

Financial Crises in Taiwan: *Lessons for Europe*

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CDIC

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European Forum of Deposit Insurers

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Central Deposit Insurance Corporation

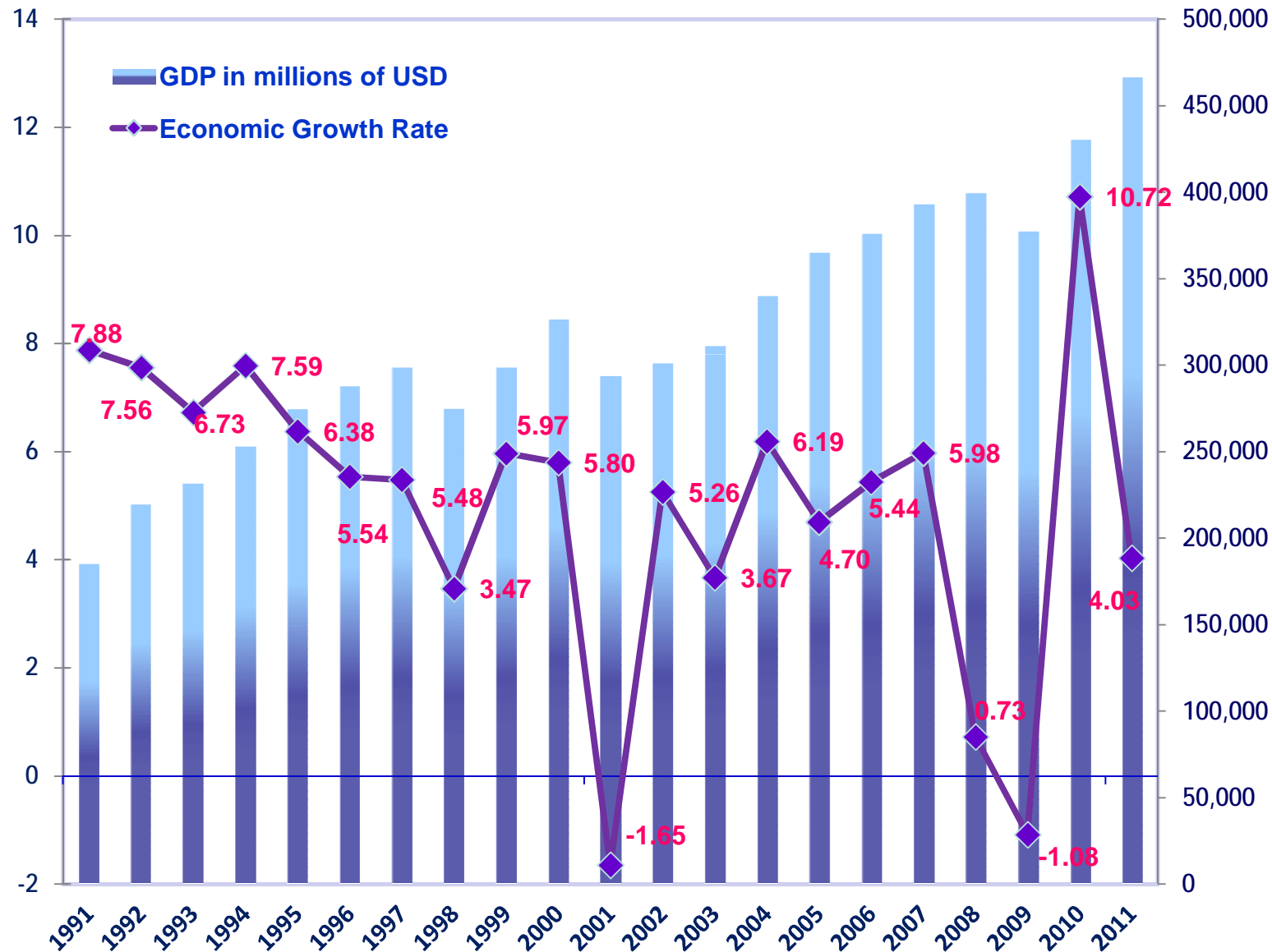
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I. Macroeconomic & Financial Sector Conditions Overview

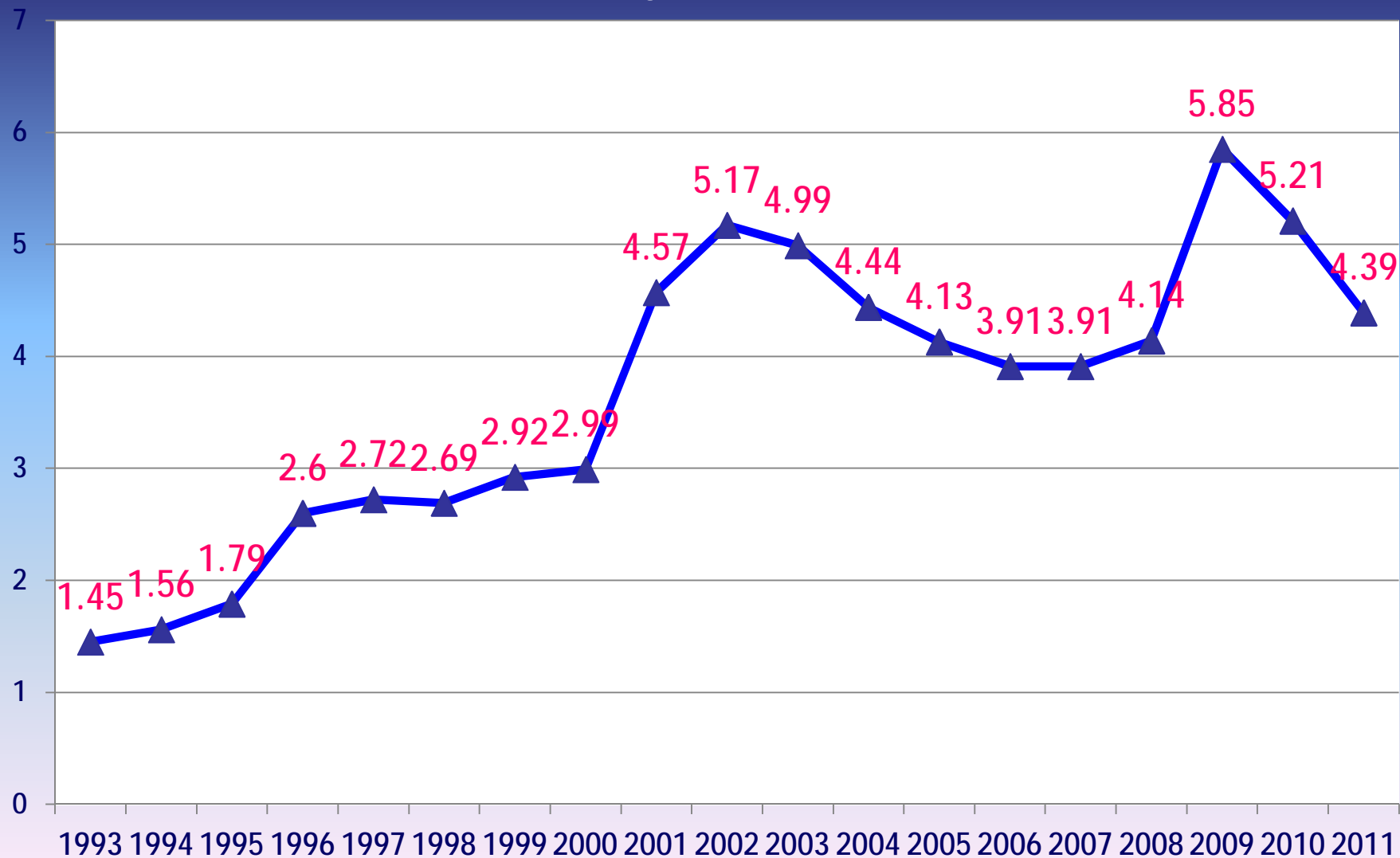


Macroeconomic Indicators I

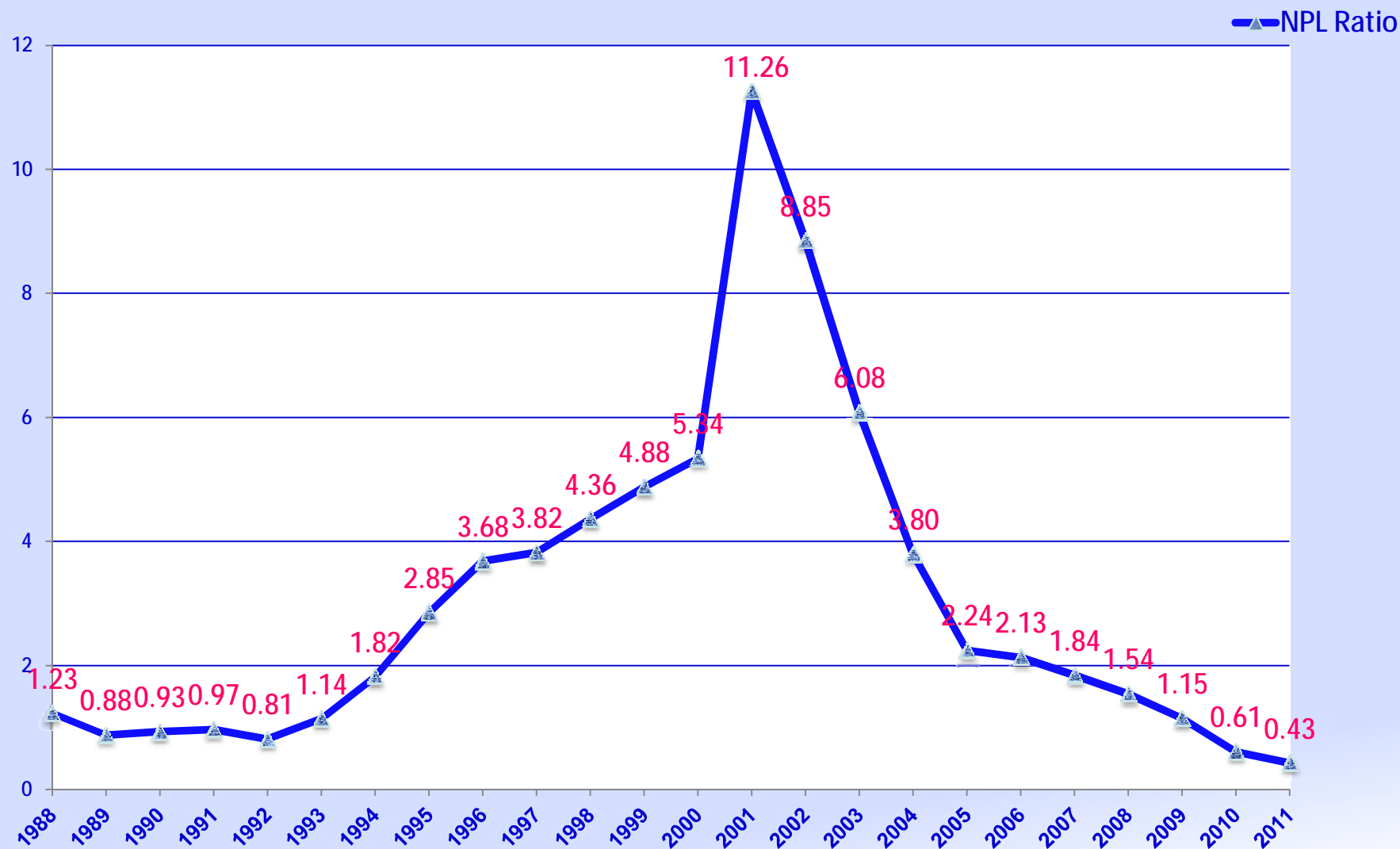


Macroeconomic Indicators II

Unemployment Rate

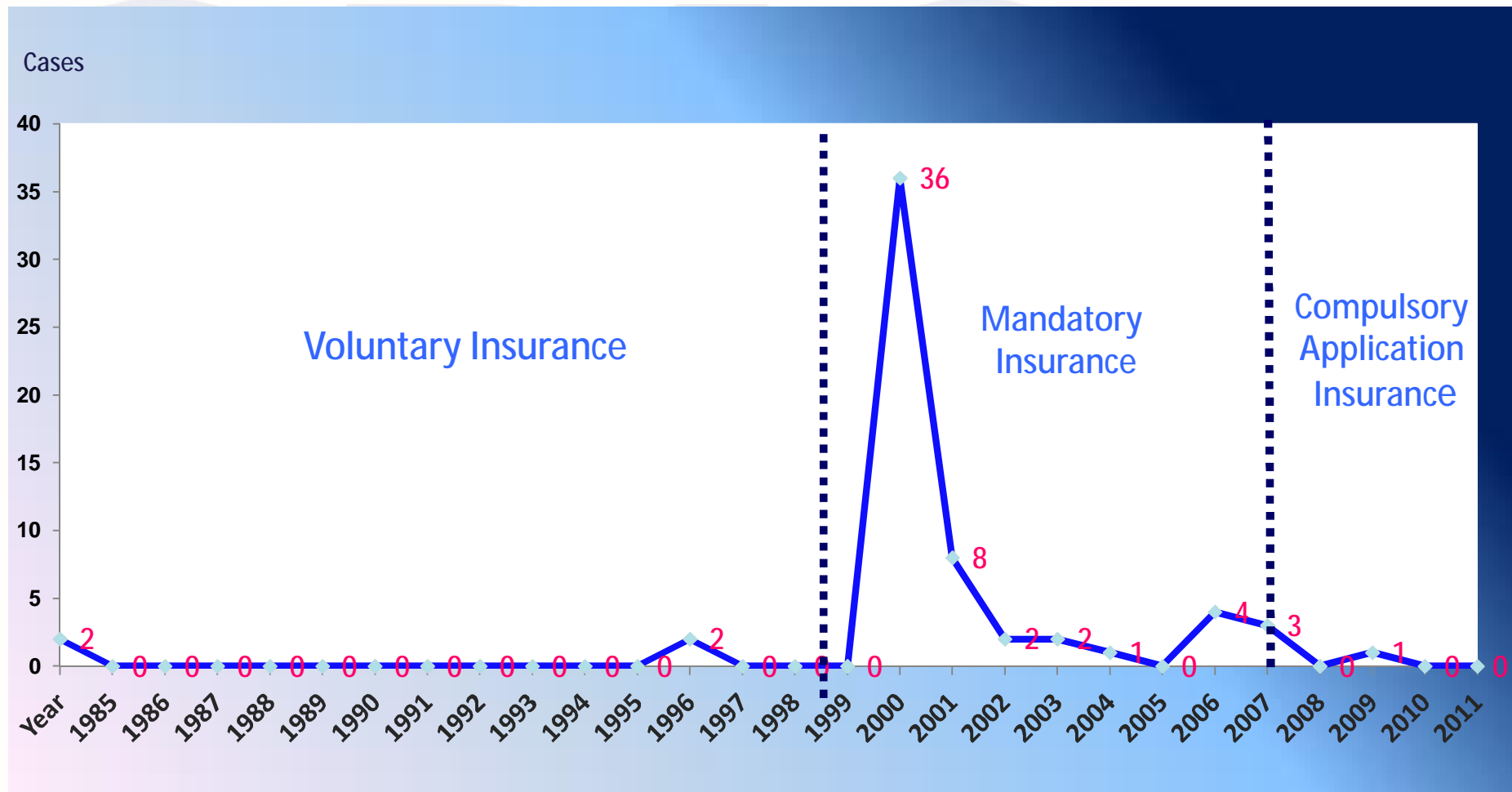


Non-Performing Loan Ratios



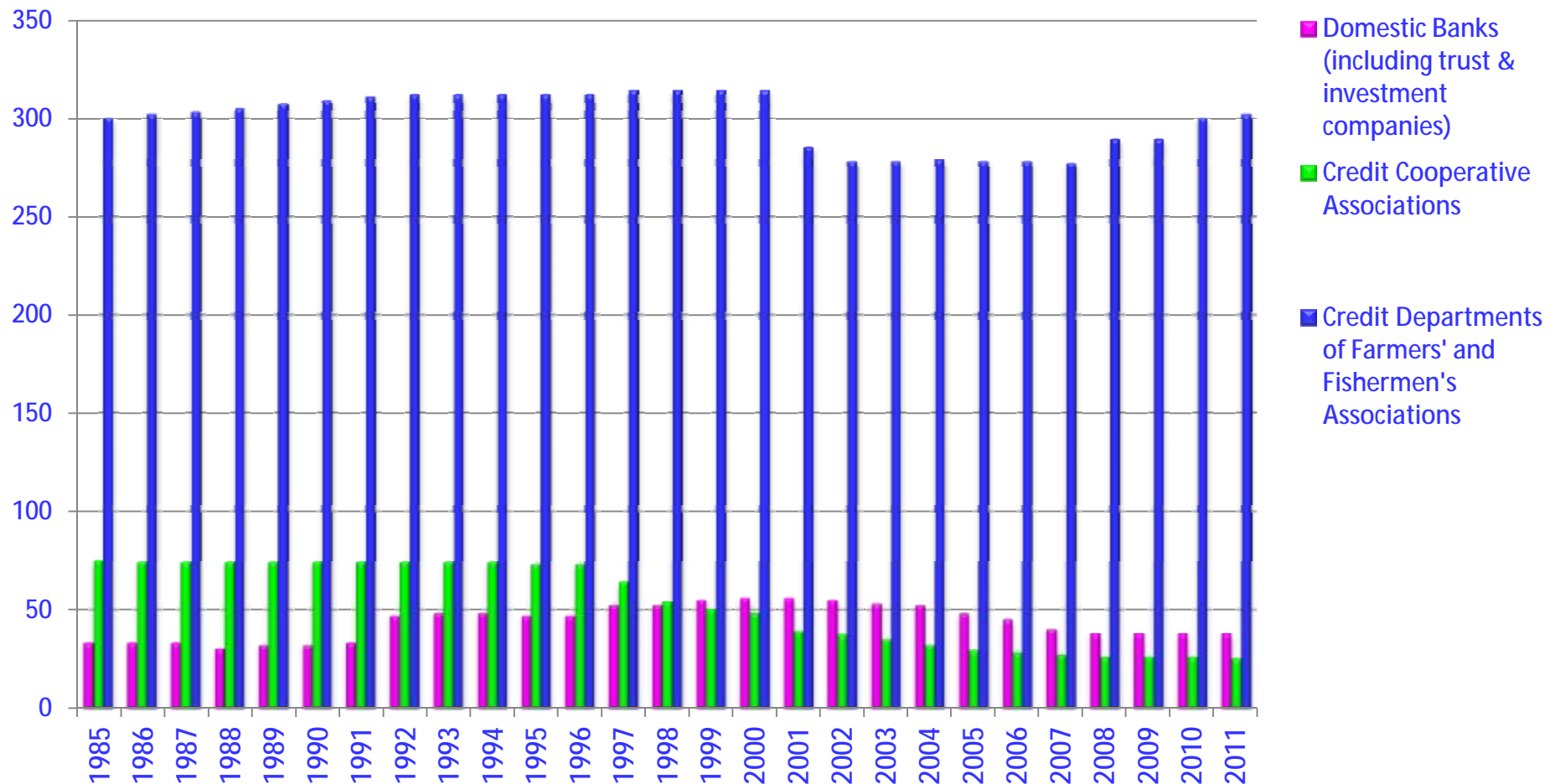
Number of Bank Failures in Taiwan

- Number of FI failures since CDIC establishment (1985-2012)



Number of FIs in Taiwan

- Number of FIs since CDIC establishment (1985-2011)



II. Financial Crisis & Lessons Learned in Different Stages

-Before the Establishment of DIS

Before the Establishment of DIS

- In 1985, systemic panic bank-run incidents broke out
- The bank runs on Tenth Credit Cooperative of Taipei City-The biggest bank runs before 1985
 - ü Chairman was a legislator of Parliament
 - ü Management embezzlement & frauds of cash vault
 - ü Unsecured loans to several affiliated companies
 - ü Assumed by a state-owned bank

Before the Establishment of DIS cont.

- The Overseas Chinese Trust & Investment Co.
 - ü Bank examination results were revealed
 - ü Chain reaction of bank runs
 - ü Insolvency due to bank runs & embezzlement
 - ü Assumed by a private bank
- Two other trust & investment companies suffered from bank runs were under custodianship by state-owned banks



Before the Establishment of DIS cont.



- Resolution policy
 - ü Government policy instruction
 - ü State-owned bank as top choice of the acquirer to stop a bank run
 - ü No market mechanism in resolution
- Banking reform
 - ü Deposit Insurance Act enacted in 1985
 - ü CDIC Taiwan established in Sept. 1985 to safeguard the rights of depositors and to maintain an orderly credit system

Before the Establishment of DIS cont.

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- Lessons learned

- ü A well-designed DIS should be developed and implemented in a stable economic environment and a sound financial system

IF a DIS is introduced at a time when macroeconomic conditions are not stable and with many problem banks, it will face:

- ü Liquidity issues
 - ü Insolvency issues
 - ü Public confidence & financial stability issues

II. Financial Crisis & Lessons Learned in Different Stages

- Under Voluntary DIS



Under Voluntary DIS

- Regional systemic financial crisis in 1995

- Bank runs of Chuang-Hwa 4th Credit Cooperative

- ü Reason of bank runs: management embezzlement

- ü Background information

- Established in Jan. 1960 at central region of Taiwan

- Financial data before bank runs as of June 1995 :

- » NPL ratio:0.98%

- » Net worth: US\$33 million

- Examination rating was 86 (A) in Aug 1993

- CEO of the credit cooperative was the co-founder of a security co. (stockholders included some employees of the credit cooperatives)

Under Voluntary DIS cont.

Ü Fraud methods: loans to dummy accounts

- From Jan. 1989: unsecured loans & loans with unqualified collaterals to illegal dummy borrowers
- Dummy accounts outstanding amounted to US\$294 million in Oct. 1992 and US\$75M in July 1995 before bank runs
- Embezzlement of US\$ 0.8 M from the cash vault
- All loans associated with advancing to the securities speculators of the affiliated securities co.
- July 29, 1995 (Saturday)
 - Both CEO of credit cooperatives and affiliated securities Co. were disappeared
 - Outbreak of bank runs starting from Saturday morning with deposit outflows about US\$10M
- July 30, 1995 (Sunday): ATM withdrawals amounted to US\$ 3M
- July 31, 1995 (Monday): money outflow amounted to US\$ 88 M

Under Voluntary DIS cont.

Regulators responses & actions

At the beginning

- No actions were taken as financial conditions seemed good
- Examiners were sent to conduct on-site examination

Aug 1, '95

- Embezzlement by CEO
 - Detected by examiners amounted to US\$74M (2.2times of net worth)
- Insolvency & Illiquidity
 - Running out of cash and unable to meet deposit withdrawals
 - No financial accommodations from regulators, central bank and local government

Aug 2, '95

- Supervisory enforcement actions to the credit cooperative:
 - Business shut down for 3 months
 - Put under receivership
 - Properties of the management team were confiscated

Under Voluntary DIS cont.

ü Outbreak of regional systemic financial crisis

Aug 2, '95

- Depositors of Wen-Lin Credit Cooperative at the neighboring district began to withdraw money unreasonably

Aug 3, '95

- Media broadcasting on more uninsured community institutions in Chunghwa county further shaken public confidence
- Banks runs spreading over: 6 credit cooperatives & other community FIs affected in the same county

Aug 4, '95

- Bank runs expanded into other county

Under Voluntary DIS cont.

Reasons for calming down bank-run storm

Aug 4, '95

- Bank regulator - MOF's prompt corrective actions
 - Bank runs of uninsured community FIs may spread over
 - Taiwan credit cooperative banking system might collapse if all community FIs suffered from bank runs
 - Half deposits of Taiwan Cooperative Bank came from community FIs

PCA measures

Aug 5, '95

- Taiwan Cooperative Bank took over & assumed all liabilities of Chung-Hwa 4th Credit Cooperative
- Management team of Chung-Hwa 4th Credit Cooperative was liable to pay back embezzlements
- CDIC accepted membership application by uninsured FIs right away
- CDIC provided on-site guidance toward new member FIs if necessary
- In case of lacking liquidity, Bank of Taiwan provided fully support, and Central Bank should provide accommodations if necessary.

Under Voluntary DIS cont.

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ü Results of PCA measures :

- Bank runs were eased off in a few days
- Regional systemic financial crisis was dismissed right away



Under Voluntary DIS cont.

Ü Lessons learned

- A model FI today may become a threat tomorrow if not well managed and supervised
 - Gorgeous performance of financial statements is not trust worthy
 - Good examination rating may like castle in the air
 - Hidden management fraud inside like a tip of iceberg
 - Covered crime of management may last for a long time if not well supervised
- Problems in conducting examination
 - Taiwan Cooperative Bank is a state-owned commercial bank not the banking supervisor
 - Examination power should be independent and avoid conflicts of interests
 - Handling examination reports should be dealt with care to early rectify deficiencies

Under Voluntary DIS cont.

ü Lessons learned

- Voluntary deposit insurance system cannot maintain financial stability
 - Deposits in the uninsured financial institutions may create safety concerns
 - Rumors or scandals of management may exacerbate public confidence
- Crisis = Opportunity: Systemic crisis triggered reforms
 - Receivership of troubled uninsured FIs triggered the regional systemic financial crisis and reforms
 - Jan. 1999: *Deposit Insurance Act* was amended
 - » Making DIS compulsory
 - » CDIC was entrusted with the power and tools to handle problem member institutions
 - Banking supervisory system was reformed
 - » Oct. 1996: financial examinations were reorganized
 - » CDIC Taiwan took charge of examination toward community FIs instead of Taiwan Cooperative Bank

II. Financial Crisis & Lessons Learned in Different Stages *-Under Compulsory DIS*



Under Compulsory DIS

From 1999 to 2010, 57 member institutions were in trouble causing the systemic crisis to the banking system and were put into conservatorships by CDIC Taiwan.



Under Compulsory DIS

- Background of financial crisis

- ü Macro factors

- Real estate market mired in recession after the burst of economic bubbles in the late 1990's
 - The situations exacerbated by 1997 Asian financial crisis
 - The shock of big earthquake in Sept. 21, 1999
 - Bad loans continuing to soar, but no NPLs secondary market until 2001
 - Rampant rumors of systemic financial risk

Under Compulsory DIS cont.

- Background of financial crisis
 - ü Non-macro factors:
 - Unqualified member FIs in voluntary DIS became a member in compulsory DIS and continued deteriorating in business
 - No PCA mechanism for problem FIs to exit from market until net worth turned negative



Under Compulsory DIS cont.

Number of Bank Failures



Year	Banks	Credit Coop.	Credit departments of farmers' & fishermen's associations	Methods
1999		1		Whole bank P&A
2001		7	29	Whole bank P&A
2002		1	7	Whole bank P&A
2004	1	1		Whole bank P&A and Partial P&A
2005	1		1	Whole bank P&A and Partial P&A
2007	3		1	Whole bank P&A and Partial P&A
2008	3			Partial P&A and P&A with put back option
2010	1			Partial P&A
Subtotal	9	10	38	
Total	57			

Under Compulsory DIS cont.

- Impact of systemic financial crisis to DI Fund
 - ü Total loss is too big for DI fund to afford
 - ü If no outside funding sources, DI fund became in deficit for a long time
 - ü Member banks had to pay more insurance premium
 - ü Negative impact on public confidence and financial stability



Under Compulsory DIS cont.

- Establishment of Financial Restructuring Fund (FRF) in 2001

ü Purposes of FRF:

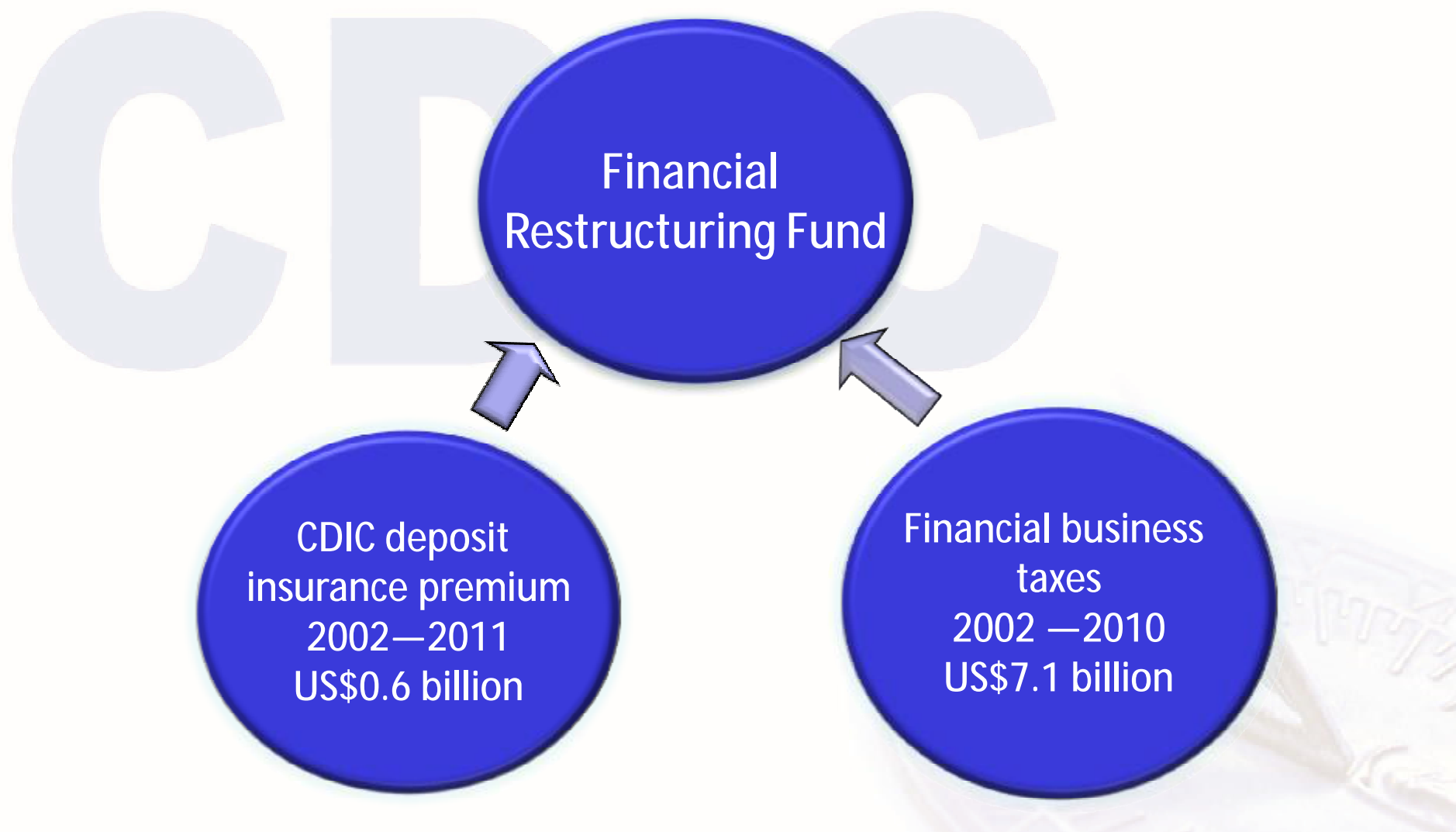
- To quickly resolve financial crises
- To safeguard depositors' benefits
- To facilitate the withdrawals of problem banks from the market smoothly
- To prevent the occurrence of financial turmoil.

ü Period of FRF

- A period of 3 years (July 2001 to July 2004)
- Extend one year to July 2005

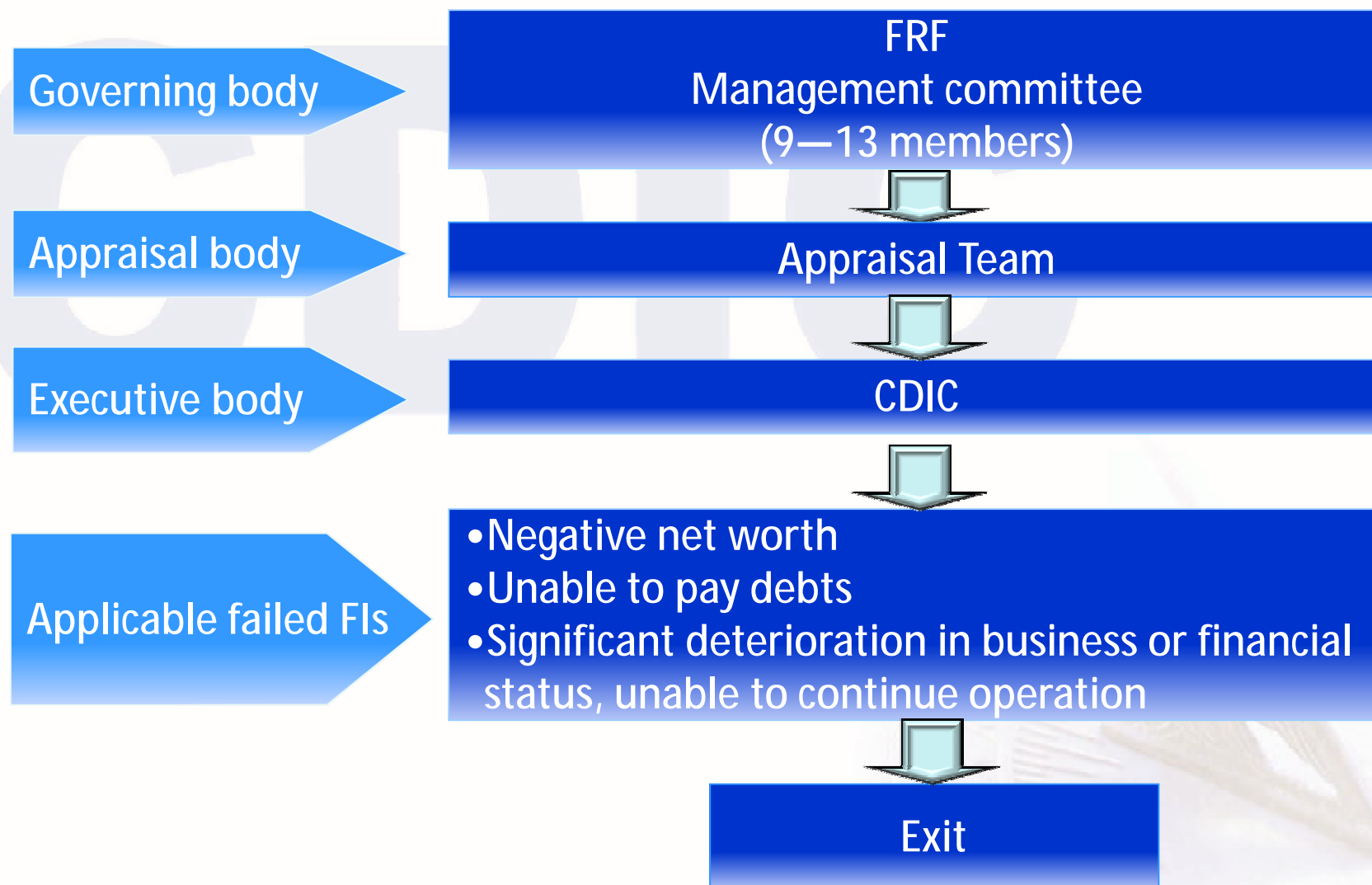
Under Compulsory DIS cont.

Funding Sources of FRF



Under Compulsory DIS cont.

• Management of FRF



Under Compulsory DIS cont.

- Unlimited coverage of deposits by FRF
 - ü Providing a transitional blanket guarantee to all depositors and other creditors
 - ü During FRF period, maximum coverage NT \$1 million of deposit insurance still applicable to non-FRF target banks
- Principles for handling failed institutions by FRF:
 - ü Stability of financial order
 - ü Protection the benefits of depositors
 - ü Continuity of financial services
 - ü Minimization of social costs

Under Compulsory DIS cont.

- Methods of resolution
 - ü CDIC as a conservator
 - ü Employing consultants in bids or appraisers in appraisal
 - ü Selling the target institutions through negotiations or public bids
 - ü Making up for the gaps of liabilities in excess of assets

Under Compulsory DIS cont.

- Failed banks
 - ü Purchase & assumption
 - CDIC as a conservator
 - Through open bids with qualified buyers
- Failed community FIs
 - ü Mostly assumed with the banks
 - ü Only few assumed with other community institutions
- Cash payout
 - ü Last but not least
 - ü Never in use



Under Compulsory DIS cont.

- Strategy of open bids
 - ü Banks: Auctioning off in separate parts
 - Bad bank: NPLs by several batches
 - Good bank: Non-NPL assets/liabilities and operations in one batch (in principle)
 - ü Community FIs : Whole in one block



Under Compulsory DIS cont.

- Outsourcing resources
 - ü Consulting firm: Sales strategy and auction processes
 - ü Accounting firms: Assessment of the assets and liabilities
 - ü Appraiser: Appraisal of specific real estates
 - ü Lawyers: Pursuit of civil and criminal actions against responsible parties and employees of failed banks

Under Compulsory DIS cont.

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- Disclosure of information

üFRF information disclosed on CDIC website including:

- Status of payment to make up the gap between assets and liabilities
- Follow-up of the pursuit cases involved in illegal behavior by persons-in-charge or employees
- Financial statements of FRF



Under Compulsory DIS cont.

- Pursuit of failed banks illegal cases under FRF

Data period: 2001~2010

Categories	Percent (%)
Violation of credit practices	38.6
Inappropriate appraisal of collaterals	26.0
Violation of banking law	12.3
Inappropriate credit evaluation	10.9
Violation of delegation regulations	4.0
Fraud or embezzlement	3.0
Others	5.2
Total	100

Under Compulsory DIS cont.

- Major factors of bank failures under compulsory DIS

- Macro issues

- Political issues
 - Bear market of real estate and stock
 - Big earthquake effects
 - Inadequate banking supervision
 - Lack of prompt corrective action mechanism
 - Fierce competition due to overbanking

Under Compulsory DIS cont.

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- Major factors of bank failures under compulsory DIS

- Non-macro issues

- Lack of corporate governance
 - Poor credit & risk management
 - Frauds or embezzlements



Effectiveness of FRF

- Resolved systemic banking crisis
- Over 5 million depositors' rights & interests were safeguarded
- 56 problem banks exited smoothly from the market
- Over 6,800 (67%) employees of problem banks were rehired
- Total resolution cost to 2011 GDP was only 1.65%

Lessons Learned

- Implementing PCA mechanism to maintain financial stability

ü *Banking Act* amended in 2008

- If $BIS\% < 2\%$, the bank will be put under conservatorship within 90 days
- If $2\% < BIS < 4\%$, the bank will be put under supervisory superintendence

ü Reasons

- Huge loss to Financial Restructuring Fund & DI fund
- Big threat to DI Fund when triggering at negative net worth of a bank
- Lowering down taxpayers' and DI Fund's burdens

Lessons Learned cont.

- Setting up target ratio for DI Fund to accelerate fund accumulation
 - ü DI Act (§ 16) amended in Jan. 2007 –
DI Fund to covered deposits at 2%
 - ü Source of fund
 - Annual premium revenue by risk-based differential premium system
 - Annual business taxes (2%) from banking industry

Lessons Learned cont.

- Reform DIS membership system
 - ü DI Act (§ 10) amended in Jan. 2007 –
Making DIS from compulsory to compulsory application
 - ü Reasons
 - Allowing CDIC to control insurance risk
 - New FIs are compulsory to apply for DI membership
 - New FIs can be a member of CDIC after meeting the criteria

Lessons Learned cont.

- Strengthening banking supervision
 - ü Reforming banking supervisors
 - July 2004, the Financial Supervisory Commission was established to supervise and examine banks and credit cooperatives
 - January 2004, the Bureau of Agricultural Finance was established to supervise community FIs
 - ü Implementing Basel III capital requirements
 - ü Conducting risk-based examination mechanism
 - ü Requiring coverage ratio for loans
 - Coverage ratio for NPLs > 1% from 2010
 - Coverage ratio for total loans > 1% from 2013
 - Coverage ratio for classified I loans > 1% from 2013 to 2015

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III. Conclusion



Conclusion

- Better risk minimizing or controlling mechanism for DIS should be developed

Deposit insurers with risk minimizer mandate

- ü Off-site monitoring for members' operation improvements

- ü On-site inspection for data accuracy of call reports

- ü Cooperation with supervisors to assist bank's self-restructuring, control insured risk and avoid payout loss

Payout => last choice and worst case

Conclusion cont.

- Strong institutional framework should be in place for economic and financial system to reduce risk of bank failures or crises
 - ü Crises do occur – in Taiwan, Europe and Globally
 - ü Lessons should be learned and reforms should be taken
 - Formal institutional cooperation mechanism in dealing with banking/financial crisis should be in place
 - Effective tool kit for liquidity crisis or failure resolution should be developed

Conclusion cont.

- Sufficient DI fund should be in place to maintain financial stability and public confidence
 - ü Target ratio for DI fund
 - ü Reliable sources of fund
 - ü Risk-based premium system



Conclusion cont.

- Early prevention and cure of problem banks is better than passive payout or resolution
 - ü Prompt corrective action mechanism
 - ü Risk-based examination
 - ü Higher BIS or capital adequacy ratio requirements than Basel III

Conclusion cont.

- Panaceas for curing financial crises are effective supervision and market discipline
 - ü Banking supervisors cannot prevent financial crisis alone
 - ü Market discipline should be improved and strengthened
 - Corporate governance & rating
 - Consumer protection
 - Information disclosure
 - Risk-based internal auditing



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Thank You!

