obtain protection but refuses to do so.

The most common form of fidelity bond used by commercial and savings banks is the Financial Institution Bond, Standard Form No. 24. Other forms may be encountered and should be thoroughly analyzed to determine the extent of coverage. Standard Form No. 24 has two different limits of liability: a single loss limit of liability and an aggregate limit of liability. The single loss limit applies to individual claims, whereas the aggregate limit applies to the total of all loss recoverable under the bond. When the aggregate limit of liability is exhausted, the bond automatically terminates regardless of the remaining term and without any refund of premium.

Fidelity bonds based on Standard Form No. 24 cover losses that are first discovered by the institution during the policy period and result from dishonest or fraudulent acts, usually by officers and employees, acting alone or in collusion with others. Generally, the fidelity bond only covers such dishonest or fraudulent acts when they are committed by the employee with the intent to cause the insured to sustain a loss and to obtain an improper financial benefit. However, coverage for losses resulting from loans – which is often the basis for fidelity bond claims pursued by the FDIC-R – is more restricted. Such losses are usually covered only if the employee acts in collusion with another party to the transaction and actually receives an improper financial benefit.

Fidelity bonds also contain several conditions that may prevent recovery by the FDIC-R. For example, fidelity bonds terminate upon the appointment of a receiver. Thus, coverage is available only when the institution discovered the loss prior to its failure. Also, coverage terminates for any individual employee after the institution obtains knowledge of any dishonest or fraudulent act by the employee. Insurers may seek rescission of the bond if the institution was aware of employee dishonesty and failed to disclose that dishonesty in its application for the bond.

IV. Conclusion

D&O liability insurance and fidelity bonds serve different purposes. D&O liability insurance provides coverage to directors and officers in connection with claims made against them for negligence and other wrongful acts in their management of the failed institution, while a fidelity bond protects the institution itself from dishonest acts committed against it. The terms and conditions of D&O insurance vary widely, while the terms and conditions of fidelity bonds are relatively consistent. Both types of insurance serve as important potential recovery sources for FDIC-R claims.

Annex 3. Extract from Part 4 of the UK Financial Services (Banking Reform) Act 2013[31]

Offence

36 Offence relating to a decision causing a financial institution to fail

(1) A person ("S") commits an offence if—

(a) at a time when S is a senior manager in relation to a financial institution ("F"), S—

(i)takes, or agrees to the taking of, a decision by or on behalf of F as to the way in which the business of a group institution is to be carried on, or

(ii)fails to take steps that S could take to prevent such a decision being taken,

(b) at the time of the decision, S is aware of a risk that the implementation of the decision may cause the failure of the group institution,

(c) in all the circumstances, S's conduct in relation to the taking of the decision falls far below what could reasonably be expected of a person in S's position, and

(d) the implementation of the decision causes the failure of the group institution.

(2) A "group institution", in relation to a financial institution ("F"), means F or any other financial institution that is a member of F's group for the purpose of FSMA 2000 (see section 421 of that Act).

(3) Subsections (1) and (2) are to be read with the interpretative provisions in section 37.

(4) A person guilty of an offence under this section is liable—

(a) on summary conviction—

(i)in England and Wales, to imprisonment for a term not exceeding 12 months (or 6 months, if the offence was committed before the commencement of section 154(1) of the Criminal Justice Act 2003) or a fine, or both;

(ii) in Scotland, to imprisonment for a term not exceeding 12 months or a fine not exceeding the statutory maximum, or both;

(iii) in Northern Ireland, to imprisonment for a term not exceeding 6 months or a fine not exceeding the statutory maximum, or both;

(b) on conviction on indictment, to imprisonment for a term not exceeding 7 years or a fine, or both.

37 Section 36: interpretation

(1) This section has effect for the interpretation of section 36.

(2) "Financial institution" means a UK institution which—

(a) meets condition A or B, and

(b) is not an insurer or a credit union.

(3) Condition A is that it has permission under Part 4A of FSMA 2000 to carry on the regulated activity of accepting deposits.

(4) Condition B is that—

[31]http://www.legislation.gov.uk/ukpga/2013/33/pdfs/ukpga_20130033_en.pdf. Pages 49 to 51.

(a) it is for the purposes of FSMA 2000 an investment firm (see section 424A of that Act),

(b) it has permission under Part 4A of that Act to carry on the regulated activity of dealing in investments as principal, and

(c) when carried on by it, that activity is a PRA-regulated activity.

(5) In subsection (2)—

(a) "UK institution" means an institution which is incorporated in, or formed under the law of any part of, the United Kingdom;

(b) "insurer" means an institution which is authorized under FSMA 2000 to carry on the regulated activity of effecting or carrying out contracts of insurance as principal;

(c) "credit union" means a credit union as defined by section 31 of the Credit Unions Act 1979 or a credit union as defined by Article 2(2) of the Credit Unions (Northern Ireland) Order 1985.

(6) Subsections (3), (4) and (5)(b) are to be read in accordance with sections 22 and 22A of FSMA 2000, taken with Schedule 2 to that Act and any order under section 22.

(7) A person is a "senior manager" in relation to a financial institution if, under an arrangement entered into by the institution, or by a contractor of the institution, in relation to the carrying on by the institution of a regulated activity, the person performs a senior management function.

(8) A "senior management function" is a function designated as such—

(a) by the FCA under subsection (6A) of section 59 of FSMA 2000 (approval for particular arrangements), or

(b) by the PRA under subsection (6B)of that section.

(9) A financial institution ("F") is to be regarded as failing where—

(a) F enters insolvency,

(b) any of the stabilization options in Part 1 of the Banking Act 2009 is achieved in relation to F, or

(c) F is taken for the purposes of the Financial Services Compensation Scheme to be unable, or likely to be unable, to satisfy claims against F.

(10) In subsection (9)(a) "insolvency" includes—

(a) bankruptcy,

(b) liquidation,

(c) bank insolvency,

(d) administration,

(e) bank administration,

(f) receivership,

(g)a composition between F and F's creditors, and

(h) a scheme of arrangement of F's affairs.

38 Institution of proceedings

(1) In this section "an offence" means an offence under section 36.

(2) Proceedings for an offence may be instituted in England and Wales only—

(a) by the FCA, the PRA or the Secretary of State, or

(b) by or with the consent of the Director of Public Prosecutions.

(3) Proceedings for an offence may be instituted in Northern Ireland only—

(a) by the FCA, the PRA or the Secretary of State, or

(b) by or with the consent of the Director of Public Prosecutions for Northern Ireland.

(4) In exercising its power to institute proceedings for an offence, the FCA or the PRA must comply with any conditions or restrictions imposed in writing by the Treasury.

(5) Conditions or restrictions may be imposed under subsection (4) in relation to—

(a)proceedings generally, or

(b)such proceedings, or categories of proceedings, as the Treasury may direct.

Annex 4. DICJ Experience in Pursuing Criminal Liability against Parties at Fault

In the past, in pursuing criminal liability against the former management of a failed financial institution, most cases where the management caused damage to the financial institution and led it into failure through the careless management of lending and collateral release activities were pursued for the crime of an aggravated breach of trust stipulated in the Companies Act (statutory penalty; imprisonment with work for not more than 10 years or a fine of not more than JPY 10 million) or breach of trust charges under the Penal Code (imprisonment with work for not more than five years or a fine of not more than JPY 500,000).

Criminal liability is also pursued in cases where the management has submitted to the Financial Services Agency annual securities reports(which are mandatory under the Banking Act) containing a misstatement, or where the management has avoided inspection by the supervisory authorities.

As stipulated in the Deposit Insurance Act, the DICJ becomes the financial administrator of a failed financial institution, and it is required to take measures to file an accusation when it believes that an offense has been committed by the management.

In pursuing criminal liability, the DICJ has so far accused former management of committing a breach of trust or aggravated breach of trust in 38 cases.

One example of such a case is when the DICJ, in the capacity of the financial administrator, accused the representative director and the senior managing director of the bank mentioned earlier (former Ishikawa Bank) of committing an aggravated breach of trust in extending the aforementioned loans.

The police and prosecutor’s office subsequently conducted an investigation into the case, and the prosecutor’s office brought a charge of committing an aggravated breach of trust. The court ordered a three-year jail term for the representative director and three years in prison with five years’ probation for the senior managing director.

Annex 5. Extracts from the Regulation of the Deposit Insurance Agency of Russia on Identifying and Investigating Deposit Insurance Fraud

When an insured event occurs (typically banking license revocation) the Agency submits to the Bank of Russia a proposal to include an employee of the Dubious transaction investigation unit to the failed bank's provisional administration (hereinafter referred to as an Expert)…

The Expert requests from the Head of the provisional administration and the bank's departments (such as legal department, front office, chancellery, etc.) cease and desist orders/warnings of the Bank of Russia, copies of non-executed payment orders, customer complaints and court proceedings materials.

In the course of examination the Expert should identify balances on accounts of individuals that resulted from transactions that occurred in the period when the bank was unable to meet his liabilities or when the bank was not allowed to open new bank accounts to individuals or take funds from individuals (based on prohibition order of the Bank of Russia) that were not supported by actual inflow of monetary funds to the bank…

Such unduly formed/recorded balances may include the following:

- The balance results from internal transfer of monetary funds from an account of another individual when this transfer was executed for the purpose of splitting the balance of this individual's account that exceeded the established coverage limit and obtaining full deposit insurance coverage for his funds;
- The balance results from internal transfer of monetary funds from accounts that are not eligible for deposit insurance coverage (such as trust accounts, broker accounts, accounts of legal entities or individual entrepreneurs);
- The balance results from internal transfer of monetary funds for:
  - repaying the bank's liabilities (promissory notes);
  - executing contracts on purchasing property, securities or shares in the bank's equity capital;
  - granting a loan.
- The balance results from placing cash money through the bank's cash desk in the amounts that did not exceed the established coverage limit and this transaction is executed simultaneously with withdrawal of cash from the bank's cash desk from accounts of individuals in excess of the coverage limit or from accounts that are not eligible for deposit insurance coverage. I.e., the bank just recorded transactions with cash money without any real inflow or outflow of cash money in the bank's cash desk.

For identifying accounts of individuals with unduly formed/recorded balances the Expert should identify the exact date when the bank started to show evidences of its inability to meet its obligations. The sources of such information include data from the bank's electronic databases, documents of the bank (including cease and desist orders/prohibitions of the Bank of Russia, customer complaints, court proceedings materials, etc.).

For every department/branch/office of the bank the Expert should identify:

- The date when first delays with executing customers' payment orders occurred;

- The dates of unexecuted external payments or requests for withdrawing cash money from customer accounts;
- The date of opening an account for recording unexecuted payment orders of customers;
- The date when the Bank of Russia imposed limitations or prohibition on the bank's operations, etc.

The expert should examine the sources of funds that were recorded at all such bank accounts…

The results of investigation are reflected in the Experts report. The report should be accompanied with the supporting evidences (documents, interviews, abstracts from bank records, etc.). The report is subject to approval by the deputy director of Department of Investigation in charge of the Dubious Transactions Investigation Unit…

Not later than four working days prior to the starting date of depositor reimbursement the Department of investigation presents the report to the Commission on preventing unjustifiable payment of insurance.

If the Commission makes a decision to recommend to the bank not to include specific unduly formed account balances in the Register of liabilities to insured depositors, the Expert should within one working day prepare and submit to the Head of the bank's provisional administration request to make necessary amendments in the Register of liabilities to insured depositors.

If the Commission makes such a decision the Agency employees that are members of the provisional administration organize further work on collecting evidences of unduly formed balances on non-eligible depositors' accounts for using them for supporting the Agency's position in disputes with such depositors (including in courts).