Deposit Insurance

1. Participation Basis from Voluntary shifted to Compulsory

(1) Business development in the period of voluntary insurance

Taiwan's deposit insurance system adopted a voluntary basis at its foundation. The idea was to follow the trend of financial liberalization and hence give the financial institutions higher freedom to choose participation in the system or not so as to meet management challenges. In the meantime CDIC had the authority of examination and approval to ensure the business principles of insurance industry were in place. However, the deposit insurance system was at its infancy in Taiwan at that time and the majority of the society was unfamiliar with the system. Moreover, depositors were not aware of the importance of such insurance system partly due to their confidence in the government's ability in maintaining financial stability and guaranteeing deposit safety. As a result, they were reluctant to participate in the system and deliberately avoided the burden of increasing deposit insurance assessment. Similarly, the majority of financial institutions side-stepped the system under the pretext of the difficulties and time consuming of computing premiums as businesses were not computerized at that time. Therefore, the business development in the beginning period of foundation did not meet expectations.

In order to break the deadlock, a promotion team of deposit insurance business was established despite external disadvantages. The team was dispatched to local financial institutions all over Taiwan and organized road shows for deposit insurance system. One on one presentation of the system and communications with responsible parties of the financial institutions were also made. With the assistance of the financial authorities of the then Taiwan Provincial Government, finance bureaus at the local government levels were invited to the presentations and policy implications of the deposit insurance system explained. They were encouraged to assist the participation of the local financial institutions under their jurisdiction. CDIC in the meantime increased maximum coverage and decreased premiums. All the efforts and measures managed to increase rapidly the number of insured institutions from 48 in end 1986 to 116 in end 1987 (refer to Appendix 5).

In retrospect, the five state-owned banking institutions that joined the deposit insurance system had been the benchmark as they set an example and subsequently prompted private financial institutions to join the insurance deposit. The success was achieved after continued and tireless efforts made to communicate with the public banks, the competent authority and the legislators for their support. However, the critical eight banks that were under the then Taiwan Provincial Government (these banks were under the jurisdiction of Ministry of Finance in 1997 when the government started to streamline the organization and businesses of the Taiwan Province Government) did not join the deposit insurance system in the voluntary period as they failed to win the approval of the Province Council. As a result, the majority of local financial institutions were deterred from participating as well, which had been the biggest obstruction in the promotion of CDIC's business. The eight banks did not join the deposit insurance until February 1999 when the mandatory system was in full implementation.

On the other hand, CDIC fully realized that the success of the deposit insurance system hinged very much upon the public's awareness of the security of their deposits, which would also act as big contributor to prompting the participation of financial institutions. Therefore, CDIC had launched a media campaign in April 1989 and promoted the idea of deposit insurance to the society as a whole. Speeches were toured in colleges and universities aided with prizes and rewards or public welfare activities for promotion. More often, giveaways were widely distributed in various occasions of all kinds of group gatherings or campaigns. Understanding and appreciation of the importance of the deposit insurance system by depositors and the society was finally achieved after CDIC's continued campaigning and promotion.

(2) Background of shifting to mandatory insurance and current status

In the second half of 1995, the crisis of the Fourth Credit Cooperative Association of Changhua City broke out, spilling over to some financial institutions with weaker internal management in Taiwan. A series of panic run followed. It was widely held that the government was required to embark on adequate reform of the financial supervision system in order to contain the hidden crisis in the financial system. In August 1995, Ministry of Finance and Central Bank started a revamp of the deposit insurance system under the order of the Executive Yuan. The conclusion was made that a full mandatory deposit insurance system should be implemented. CDIC amended part of the *Deposit Insurance Act* to meet the said policy instruction and changed the deposit insurance system to a mandatory basis. The amended act passed the Parliament and was promulgated and took effect on January 20, 1999. Ever since then Taiwan's deposit insurance has become mandatory. At that point of time the total 57 financial institutions that legally accepted deposits but did not participate in the deposit insurance system all joined the deposit insurance on February 1, 1999 and became CDIC's insured institutions. The only exception was the Taipei Branch of Deutsche Bank that was legally exempted from participation as it was guaranteed by the deposit insurance system of its home country.

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2. Adjustment of Maximum Coverage and Scope of Coverage

(1) Maximum coverage adjusted to NT$1 million

Maximum coverage refers to the maximum amount of a depositor's deposit that is guaranteed in one insured institution. The purpose of maximum coverage is aimed at limiting the pay-off liability of the deposit insurance corporation and preserving some sort of market sanction power so as to avoid the insured institutions undertaking excessive risks.

CDIC set the maximum coverage of deposit insurance at NT$700,000 when it was founded, with approval by Ministry of Finance and Central Bank. The benchmark of this maximum coverage was equivalent to the same amount of deposit by the postal savings exempt from tax on interest, and preferential deposit amount of each demand savings account at the banking industry. It was increased to NT$1 million per depositor on August 15, 1987 and remains effective today. The adjustment was made in order to enhance the willingness of financial institutions to join the deposit insurance, to strengthen guarantee for depositors, and to reflect the actual income growth of the economic development.

The current maximum coverage of NT$1 million is about 2.2 times Taiwan's per capita gross domestic production. It will be reviewed periodically in future by CDIC taking into account of the capability of the deposit insurance pay-off special reserves, national economic development and growth of national income, and maintaining market sanction power.

(2) Changes of scope of coverage

The deposit items insured by CDIC include checking deposits, passbook deposits, time deposits, savings deposits, postal savings deposits, and trust funds whose purpose was designated by the insured institutions. What is not insured include deposits in foreign currency, trust funds whose purpose was designated by the trustors, negotiable certificates of deposit, deposits by all levels of governments, deposits by the Central Bank and banks, Chunghwa Post Corporation, trust and investment corporations, credit cooperative associations and the credit departments of farmers' and fishermen's associations, as well as the amount deposited by each individual depositor in one insured institution that exceeds the maximum coverage.

When the *Deposit Insurance Act* was amended to adopt a mandatory basis in 1999, the coverage of deposit insurance was also amended to only the principal of deposits. This is in contrast to the coverage of both principal and interest of deposits at the establishment of CDIC. The reason behind the change was the augmentation of CDIC's insurance risks as a result of the rapid increase of the number of the insured institutions at that time. Such change was necessary to contain potential moral hazard wherein small-amount depositors might be lured by the high-risk insured institutions that offered high interest rates. It would also enhance the efficiency of computing payoffs and reflect the reciprocal principle that interest was not included in the insurance assessment.

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3. Flat Premium Basis shifted to Risk-based Premium

(1) Reduce premium to increase willingness of participation in the insurance

In the beginning of the founding of Taiwan's deposit insurance system, financial institutions were circumvented in many aspects including setting up and business scopes. Consequently, risk differentiation among individual institutions was not evident. Deposit insurance used a flat premium basis. In the early stage the premium was set to 0.05% by Ministry of Finance. In July 1987 CDIC reduced the premium to 0.04%, which was aimed at reducing the premium burden of financial institutions and encourage them to join the insurance system. The adjustment was made in accordance with the domestic economic and financial situations at that stage and consulting the opinions of the industry. The reduction was subsequently approved by Ministry of Finance. In January 1988, the premium was decreased again to 0.015%. As financial liberalization sped up later on, degrees of risk that reflected the effectiveness of management of domestic financial industries had been differentiated. With a series of financial crises breaking out, the flat premium basis that applied universally to all financial institutions regardless of their nature or soundness had come under critical questioning of its fairness. Eventually the risk-based premium system was brought up for discussion and implementation.

(2) Background and reason of shifting to risk-based premium

In 1994 the U.S. implemented risk-based assessment rate system for deposit insurance. By adopting a sequential and gradual approach, it enlarged the risk premium differentials and achieved significant results in aspects of inducing insured institutions to reduce management risk, increasing premium fairness and boost deposit insurance funds. At that period of time Taiwan was experiencing the impact of economic slowdown, and challenges of financial liberalization and globalization. Management risks among domestic financial institutions differed increasingly. The fairness of a flat premium basis of deposit insurance was strongly questioned as it was susceptible to moral hazards and induced financial institutions to undertake increasing high risks. In order to harmonize premium rates with the different levels of risk presented by individual institutions, CDIC drafted the"Proposal for a Deposit Insurance Risk-based Premium System". This system was formulated on the basis of a broad consensus reached among the business, government and academic sectors and in line with the implementation of the mandatory system of deposit insurance. The proposal was submitted to Ministry of Finance, which ratified and officially enacted the"Implementation Scheme for the Deposit Insurance Risk-based Premium System" on July 1,1999. At that time, Taiwan became the first Asian country to implement such a system.

The said risk-based premium scheme adopted "capital adequacy ratio of the insured institutions"and"aggregate scores of the examination data ranking of the National Financial Early-Warning System" as risk indicators. Each of the two indicators was divided into three grades. The insured institutions were categorized in nine risk groups. A three-grade premium was applied to the nine risk groups. In the beginning period of implementation, the minimum premium was 0.015%, the middle premium 0.0175% and the maximum premium 0.02%. The difference of each grade of premium was 0.0025%. However, the accumulation of the deposit insurance pay-off special reserves was very slow due to the fact that Taiwan had adopted a voluntary insurance system and charged relatively lower premiums for quite some time. In order to build sufficient deposit insurance pay-off special reserves and strengthen the ability of dealing with problem financial institutions and boost depositors' confidence, CDIC reported to and was approved by Ministry of Finance on January 1, 2000 to increase the difference of the three-grade premium to 0.005% and the three grades have ever since become the minimum of 0.05%, the middle of 0.055%, and the maximum of 0.06%, which are still effective today. In the process of the adjustment to the risk-based premium system, CDIC had tried all methods to minimize any potential resistance. On the one hand, CDIC continued to communicate with the responsible parties of the insured institutions and to elaborate on the idea of a sound deposit insurance system, namely "what is taken from the industry is used in the interests of the industry". On the other hand, CDIC also held conferences on the risk-based premium and explained to the insured institutions, the Bankers Associations of R.O.C., the National Federation of Credit Co-operatives, R.O.C., National Training Institute for Farmers' Organizations as well as the academia. The adjustment finally won the universal support of all fields and was implemented on January 1,2000 without fail.

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4. Deposit Insurance Fund and Optimal Target Fund Rate

(1)Current status of capital and deposit insurance pay-off special reserves

According to the *Enforcement Regulation of the Deposit Insurance Act*, the original total capital of CDIC was NT$2 billion. It was increased to NT$5 billion in July 1992 as an increasing number of private banks had been set up since end 1991 and hence altered the competitive landscape of domestic financial industry. The injection of capital was meant by Executive Yuan to build CDIC's capital and enhance its ability to undertake risks. The government had budgeted the incremental NT$3 billion in 1993 and 1994. In the aftermath of the crisis of the Fourth Credit Cooperative Association of Changhua City, Executive Yuan increased again CDIC's capital to NT$10 billion in November 1995 to speed up the accumulation of CDIC's deposit insurance pay-off special reserves, which had laid the foundation of the sound operation of the deposit insurance system. The government had budgeted NT$5 billion year on year until end 1999.

In addition, the *Enforcement Regulation of the Deposit Insurance Act* requires that CDIC shall set aside deposit insurance pay-off special reserves each year in an amount not less than 60% of that year's assessment income. In accordance with the *Act*, CDIC set aside 80% after being approved by Ministry of Finance in order to speed up the accumulation of the special reserve. The proportion was raised again to 90% of the annual premium income in consideration of the amendment of the *Deposit Insurance Act* in 1999 and the shifting of deposit insurance from a voluntary to mandatory basis that had augmented CDIC's insurance risk. In June 1999 the government amended the *laws* and reduced business tax rates of the banking and insurance industries from 5% to 2% with a view to assisting financial institutions to reduce the non-performing loan ratios. The revenues from the difference of the 3% business tax rates were used to write off non-performing loans or designate the allowance for doubtful debt. Since the designated allowance for doubtful debt of financial institutions was similar to the deposit insurance pay-off special reserves of CDIC in nature, both having the function of enhancing abilities of undertaking risks and losses, CDIC acquired the approval of Ministry of Finance in November 1999 to reduce business tax rates from 5% to 2% following the example of the banking and insurance industry. The revenues out of the difference of the 3% business tax are paid in to deposit insurance pay-off special reserves and this is still effective today. In July 2001, as the *Statute for the Establishment and Management of the Executive Yuan's Financial Restructuring Fund* was enacted, the *Deposit Insurance Act* was partly amended. Ever since then CDIC shall close all accounts at the end of each fiscal year, and shall place the whole amount of the profit, if any, in the deposit insurance pay-off special reserves.

(2)Setting the optimal target fund rate

It is the practice of the advanced countries to stipulate by statute that the deposit insurance fund shall maintain a given ratio of the covered deposits in order to ensure capital adequacy to fulfill insurance liability. Currently, Taiwan's deposit premium averages 0.054% of the insured deposits, or equivalent to 0.022% of the total insurable deposits. This is among the lowest levels in the world and leads to the slow accumulation of the deposit insurance pay-off special reserves. As up to end of August 2005, the pay-off special reserves approximated NT$13.2 billion. After adding CDIC stockholders' equity of about NT$11.3 billion, this is about 0.27% of the insured deposits, falling far short of the target fund rate, 1.25%, of the advanced countries. In view of such situation, CDIC will review the current premium structure by making reference to insurance risk and the experiences of the advanced countries in order to establish appropriate target rate of deposit insurance fund and strengthen depositors' confidence and see full benefits of the deposit insurance.