Maintaining Deposit Insurance System in Taiwan

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Distinguished Guests, Ladies and Gentlemen:

I would like to express my sincerest thanks to our host, Kazakhstan Deposit Insurance Fund, for providing this opportunity to introduce Taiwan's deposit insurance system.

My presentation today includes four parts. I will first briefly introduce the establishment of the Central Deposit Insurance Corporation, or CDIC Taiwan, and then provide with you a better understanding of the deposit insurance system in Taiwan. Next, I will talk about the Financial Restructuring Fund and its function as a temporary blanket guarantee mechanism for handling problem financial institutions. And finally, I will talk about Taiwan's major policy concerns and future plans in deposit insurance.

Establishment of CDIC

CDIC was established as a result of the impact and lessons learned from major banks failures in both Taiwan and other countries. In 1984, the failure of the Continental Illinois Bank in the U.S. caused a serious shock to the international financial market, and financial institutions in Taiwan began facing a series of panic runs and financial crises the following year. It became clear then that Taiwan needed a deposit insurance system to deal effectively with financial volatility, protect depositors, and maintain financial stability. In early

1985, the legislature passed the Deposit Insurance Act, and later in September, the CDIC was jointly established by the Ministry of Finance and the Central Bank. CDIC is a government agency with the powers to implement its mandates. In September this year we are going to celebrate our 20th anniversary together with the hosting of the IADI 4th Annual Conference in Taipei.

According to the Deposit Insurance Act, the objectives of CDIC are similar to those of most other deposit insurers, namely, to safeguard the benefits of depositors in financial institutions, to promote savings, to maintain an orderly credit system, and to enhance the sound development of financial operations.

The major responsibilities of CDIC are to protect small depositors through a deposit insurance system; to manage insured risk through on-site examinations and early warning system; to provide funding support for problem institutions; and to dispose of failed insured institutions.

Deposit Insurance System in Taiwan

Membership System

I would like now to talk a bit about the specific components of Taiwan's deposit insurance system, starting with the membership system. Participation in the deposit insurance scheme was voluntary in the initial phase. This reflected the fact that most financial institutions were owned by the government before 1990. In addition, strict regulation of the banking sector and conservative lending policies by financial institutions helped banks stay profitable and largely free of bad debts at this time.

Since 1990, regulatory restraints on the banking sector have been relaxed to stimulate service quality improvements and innovation in the financial sector. Such loosening also accorded with a worldwide trend toward financial liberalization and globalization. In 1990, the government approved the establishment of 16 new private banks. However, as the market scale did not substantially grow, the banking sector became fiercely competitive to the detriment of profitability.

In this climate, the voluntary deposit insurance system gave rise to the problem of adverse selection, which hampered our ability to grow the deposit insurance fund.

These considerations, as well as the need to create an exit mechanism for failing banks, led to a revision of the Deposit Insurance Act in 1999. One of the biggest changes was to make participation in the deposit insurance system compulsory so as to make the system a more effective part of the overall financial safety net.

Coverage, Assessment, and Funding

Currently, the maximum coverage for each depositor in one insured institution is set at 1 million new Taiwan dollars, which is around 31,000 US dollars and 2.3 times per-capita GDP.

In July 1999, the flat premium system was replaced with a risk-based premium to more fairly account for the different risk levels of insured institutions. This system also aimed to discourage financial institutions from taking excessive risks, and thereby reduce moral hazard. My colleague Ms. Yvonne Fan will introduce this system in more detail later.

Regarding funding, CDIC has three sources of funds. These are paid-in capital; assessment income, which is the main source of funds for the payment of insurance claims; and special financial accommodation from the Central Bank.

Resolution Methods and Legal Receiver

As stipulated by the Deposit Insurance Act, when a financial institution is closed by the competent authority, CDIC will move to maintain order in credit system and protect the interests of depositors by fulfilling its insurance responsibility via different resolution methods. Such methods include straight pay-out; insured deposit transfers; purchase and assumption; and open bank assistance. CDIC is also the legal receiver in commencing the wind-up procedures of the failed institution.

Risk Management and Public Awareness

As mentioned, risk management is encouraged through a risk-based premium system. CDIC has also developed a financial early-warning system to further strengthen risk management functions in the banking sector. My colleague Mr. William Su will introduce the early-warning system in more detail later on.

In regards to public awareness, we adopt various channels for communicating deposit insurance information, including public seminars and print and broadcast media ad campaigns. In addition to fulfilling the objectives of the deposit insurance system, such communication enhances market discipline and reduces moral hazard.

Establishment of the Financial Restructuring Fund

Next, I'd like to talk about why the government of Taiwan set up the Financial Restructuring Fund. As mentioned earlier, profitability in the domestic banking sector fell considerably with the increased competition resulting from the entry of 16 new private banks in 1990. Banks were also hit along with corporations by the Asian financial crisis in 1997, and the following global economic recession, which resulted in rapid increase of non-performing loans.

Realizing that the deposit insurance fund was insufficient to deal with a problem of this magnitude, the legislature approved the creation of a four billion US dollar Financial Restructuring Fund on July 9, 2001. The fund aimed to prevent a regional banking crisis, to get problem financial institutions smoothly withdrawn from the market, and to strengthen the environment for financial operations. The fund is financed by the government and implemented by CDIC. A temporary blanket guarantee has been provided under the fund for a period of four years, from July 2001 to July 2005.

Since July 2001, 48 financial institutions have been smoothly withdrawn from the market by means of purchase and assumption (P&A) transactions. During the operational period of the fund, Taiwan's banking sector has falling average NPL ratio and higher profitability. The economy has also rapidly recovered, underscoring the success of the government in carrying out comprehensive financial reform in a stable way.

Major Policy Concerns & Future Plans

I would like now to share with you some of the lessons learned by CDIC in hope that they may serve as a reference for other deposit insurance systems.

Strengthen Transparency

The first lesson has been to realize the need to strengthen the transparency of the financial industry and corporate entities. Improving transparency has become a major policy objective of most governments. With the introduction of the International Accounting Standard Board's IAS 36 and 39, and the upcoming implementation of the Basel II Accord in Taiwan by the end of 2006, one of the most pressing issues we face is how to harmonize domestic accounting practices with international standards. Information transparency should reflect the real condition of an institution, and the public should be promptly informed of any major operational changes at the institution so that market discipline can work.

Transition from Blanket Guarantee to Limited Coverage

Another issue we face is how to smoothly transition from a blanket guarantee to limited coverage system this July, when the Financial Restructuring Fund expires.

The first phase of this transition has been to meet the preconditions for lifting the blanket guarantee as recommended by the IMF. Such preconditions include the completion of financial restructuring; implementation of a prudential regulatory and supervisory apparatus; improved disclosure, accounting practices; and creation of an exit policy for problem banks. Additionally, we have developed complementary measures on financial supervision, external monitoring and deposit insurance. Some of these measures will be discussed in greater detail later. Another component of the transition program has been to educate depositors and member institutions about the shift to the limited coverage system. We are therefore hopeful that the transition in July will go smoothly.

Enhancing Risk Management

Another focal policy area of CDIC has been to enhance its risk management functions. I have already mentioned the roles of the early warning system and risk-based premium to this end. In addition, CDIC will be authorized to approve the membership and conduct special inspections or investigations on specific items stipulated in the draft amendment of the Deposit Insurance Act. Such items include inspections of the accuracy of assessment base or for the purposes of resolution of bank failures and termination of deposit insurance; and investigation of the civil liabilities of the management of problem financial institutions.

Setting Up Minimum Fund Level & Appropriate Funding Sources

CDIC is also working on setting up a minimum level for the deposit insurance fund. This will ensure sufficient funding is available to maintain the confidence of depositors and fulfill the functions of deposit insurance.

The deposit insurance fund in Taiwan, as a ratio of insured deposits, is far below the ratios in some countries, such as the U.S. We are therefore in the process of amending the law to include a minimum funding level, as well as to specify appropriate funding sources, in order to boost the funding level within a specified period.

Early Intervention & Prompt Corrective Action

Experience has shown that bank resolution costs increase the longer disposal is delayed. A rule-based supervisory approach, like the early intervention and prompt corrective actions taken by U.S. regulators since 1991, could effectively reduce the problem of forbearance and the cost of resolving problem financial institutions.

The criteria and measures for handling problem financial institutions in Taiwan is stipulated in the Banking Law. However, the law could stipulate more specific or rule-based trigger points for market exit, as well as who triggers the resolution process, how it is triggered, and when. Greater clarity on these points would reduce the supervisory forbearance and social cost of bank resolution, and thereby enhance financial stability.

Enhancing Resolution Functions

CDIC has gained considerable experience in handling failing and failed institutions in the past few years, and our techniques have gotten more advanced with time. In order to further strengthen our ability to resolve bank failures, the government has taken various measures to enhance resolution-related functions. These include introducing a bridge bank mechanism and financial tools, such as asset-backed securities (ABS) or mortgage-backed securities (MBS) in the disposition of assets acquired from problem institutions. We are also enforcing higher penalties for financial crime, and are amending and integrating bankruptcy and corporate restructuring laws.

Promoting Interrelationships & Clear Division of Responsibilities of Each Financial Safety Net Player

The effectiveness of a financial safety net depends critically on coordination among its key players.

This is especially true in the current financial climate of extensive cross-border transactions and large financial conglomerates. The central bank, financial supervisory authority and deposit insurer all need to work closely together and establish an effective coordination mechanism. Such a mechanism should facilitate cooperation in areas such as information exchange, examination, enforcement of prompt corrective actions and penalties for violators, provision of financial assistance, bank resolution, and handling of systemic risk. It is also imperative that the responsibilities of each component of the financial safety are clearly defined if the safety net is to function optimally.

Mechanism of Handling Systemic Crisis

I would like to talk about the handling of systemic crisis. It is clear that a systemic banking crisis would induce a chain reaction that would impact the entire payment system, and even damage confidence and order in the financial sector. This in turn could impact the overall economic growth of a country.

Such a crisis could or should never be handled by any single financial supervisor or deposit insurer alone. The current draft amendment of the Deposit Insurance Act will introduce such a mechanism, in order to respond to a possible systemic crisis in the future, especially in view of the trend toward consolidation in the banking sector.

Conclusion

The financial reforms carried out by my government in recent years have left Taiwan with more effective financial supervision and a sounder, more competitive financial industry overall. In achieving financial stability, an effective deposit insurance system has naturally played an indispensable role. In keeping with the mission of the International Association of the Deposit Insurers (IADI), we need to continue working closely together, sharing our experience and knowledge, in order to contribute to the stability of financial systems.

Ladies and Gentlemen, I would like to bring my presentation to a close here. Next, my colleague Mr. William Su will introduce Taiwan's early warning system. And then my colleague Ms. Yvonne Fan will deliver a presentation on the risk-based premium system in Taiwan.

Thank you very much for your attention.