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The Structure and Functions of the Deposit Insurance System--The Performance of the CDIC*

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I. Introduction

Deposit-taking financial institutions serve as intermediaries for funds by absorbing highly liquid deposits which become their liabilities, and by making use of these funds to extend highly illiquid loans which become their assets. These institutions are not only the lifeblood that sustains the economic development process, but they also play a distinctive role in that they together bear all of the risks associated with the economic system. Since, traditionally, the vast majority of the funds of banks consist of the deposits of depositors, the own-capital ratios of banks in the world have tended to be very low, averaging around 10%.

By creating credit through the extending of loans, banks increase their assets and, as they lend, bear a significant amount of risk. This risk can take the form of credit risk, interest rate risk, exchange rate risk, operations risk, liquidity risk, regulatory risk and reputation risk. Because the operations of financial institutions exist almost entirely for the good of the general public, there is not a government anywhere in the world that does not resort to various means, both direct and indirect, that would serve to keep to a minimum any damage that might be inflicted on the rights and interests of depositors should a financial institution's operations be below standard. In the past, by closely supervising financial institutions and maintaining controls over the scope of their business operations as well as the setting up of additional branches, the government has indirectly safeguarded the deposits of depositors. More recently, however, as the financial environment has rapidly changed and liberalization, internationalization and increasingly fierce competition have become the norm, the former restrictions over the operations of financial institutions have gradually been lifted with the result that the operating risks inherent in the financial sector have substantially increased. Most countries have therefore successively adopted deposit insurance or guaranteed deposit systems with a view to directly safeguarding the rights and interests of the small depositor.

Deposit insurance differs from general forms of commercial insurance. Commercial insurance, one the one hand, is profit-oriented and only serves to safeguard the property of an individual. Deposit insurance, on the other hand, is a kind of policy-based insurance that seeks to stabilize financial conditions and safeguard the rights and interests of depositors in financial institutions by encouraging cooperation between the government and businesses in relation to the provision of credit. It is not profit-oriented. In addition, deposit insurance also serves to guard against financial risk to an appropriate degree. In other words, deposit insurance does not merely passively wait for a catastrophe to happen before providing compensation, but adopts all kinds of preventative measures to promote the sound operations of insured institutions, and effectively control all kinds of financial risk. This is where deposit insurance and commercial insurance in general fundamentally differ.

Because the deposit insurance system has a direct bearing on the common interests of all financial institutions as well as the rights and interests of depositors within those institutions, many of the countries that have implemented deposit insurance have made participation in it mandatory. At the same time, in order to increase the effectiveness of its implementation as well as increase the rights and responsibilities of deposit insurance institutions within the law, the deposit insurance system has been closely integrated with the system of financial supervision, thereby facilitating its implementation.

The deposit insurance system in the R.O.C. was established in September 1985. Owing to the financial turmoil associated with a series of panic runs and financial crises that involved four deposit-taking financial institutions at around that time, the government actively implemented its deposit insurance system in that year, in order to guard against systemic risk and safeguard the rights and interests of depositors.

In the years that immediately followed the setting up of the Central Deposit Insurance Corporation (or CDIC), many of the restrictions on financial activities remained in force, and most financial institutions were still state-owned. For this reason, the government opted for a deposit insurance system in which participation was voluntary, and, in spite of the CDIC's diligent efforts to promote the concept of deposit insurance, only a relatively partial number of financial institutions became insured. It was thus not possible for the effectiveness of deposit insurance to be brought into full play. However, as the financial supervisory system and market discipline became increasingly unable to keep up with the pace of financial liberalization and internationalization from the early 1990s onwards, there was a succession of panic runs on financial institutions in 1995. Those institutions that were insured quickly resolved their panic runs, but those that had not participated in the deposit insurance system overcame their difficulties by either becoming insured or else being taken over by or merged with other insured institutions. The outcome of these events was that those community financial institutions that had previously adopted a wait-and-see approach in relation to participation in deposit insurance, at last fully realized its importance in maintaining the confidence of depositors and safeguarding a financial system seriously impacted by a succession of panic runs. The community financial institutions thus vied with each other to participate in deposit insurance and, after the CDIC had evaluated their assets and business operations, all applications were approved, with the exception of those that did not meet the required criteria. At the same time, the government took active steps to revise the *Deposit Insurance Act* through the legislative process, adopted a deposit insurance system in which participation was made mandatory and implemented a differential risk-based premium system. In revising its the existing legal framework, the CDIC carefully noted the reforms adopted by the Federal Deposit Insurance Corporation of the U.S. As a result, the CDIC has been vested with increased authority in handling problem financial institutions, thus enabling it to implement deposit insurance in a timely manner.

The financial turmoil which broke out in July 1997 began by affecting the countries of Southeast Asia and then spread to both South Korea and Japan, before making its presence felt in Taiwan. Fortunately, the impact of the crisis on the Taiwan economy was less significant than in the case of the other countries. This was in large part due to its relatively strong economic fundamentals, but the CDIC also had an important part to play.

During the last two years, in addition to conducting general-scope financial examinations in respect of the 82 insured institutions for which it was responsible in the past, the CDIC has also been required to examine the whole body of community financial institutions. This means that any inherent deficiencies can be discovered early on and the competent authority quickly alerted, so that appropriate conservatorial and other remedial policies can be implemented in a timely manner, thereby strengthening the management of financial risk. In addition, with the setting up of a financial early-warning system, the benefits of depositors may be fully safeguarded and financial conditions stabilized.

It is particularly interesting to note that the International Monetary Fund has ruled that aid-recipient countries should establish deposit insurance systems to replace the current system where the government acts as the guarantor, in order to safeguard the rights of depositors. For this and other reasons, we are waiting for our Legislative Yuan to complete its second and third readings of our revised *Deposit Insurance Act*, so that we will be increasingly able as is the case in the advanced industrialized countries to safeguard the benefits of depositors in financial institutions, promote savings, maintain an orderly credit system, and enhance the sound development of financial operations. The remainder of this paper is divided into four sections as follows:

1. Financial Institutions and the Deposit Insurance System in the R.O.C.
2. The Status and Legal Objectives of the CDIC
3. CDIC's Current Handling of Problem Financial Institutions and Related Accomplishments
4. The Direction of CDIC's Future Development and Problems with the Deposit Insurance System

II. Financial Institutions and the Deposit Insurance System in the R.O.C.

A. Financial Institutions in the R.O.C.: Their Structure, Market Shares, Operating Performance and Risk-related Problems

(1) The Structure of Financial Institutions in the R.O.C.

Kinds of Financial Institutions: Financial institutions in Taiwan may be broadly classified into monetary institutions and non-monetary institutions. Monetary institutions refer to financial institutions in general that have the ability to create money. At the end of March 1998, there were a total of 465 such institutions in the R.O.C., of which 46 were domestic banks, 45 were foreign banks with branches in Taiwan, 60 were credit cooperative associations, and 314 were the credit departments of farmers' and fishermen's associations. Non-monetary institutions refer to those financial institutions that do not have the ability to create money. Currently there are 80 such institutions in Taiwan, including 5 investment and trust companies, the Postal Savings System, 55 insurance companies, 15 bills finance companies, and 4 securities finance companies.

Ownership of Financial Institutions: In terms of ownership, of the 465 monetary institutions, only 9 (or 1.9%) of them are state-owned. (At the end of December 1997, there were 13 state-owned financial institutions, but 4 of these were privatized in January this year.) The remaining 456 monetary institutions (or 98.1%) are all privately-owned. Community financial institutions, i.e. credit cooperative associations and the credit departments of farmers' and fishermen's associations, accounted for the largest group of these monetary institutions with 374 or 80.4% of the total at the end of June 1998. However, the number of credit cooperative associations declined from 73 at the end of December 1996 to 56 at the end of June 1998, owing to some of them being converted into commercial banks or else merged with or taken over by other financial institutions.

Branch Networks: Financial institutions in Taiwan are organized on the basis of branch networks. The competent authority, i.e. the Ministry of Finance, imposes strict controls over the establishment of financial institutions in the R.O.C. as well as over the setting up of additional branches.

Business of Financial Institutions: Domestic banks consist of both commercial banks and specialized banks. The principal business activities of commercial banks are accepting checking deposits and supplying short-term credit. Generally speaking, these local banks in certain respects operate just like department stores. For instance, in addition to handling the various kinds of commercial banking business stipulated in the *Banking Law*, many of these commercial banks have also established savings and trust departments, so as to engage in the business of savings banks and investment and trust companies. Furthermore, the vast majority of specialized banks also engage in some of the business activities of commercial banks, in addition to the specialized kinds of business as specified in the laws for which they were set up. The Taiwan branches of foreign banks are also regarded as commercial banks and may thus engage in commercial banking business and, like their domestic counterparts, may also establish savings and trust departments, and handle savings deposits and long-term loans and engage in trust business. Credit cooperative associations are established by mutual cooperative organizations in townships and rural areas, while the credit departments of farmers' associations are engaged in deposit and loan business in rural areas and are the most grass-roots financial institutions in these locations. The credit departments of fishermen's associations likewise operate at the grass-roots level in the fishing industry.

(2) Deposit and Loan Market Shares of Financial Institutions

From Table 2: An Analysis of the Deposit and Loan Business Market Shares of Major Financial Institutions in the R.O.C., it may be seen that, of the various categories of monetary institutions, domestic banks accounted for the largest share of deposits at the end of March 1998 with 66.71%, followed by the Postal Savings System with 14.91%, the credit departments of farmers' and fishermen's associations with 8.55%, credit cooperative associations with 7.47% and the local branches of foreign banks with 2.36%. As regards the respective market shares in respect of loans, domestic banks again accounted for the largest share with 84.65%, followed by the credit departments of farmers' and fishermen's associations with 6.54%, credit cooperative associations with 5.52% and the local branches of foreign banks with 3.29%.

(3) Financial Institutions and their Operating Performance

In Table 3: An Analysis of the Operational Performance of Deposit-taking Financial Institutions in the R.O.C., we can see that in terms of the operating performance of financial institutions, for all deposit-taking financial institutions, there was a marked improvement in performance at the end of 1997 compared with the end of the previous year. This was regardless of whether it was liabilities as a multiple of net worth, the net profits ratio, the return on equity, or the return on assets that was the variable under consideration. Nevertheless, the pastdue loans ratio steadily increased from 1.33% in 1993 to 4.37% in 1997, indicating a gradual deterioration in asset quality. In order to resolve this problem and respond to the challenges faced by financial liberalization and internationalization, both the Ministry of Finance and the other financial supervisory bodies asked all financial institutions to increase both their capital and bad debt provisions in order to strengthen their risk management. For these reasons, the ratio of liabilities as a multiple of net worth steadily declined from 16.26 in 1993 to 12.82 in 1997. This was one of the important factors why Taiwan's financial system emerged relatively unscathed from the outbreak of the Southeast Asian financial turmoil in 1997 and was able to remain comparatively stable.

(4) Risk-related Problems and the Decline in Performance

Owing to the competent authority's implementing a system of supervision that focused strongly on capital, the net worth of banks in general in Taiwan tends to be relatively high. In addition, in view of the adoption of bank branch networks, banks' overall scales of operations in

Taiwan tend to be rather large. While the competent authority attaches a great deal of importance to financial discipline and financial examination, the trend towards financial liberalization and internationalization, i.e. as evidenced by interest rate liberalization, the adoption of a floating foreign exchange rate regime and the introduction into the market of financial derivatives products, has meant that the degree of uncertainty faced by financial institutions has dramatically increased. In addition, community financial institutions are no longer performing as well as before. Their pastdue loan ratios have gradually risen, while their market shares have steadily declined. The main reasons for the gradual deterioration in their operating performance as well as the risk-related problems they currently face may be briefly explained as follows:

1. Major Reasons for the Decline in Performance

(1) The revisions to the *Banking Law* in 1989 led to the liberalization of interest rates as well as the range and scope of the operations of banks. However, the business of community financial institutions continued to be restricted to the more traditional kinds of business. As interest rate spreads declined, the ability of these institutions to rely upon these spreads for their livelihood gradually diminished, so that their operations became less and less profitable.

(2) In 1991 and 1992, the entry of new private commercial banks into the market intensified competition within the banking sector. In order for community financial institutions to maintain their existing levels of business, they increased their lending to high-risk clients in the agricultural and construction sectors. If one adds to this an insufficiently sound system for investigating and extending credit as well as a lackluster real estate market, it will be seen that their asset quality deteriorated.

(3) Until 1995, community financial institutions were examined by the Taiwan Cooperative Bank. Due to a shortage of examination personnel, on-site examinations for some of these

institutions were carried out only once every one to three years. There was also no system in place for engaging in off-site monitoring. Consequently, operational deficiencies were not quickly discovered and it was not unusual for malpractices to occur.

(4) During the first half of 1995, increased volatility in Taiwan's financial markets resulted in a small number of poorly-managed financial institutions experiencing panic runs. This undermined the confidence of depositors, and led to a decrease in the community financial institutions' combined market share.

2. Operational Risk-related Problems Faced by Financial Institutions

The major kinds of operational risk that financial institutions face include the following:

(1) Credit risk.
(2) Interest rate risk.
(3) Country risk and foreign exchange rate risk.
(4) Operations risk.
(5) Liquidity risk.
(6) Regulatory risk.
(7) Reputation risk.

B. A Brief Introduction to the System of Financial Supervision

(1) The Competent Authorities Responsible for Financial Supervision and Control

The structure of supervision within the financial system and the main financial supervisory bodies in our country are presented in Table 4. Here it can be seen that the principal government agencies responsible for supervision are the Ministry of Finance and the Central Bank of China.

The Ministry of Finance is responsible for financial administration and the supervision and control of financial business, while the Central Bank of China, in addition to implementing monetary policy, also handles a considerable amount of financial supervision and control.

1. With regard to the supervision of banks, according to Article 19 of the *Banking Law*, the competent authority responsible for financial administration at the central government level is the Ministry of Finance, while at the provincial and municipal levels, responsibility is vested in the departments of finance of the provincial and municipal governments, respectively. The principal rights and responsibilities of the Ministry of Finance with regard to supervision are concerned with the granting of approval to establish banks, business license applications, minimum capital requirements, permissible business activities, mergers involving banks and conversions into banks, approval to set up additional bank branches, the work of financial examination, and the right to punish violators.

2. With regard to the supervision of community financial institutions, i.e. credit cooperative associations and the credit departments of farmers' and fishermen's associations, according to Article 5 of the *Law Governing Credit Cooperatives*, the competent authority at the central government level is the Ministry of Finance. At the provincial and municipal levels, the competent authorities are the departments of finance of the provincial and municipal governments, respectively, while at the county and township levels they are the county and township governments, respectively.

(2) Major Financial Examination Bodies

The three major supervisory bodies responsible for examining the operations of financial institutions in Taiwan are the Ministry of Finance, the Central Bank of China and the Central Deposit Insurance Corporation. Their respective duties as well as the way in which examination personnel are allocated among them are described in detail in Tables 5 and 6.

1. *The Ministry of Finance:* According to Article 45 of the *Banking Law*, the Ministry of Finance may at any time dispatch personnel, or commission the Central Bank of China, or instruct the competent authorities at the local government level to dispatch personnel to examine the business and accounts of banks. The main financial entities examined by the Ministry of Finance include the commercial banks newly established in 1991 or later, some of the domestic banks established before 1991, investment and trust companies, the Taiwan branches of various foreign banks, all insurance companies and securities finance companies.

2. *The Central Bank of China:* According to Article 38 of the *Central Bank of China Act* which states, among other things, that the Central Bank may conduct bank examinations in coordination with the bank examination program delegated to the Bank by the Ministry of Finance, the *Regulation Governing the Ministry of Finance's Delegating to the Central Bank of China the Examination of Financial Institutions*, and the *Regulation Governing the Central Bank of China's Examination of Financial Institutions*, the Central Bank of China may conduct on-site financial examinations by means of direct examinations, joint examinations or commissioned examinations. The main financial entities examined by the Central Bank include both domestic banks and the Taiwan branches of foreign banks established before 1991 that are not examined by the Ministry of Finance or the CDIC, as well as the Postal Savings System and all bills finance companies.

3. *The Central Deposit Insurance Corporation:* The CDIC's responsibilities are mainly based on the *Regulations Governing the Ministry of Finance's and the Central Bank of China's Joint Commissioning of the CDIC with the Examination of Community Financial Institutions*, Article 21 of the *Deposit Insurance Act*, which states "If the CDIC deems it necessary, and after obtaining the prior approval of the competent authority in consultation with the Central Bank of China, the CDIC may examine the business records and accounts of the insured institution,......", and the *Regulation Governing the CDIC's Examination of Financial*

Institutions. Currently, the main entities examined by the CDIC are community financial institutions and other financial institutions for which prior approval has been obtained from the Ministry of Finance in consultation with the Central Bank of China in accordance with Article 21 of the *Deposit Insurance Act*.

III. The Status and Legal Objectives of the CDIC

1. The Development of the Deposit Insurance System in the R.O.C.

Background to the Establishment: Owing to the needs of economic and financial development, and so that the government might safeguard the rights and interests of depositors in financial institutions and maintain orderly credit, plans were made to set up a deposit insurance system as far back as the 1970s. Then, in early 1985, a series of panic runs on financial institutions that included the Taipei Tenth Credit Cooperative, the Cathay Investment and Trust Corporation, the Asia Investment and Trust Corporation and the Overseas Chinese Investment and Trust Corporation precipitated a financial crisis. In order to guard against systemic risk, the government ordered that various state-owned banks take control of these problem institutions. In addition, by providing low-interest rate accommodation through the Central Bank of China, the government was able to successfully resolve the crisis. It was also in 1985 that active steps were taken to set up a deposit insurance system.

Objectives of the Establishment: The deposit insurance system in the R.O.C. was established in September 1985. The CDIC, in accordance with Article 46 of the *Banking Law* and also the *Deposit Insurance Act*, was established as a publicly-owned financial institution by the Ministry of Finance in consultation with the Central Bank of China. The objectives behind its establishment were to safeguard the benefits of depositors in financial institutions, to promote savings, maintain orderly credit, and enhance the sound development of financial operations.

Capital: The total capital of the CDIC is prescribed by the Executive Yuan, with shares in such capital being subscribed by the Ministry of

Finance, the Central Bank of China and insured financial institutions. At the time of its establishment, paid-in capital amounted to NT$800,050,000, of which two equal shares of NT$400 million each were subscribed by the Ministry of Finance and the Central Bank of China and five equal shares of NT$10,000 each were subscribed by local banks. At the end of May 1998, capital actually paid-in amounted to NT$7.9 billion, of which 99% was subscribed by the Central Government. For more information regarding the amount of capital actually paid in over the years, the accumulated deposit insurance special reserves, and deposit insurance funds available for use in handling problem financial institutions as a percentage of insured deposits, please refer to Table 7.

Insurance Coverage and the Assessment Rate: When the deposit insurance system was first set up, the maximum insurance coverage that the CDIC extended to each depositor was set at NT$700,000, but this was subsequently increased to NT$1 million. The deposit insurance assessment rate was originally set at a fixed rate of 0.05% of the insured base (i.e. the insured deposit liability). Later, in July 1987, this rate was lowered to 0.04%, and then further lowered in January 1988 to its current rate of 0.015%. The main reason for the significant reduction in the assessment rate was to give financial institutions more of an incentive to become part of the deposit insurance system, so that its coverage might rapidly extend to all financial institutions, thereby safeguarding the rights of all depositors in financial institutions and maintaining order throughout the financial system. For further details regarding adjustments in the assessment rate and insurance coverage over the years, please refer to Table 8.

2. The Current Status of Deposit-taking Institutions Participating in Deposit Insurance

(1) Under the present system of deposit insurance in which participation is administered on a **voluntary basis**, the CDIC has drawn up an Insurance Standard, the main features of which are as follows:

1. All financial institutions that have been in operation for more

than half a year shall apply to participate in deposit insurance.

2. The CDIC will not agree to extend insurance coverage to financial institutions in the following cases: (1) where after final accounts are prepared it is found that an institution's accumulated losses cannot be reimbursed or else net worth is discovered to be less than actual paid-in capital; (2) where within the preceding two years the financial institution has been in violation of Articles 32 and 33 of the *Banking Law*; (3) where a bank's ratio of own capital to risk assets falls below 6%, or where the ratio of net worth to total deposits in the case of community financial institutions is less than 3.5%; (4) where, within the last two years, there have been violations of the *Banking Law* or other major incidents have taken place that it is feared will endanger the financial institution's sound business practices; and (5) if the above-mentioned financial institution has already become a member of a competent mutual assistance organization and has also become entitled to receive that organization's funding support and agrees to transfer its assets and liabilities to another institution either through a merger or an acquisition, and has sought to obtain special permission from the Ministry of Finance, then it is not subject to the above restrictions.

3. In the case of newly-established local commercial banks and credit cooperative associations that have been in operation for less than two years, in addition to the above-mentioned reasons for not extending insurance coverage, the CDIC will also refuse to grant an institution permission to participate in deposit insurance where: (1) upon its application, there appears to be an unsatisfactory performance in terms of the execution of the institution's plan, its rules and regulations and business procedures, and its system of internal controls is unable to function properly or may endanger sound business practices; or (2) the applicant fails to submit to the CDIC the institution's business report, balance sheet or income statement that have already been approved by the board of directors or else

acknowledged by the examiners (or supervisors) or where the result of a preliminary review has been found to be unsatisfactory.

(2) At the end of May 1998, of the total of 467 financial institutions in the R.O.C. that accepted deposits, 403 or 86.3% were participating in deposit insurance, leaving 64 or 13.7% that were not participating. Most of the institutions not participating in the deposit insurance system were credit departments of farmers' associations. The principal reason for this was the voluntary nature of the deposit insurance system and the fact that certain of these institutions still needed guidance due to their inability to meet the conditions for deposit insurance. For more details regarding the numbers of financial institutions both participating and not participating in deposit insurance, please refer to Table 9.

3. CDIC's Examination of Financial Institutions

At the end of May 1998, the CDIC had a total of 183 examination personnel. This represented an increase of 110 people as compared with the 73 examination personnel at the end of June 1997 just before the Taiwan Cooperative Bank ceased to engage in bank examination. Out of a total of 467 deposit-taking financial institutions, the CDIC examined the operations of 387 or 82.9% of them. More details of this are provided in Table 10. The CDIC's contribution to the work of financial examination can be clearly seen.

4. CDIC's Mechanism to Guard Against Moral Hazard

In order to prevent insured institutions from encountering moral hazard, based on the current system of deposit insurance, the CDIC may also, in addition to resorting to the deposit insurance criteria referred to above, conduct on-site examinations, engage in off-site monitoring, give the institution being examined a written warning, or also terminate its status as an insured institution. (For more details of this, please refer to the following section.)

The problem of moral hazard will be dealt with somewhat differently when the *Deposit Insurance Act* is revised. For instance, a risk-based assessment rate system will be implemented, and only the principal relating to an problem insured institution's insurable deposits will be paid where there is an insurance pay-off. Furthermore, fines will be increased and more severe punishments will be handed down to those insured institution's that fail to make improvements. The penalties in respect of institutions participating in deposit insurance that refuse assistance and guidance from the CDIC will also be increased.

IV. CDIC's Current Handling of Problem Financial Institutions and Related Accomplishments

The *Deposit Insurance Act* gives the CDIC four main responsibilities, namely, handling deposit insurance, examining the operations of insured institutions, guiding the operations of insured institutions and handling failed insured institutions. The CDIC's handling of problem financial institutions comprises the following:

A. Establishing an Ongoing System of On-site Examination with Increased Emphasis on the Frequency, Depth and Breadth of Supervision

(1) The Provision of Assistance in Examination:

The approach adopted by the CDIC to examine financial institutions is primarily based on conducting on-site examinations (including general-scope and specific-scope examinations), with the audit of the institutions' financial statements playing only a secondary role. The work of examination is carried out in accordance with the underlying operational concepts of "providing assistance rather than just conducting examinations" and "prevention is better than cure". Special emphasis is placed upon carefully examining each financial institution's approach to risk management, especially with regard to the risk control function at each level of operations within the organization. By strengthening the examination of risk management, the CDIC can at the same time help the institution being examined reduce its operational risk and thereby increase the soundness of its operations. In addition, the head office of each insured institution is in principle examined once each year. If operational risk is regarded as being rather high, then the frequency of examinations is increased.

(2) The Timely Reporting of Examination Results:

In order to enable examinations to be handled in a timely manner, should a financial institution be found to have specific problems, i.e. its adjusted net worth is negative, there is evidence of serious fraud, or the institution is found to be in the midst of a major operational crisis, then, once the examination is completed, a report on the findings of the examination should be submitted to the competent authority in a timely manner to enable the necessary corrective action to be taken.

(3) Referring Supervision-related Problems to the Bank Examination Committee:

When specific problems related to supervision arise, these should be referred to the CDIC’s Bank Examination Committee for appropriate action to be taken. The members of this committee include a Vice Minister of Finance, a Central Bank of China deputy governor, the Director General of the Ministry of Finance’s Bureau of Monetary Affairs, the Director General of the Central Bank of China’s Bank Examination Department, the Commissioner of the Taiwan Provincial Government’s Department of Finance, the directors of the respective departments of finance of the Taipei City Government and the Kaohsiung City Government, the President of Taiwan Cooperative Bank and the President of the CDIC. The committee meets once every month.

B. Monitoring the Risk Management of Financial Institutions through Off-site Surveillance

This may include any of the following:

(1) Engaging in follow-up evaluation following the completion of the examination report.

(2) Establishing a National Financial Institutions' Early-Warning System (NFIEWS) in order to take note of problem insured institutions early on and assist them in making timely improvements.

(3) Establishing a system to analyze the data of community financial institutions included within the financial early-warning system.

(4) Establishing an off-site monitoring system as well as a follow-up evaluation system involving account officers.

(5) Implementing a "compliance officer" system.

(6) Setting up a "Concern Hotline" and a "Concern Mailbox" system to encourage the reporting by employees and the general public of unlawful conduct to the authorities.

C. Methods Used to Handle Problem Insured Institutions with Unusual Operations and their Effectiveness

(1) Giving problem institutions a written warning of the need to rectify serious deficiencies within a prescribed time limit.

(2) Dispatching personnel to assist in the institution's day-to-day business operations and to actively maintain financial order.

(3) Dispatching, either as requested by the Ministry of Finance or with permission from the Ministry of Finance, an *ad hoc* conservatorial task force to take charge of the problem institution's day-to-day operations.

(4) Terminating the deposit insurance status of an insured institution.

(5) Winding up a problem institution and compensating insured

depositors.

V. The Direction of CDIC's Future Development and Problems with the Deposit Insurance System

Since the beginning of the 1990s, the R.O.C. government has actively promoted financial liberalization and internationalization in accordance with the needs of economic and financial development. It has, as a consequence, deregulated interest rates, adopted a floating exchange rate system, allowed financial derivatives products to be introduced, and the given approval for 16 new private commercial banks to be established. At the same time, the government has relaxed the restrictions on the setting up of local branches by foreign banks and the establishment by domestic banks of branches overseas.

During this period, the financial supervisory system and market discipline have not been able to keep pace with the rapid developments taking place. In early 1995, for instance, around the time of the first popularly-held presidential and vice-presidential elections in Taiwan, Mainland China's decision to hold military exercises threatened the stability of Taiwan and precipitated a large capital outflow and a dramatic fall in local stock prices. As a result, more than 10 financial institutions with operational deficiencies experienced panic runs, including the already-insured Bank of Overseas Chinese, the Taitung Medium Business Bank and several community financial institutions. In response, the CDIC dispatched *ad hoc* conservatorial task forces to manage these institutions' day-to-day operations. By cooperating with the competent authority, whether by means of adjusting their organizational structure, changing their responsible persons or facilitating a merger, the benefits of depositors in these problem financial institutions were safeguarded and the crises resolved.

A further example was that of the Changhwa Fourth Credit Cooperative. Before it became an insured institution, the credit cooperative association suffered huge losses owing to the fraudulent activities of its president. This led to a run on the institution, which resulted in the government ordering it to terminate its operations. Subsequently, there was a series of panic runs on community financial institutions in central Taiwan that at the time were not yet participating in the deposit insurance system. Due to the seriousness of the situation, the government instructed the Taiwan Cooperative Bank to take over the Changhwa Fourth Credit Cooperative. In addition, both the Yen-pu and Chungli farmers' associations were forced to suspend their operations for long periods of time due to panic runs. The depositors responded by protesting, and the CDIC once again gave these troubled associations guidance with regard to their policies. Eventually, they were taken over by larger and more established farmers' associations. In addition, with special low-interest rate financing provided by the Central Bank, these two associations participated in deposit insurance for policy considerations and their difficulties were temporarily resolved.

Consequently, at around that time, except for the large banks owned by the provincial government and some of the local branches of foreign banks which for special reasons remained outside the deposit insurance system, the community financial institutions vied with each other to apply to participate in deposit insurance. Furthermore, once their assets and business operations had been evaluated by the CDIC, apart from those that did not meet the criteria for admission to the deposit insurance system, all of their applications to participate in deposit insurance were approved.

The government has also been actively working through the legal process to revise the *Deposit Insurance Act*. The revised *Act* has already completed its first reading in the Legislative Yuan and is currently awaiting its second and third readings. Once passed, the deposit insurance system in which participation is currently voluntary can be changed to become one in which participation is mandatory and insured institutions will be assessed for deposit insurance purposes on the basis of a risk-based assessment rate. In addition, in drafting the amendments to the *Deposit Insurance Act*, much attention has been paid to the spirit in which the U.S.'s Federal Deposit Insurance Corporation has revised its own relevant legislation. According to the revised *Deposit Insurance Act*, the CDIC has been given comparable powers to the FDIC when handling problem financial institutions.

A. Directions for Future Development

After the revised *Deposit Insurance Act* is enacted, the deposit insurance system will differ quite considerably from that which is currently in place. The nature of participation, the institutions covered by deposit insurance, the scope of protection, and the provision of assistance to problem financial institutions will all differ significantly, as summarized in Table 11. The CDIC will in the future make every effort to move in the following directions:

(1) It will strengthen its ability and skills in handling problem insured institutions, in order to full exercise its function of stabilizing financial order.

(2) It will examine problem insured institutions by means of in-depth specific-scope examinations, in order to control the operating risk of these problem institutions as early as possible.

(3) In order to strengthen the risk management of insured institutions, the CDIC will adopt an approach whereby it provides assistance as soon as possible.

(4) The CDIC will implement a risk-based premium assessment rate system, in order to reflect insured institutions' operating risk.

(5) In the future when the CDIC handles problem insured institutions, it will be vested with increased authority to provide financial assistance, which will help resolve financial crises. The measures adopted to provide such assistance will include the following:

    1. Providing financial assistance to insured institutions whose day-to-day operations it is influencing by offering guidance, dispatching *ad hoc* conservatorial task forces or appointing a receiver, in order to resolve short-term liquidity crises arising from shortages of funds.

    2. Providing financial assistance to other insured institutions, in order to help them either merge with or take over either part of or all of the operations and assets and liabilities of problem insured institutions that have been ordered to terminate their operations.

(6) Speeding up the accumulation of the deposit insurance pay-off special reserves, in order to increase the ability of the CDIC to compensate depositors in the event of a crisis.

(7) Submitting requests to the competent authority to draft regulations regarding the merging or conversion of the credit departments of farmers' and fishermen's associations, in order to thoroughly resolve their operational crises.

B. A Discussion of Problems with the Deposit Insurance System

(1) **Authority to Take Disciplinary Action:** With regard to the structure of financial supervision, the CDIC at present lacks the authority to take disciplinary action against financial institutions that violate regulations. This differs from the situation that exists in the U.S.

In the U.S., in spite of the work of financial supervision and examination being divided among the federal supervisory authorities and the state banking departments, each major supervisory body is concurrently invested with the authority to conduct examinations and punish offenders. Punishments include issuing injunctions, imposing civil penalties, ordering the termination of part or all of the insured institution's business operations, and dismissing and/or replacing responsible persons. Furthermore, different corrective measures may be adopted in accordance with the offending institution's capital ratio. For this reason, the system of financial supervision adopted in the U.S. is one in which their is a clear, unified structure of authority among the various supervisory bodies. In particular, the FDIC's system is designed such that the work of examination and disciplinary action are combined together. This gives the FDIC relatively more autonomy when controlling risk.

By contrast, in the R.O.C., the CDIC only has the authority to terminate the status of insured institutions. It lacks the authority to punish insured institutions. In order to resolve this problem, it is still necessary to model our system on that adopted in the U.S., thereby giving the CDIC the authority to punish insured institutions. Only in this way can controls over risk management be strengthened.

(2) **Organizational Status and Independence:** With regard to organizational structure, the organizational structure currently adopted by the CDIC lacks both administrative authority and independence when compared with its U.S. counterpart. The FDIC, on the one hand, is one of the major supervisory administrative bodies. The CDIC, on the other hand, is organized as a joint-stock company, and is a publicly-owned institution. Like other state-owned enterprises, it is subject to restrictions imposed upon it by the *Company Law*, the *Audit Law*, the *Budget Law* and other relevant laws and regulations. In addition, its board of directors is organized on the basis of the *Company Law*. In the case of the FDIC, the composition of the board of directors, the appointment of directors, their term of office and duties and obligations are all clearly spelled out in the laws and regulations. Furthermore, the laws governing the establishment of the board of directors also specify the special status accorded to the board as well as the powers invested in it to perform its administrative duties independently. If a comparison is made with the system adopted in the R.O.C., it can be seen that the organizational status and independence of the CDIC are not as far-reaching and clear-cut as in the case of the FDIC.

(3) **Autonomy in Handling Problem Financial Institutions:** The CDIC also lacks autonomy with regard to its power to handle problem financial institutions. The FDIC, by contrast, has a wide variety of options available to it when dealing with a problem financial institution. It may, according to law, either approve the appointment of or itself appoint a liquidator in order to terminate the status of an institution. Where the possibility exists that the status of an insured institution may be terminated or that an order to terminate its status has already been given, the FDIC may also provide financial assistance, purchase and take over the insured institution, assist in a merger between that institution and another institution, or else set up a bank to assume control of the institution until the crisis is resolved. At present the deposit insurance system in the R.O.C. is

only able to provide an insured institution whose status has been terminated with financial support to resume operations, or else purchase its assets. Although the newly-revised system of deposit insurance which makes participation in deposit insurance mandatory vests the CDIC with the authority to provide problem insured institutions with financial assistance to encourage a merger or a complete takeover, and to help such institutions resolve their short-term needs for liquidity in the event of a crisis, the policy instruments available to the CDIC are still inadequate when compared with those in the hands of the FDIC. Furthermore, with regard to having the authority to approve a merger, the regulations in the R.O.C. require that approval be given by the Ministry of Finance for a merger to take place or for financial support to be provided to insured institutions that lack short-term liquid funds. This means that the CDIC lacks autonomy when handling problem insured institutions. This will in the future result in the CDIC's timeliness and efficiency in handling problem insured institutions being affected.

(4) **International Operations and Exchanges:** Recently there has been a rapid increase in the numbers of branches being established by foreign banks in Taiwan as well as branches being set up by domestic banks in the financial centers of the world. In order to more effectively control their operational risk, it is essential that international cooperation and exchanges be strengthened between the CDIC and financial supervisory agencies in other countries.

The CDIC should strengthen its already close cooperation and exchanges with other financial supervisory agencies abroad in order to facilitate the two-way provision of information and the sharing of experience. In this way, we may together create an increasingly sound deposit insurance system and stabilize world financial markets.

Table 1　Numbers of Financial Institutions in the R.O.C

March 31, 1998　　Unit: Numbers of Institutions

Item / Category	Type of Institution	Total Units	Head Offices	Branches	Proportion of Total Head Offices (%)
Monetary Institutions	Domestic Banks	2,296	46	2250	9.9
	State-owned	559	8	551	1.7
	Private	1,737	38	1699	8.2
	Branches of Foreign Banks	71	45	26	9.7
	Credit Cooperative Associations	538	60	478	12.9
	Credit Departments of Farmers’ Associations	1234	287	947	61.7
	Credit Departments of Fishermen’s Associations	75	27	48	5.8
	Sub-total	4,214	465	3,749	100.0
Non-monetary Institutions	Investment and Trust Companies	66	5	61	6.3
	Postal Savings System	1,280	1	1279	1.2
	Bills Finance Companies				
	Securities Finance Companies	50	15	35	18.8
	Life Insurance Companies	6	4	2	5.0
	Property and Casualty Insurance Companies	133	30	103	37.5
		155	25	130	31.2
	Sub-total	1,690	80	1,610	100.0
Total	Total	5,904	545	5,359	—

Note 1 : This table includes only those units actually in operation. It does not include representative offices, nor the Export-Import Bank. The first local branch of each foreign bank is included in the Head Offices column, while the second and subsequent local branches are included in the Branches column.

Note 2 : The figures are based on revisions to “Financial Statistical Indicators in Taiwan” compiled by the Department of Statistics, Bureau of Monetary Affairs, Ministry of Finance, May 1998.

Note 3 : At the end of March 1998, 22 Domestic Banks had established 121 overseas offshoots including branches, agencies, representative offices and subsidiaries.

Note 4 : At the end of 1997, each banking unit (including the Postal Savings System) served on average 3,945 persons.

Table 2 An Analysis of the Deposit and Loan Business Market Shares of Financial Institutions in the R.O.C

Unit： ％

Institution / years	Domestic Banks		Local Branches of Foreign Banks		Credit Cooperative Associations		Credit Departments of Farmers' and Fishermen's Associations		Postal Savings System
	Deposits	Loans	Deposits	Loans	Deposits	Loans	Deposits	Loans	Deposits
1987	58.47	79.00	1.08	5.23	10.61	8.68	9.36	7.09	20.48
1988	60.55	79.17	1.12	4.32	11.29	10.27	9.06	6.25	17.98
1989	62.49	78.73	1.01	4.41	12.38	10.42	8.81	6.43	15.31
1990	60.41	77.90	1.24	4.21	12.95	10.61	9.30	7.29	16.10
1991	59.24	79.16	1.02	3.93	13.28	10.07	9.76	6.84	16.70

1992	58.56	78.40	1.15	3.51	13.48	10.55	9.91	7.54	16.90
1993	58.73	77.64	1.18	3.12	14.40	10.93	10.20	8.31	15.49
1994	59.58	78.62	1.28	2.84	13.96	10.31	10.32	8.23	14.86
1995	60.88	79.06	1.52	3.01	12.60	9.60	9.74	8.33	15.26
1996	61.61	80.61	1.71	3.12	11.61	8.59	19.13	7.68	15.94
1997	66.07	84.16	2.39	3.23	7.96	5.90	8.70	6.71	14.88
1998.3	66.71	84.65	2.36	3.29	7.47	5.52	8.55	6.54	14.91

Note 1：Source of Data：”Financial Statistical Indicators in Taiwan” compiled by the Department of Statistics, Bureau of Monetary Affairs, Ministry of Finance, May 1998.

Note 2：The Postal Savings System still does not extend loans and its deposits are redeposited in the Central Bank of China.

Table 3 : An Analysis of the Operational Performance of Deposit-taking Financial Institutions in the R.O.C

Category of Institution \ Item \ Year-end		Liabilities/Total Networth (multiple)	Pastdue Loans Ratio	Net Profit I Tax/Operating
Banks in General	1993	15.03	1.27%	11.95%
	1994	14.02	1.81%	13.07%
	1995	14.43	2.90%	11.24%
	1996	13.36	3.75%	11.13%
	1997	12.31	3.78%	12.71%
Community Financial Institutions	1993	23.47	1.62%	6.93%
	1994	21.79	2.45%	7.29%
	1995	19.65	4.18%	5.87%
	1996	17.31	7.24%	6.29%
	1997	16.97	8.71%	5.16%
All Deposit-taking Financial	1993	16.26	1.33%	10.87%
	1994	15.13	1.92%	11.81%
	1995	15.21	3.12%	10.09%

Institutions	1996	13.93	4.30%	10.20%
	1997	12.82	4.37%	11.59%

Note:'Banks in General' here include domestic banks, the local branches of foreign banks, and investment and trust companies. Community Financial institutions include credit cooperative associations and the credit departments of farmers' and fishermen's associations.

Table 4 The Structure of Financial Supervision and Major Financial Supervisory Body

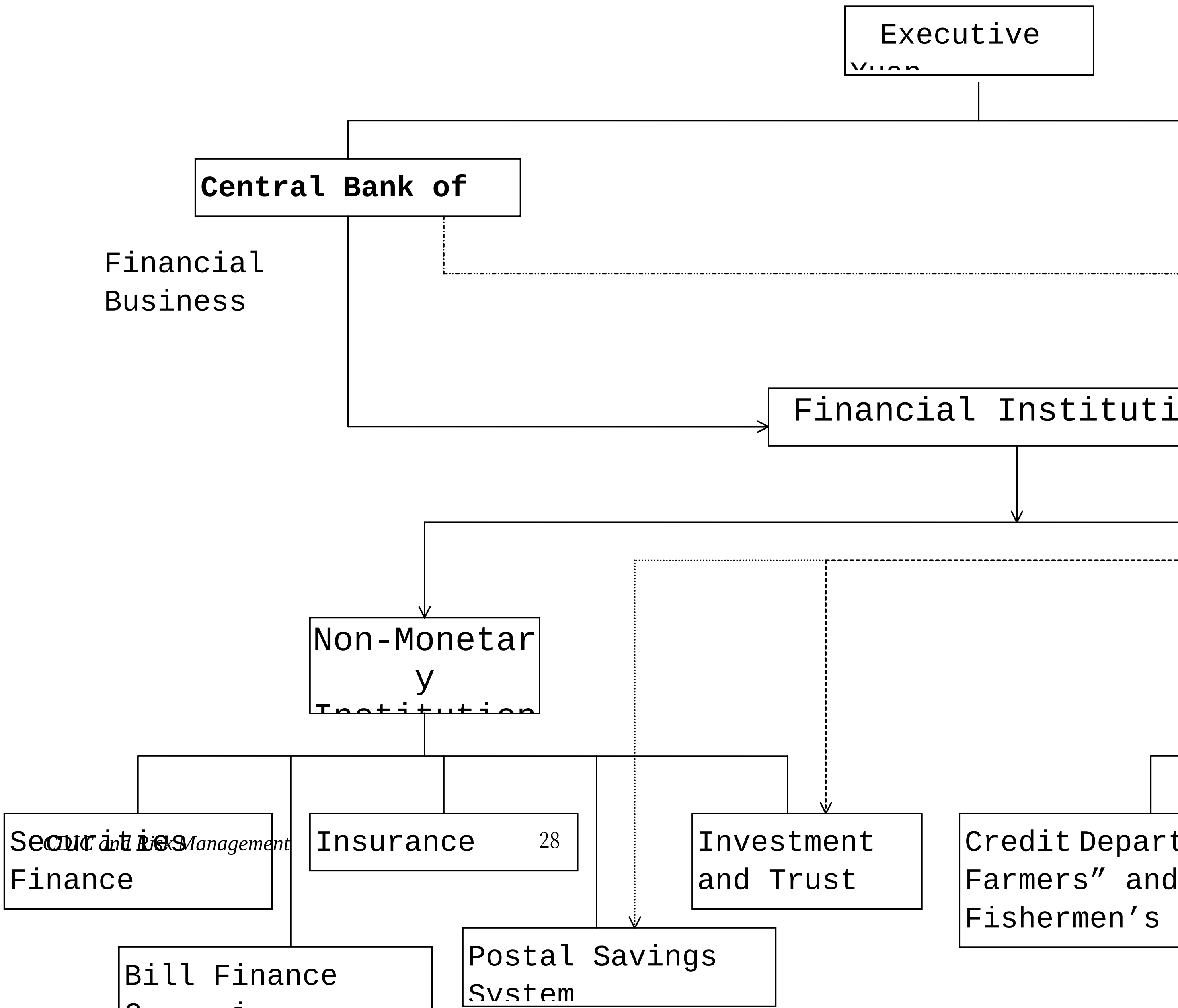
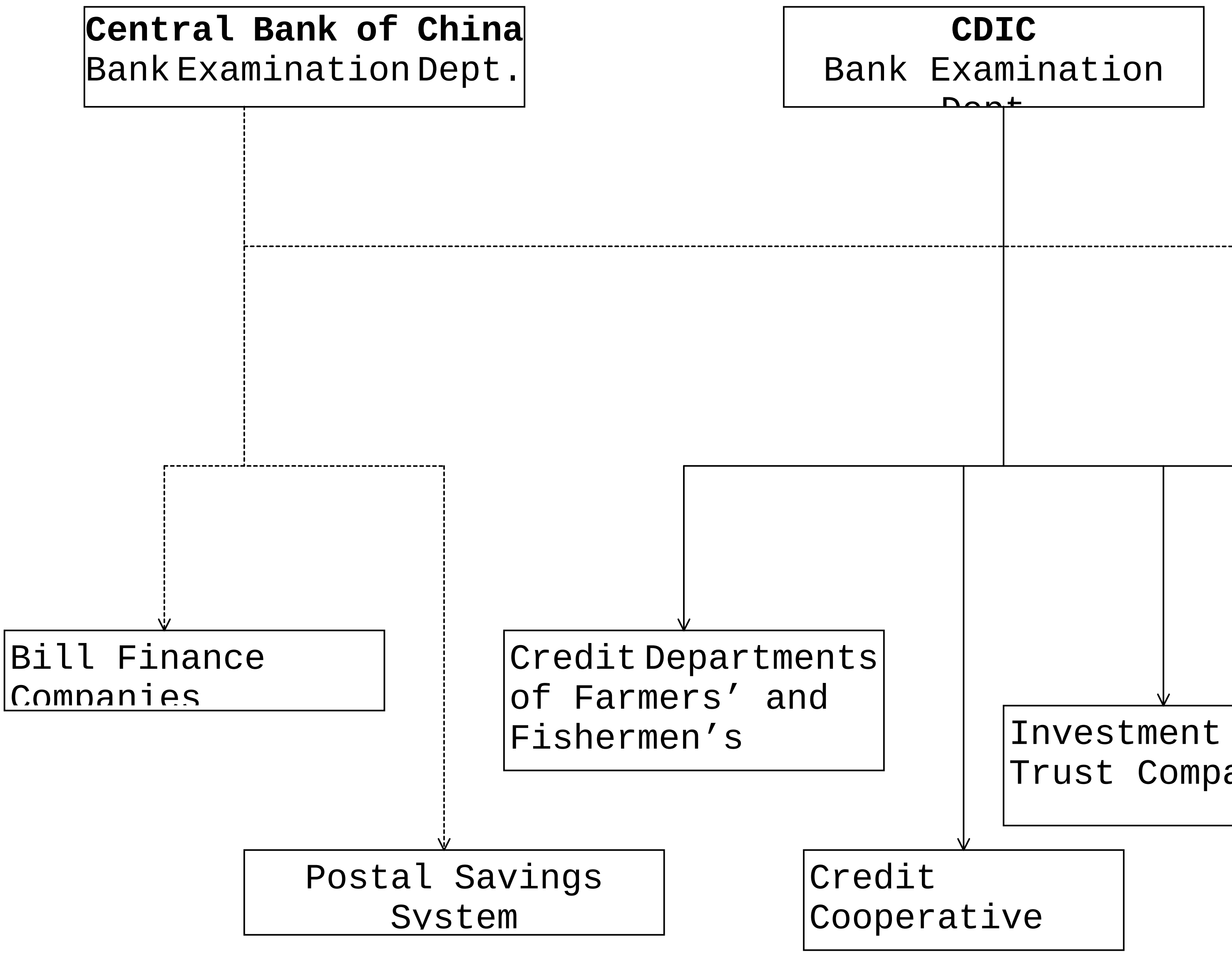


Table 5 The Sharing of the Work of Financial Examination Among the Major Financial Supervisory Bodies



Note: The Local branches of foreign banks examined by the Ministry of Finance's Bureau of Moneta
that are not registered in Europe , the Americas and Africa. The Local branches of foreign b
Bank of China refer to the Local branches of foreign banks registered in Europe , the Ame

Table 6 The Allocation of Examination Personnel Among the Major Supervisory Bodies

Unit：Persons

Supervisory Body \ Date	June 1998	June 1996
CDIC	183	73
Central Bank of China	109	114
Ministry of Finance	51	48
Taiwan Cooperative Bank	—	57
Total	343	292

Note ：The figures include internal support staff.

Table 7 Changes in the CDIC’S Deposit Insurance

funds Over the years

Unit：millions NT$, %

Date	Actual Paid-in Capital	Insured Deposits	Deposit Insurance Fund	Ratio of Deposit Insurance Fund to Insured Deposits	Ratio of Deposit Insurance Fund and Capital to Insured Deposits
1986.6.30	800	133,304	17	0.01%	0.61%
1987.6.30	1,200	201,850	83	0.04%	0.64%
1988.6.30	1,600	379,379	134	0.04%	0.46%
1989.6.30	1,950	483,378	189	0.04%	0.44%
1990.6.30	1,950	618,248	259	0.04%	0.36%
1991.6.30	1,950	753,861	345	0.05%	0.30%
1992.6.30	2,000	943,196	432	0.05%	0.26%
1993.6.30	4,000	1,151,692	536	0.05%	0.39%
1994.6.30	5,000	1,608,539	714	0.04%	0.36%
1995.6.30	5,000	1,923,972	935	0.05%	0.31%
1996.6.30	5,000	2,772,773	1,244	0.04%	0.23%
1997.6.30	7,500	3,058,978	1,603	0.05%	0.30%
1998.6.30	7,900	3,289,797	1,991	0.06%	0.30%

Table 8 Adjustments in Deposit Insurance Assessment Rate and Insurance Coverage Over the Years

Item / Date of	Insurance Assessment Rate	Insurance Assessment Base	Maximum Coverage for Each Depositor	Remarks

Adjustment				
Sep. 27, 1985	0.05%	Insured Deposits	NT$700,000	Date of CDIC's Establishment
July 1, 1987	0.04%	as above	as above	Assessment rate lowered
Aug. 15, 1987	as above	as above	NT$1 million (equi. US$30,000)	Individual coverage increased
Jan. 1, 1988	0.015%	as above	as above	Assessment rate lowered
Not yet decided	0.015% to 0.02%	as above	as above	After participation in deposit insurance is made mandatory, a risk-based premium system＊will be implemented. During the early stages, each insured institution will be assessed according to either one of five different levels (with increments of 0.00125% each), or else one of three different levels (with increments of 0.0025% each).

＊ The Risk-based Premium System will in the future be based on both the capital ratio and the CAMEL composite rating risk indicator, of which the quantitative indicator accounts for 86% and the non-quantitative indicator for the remaining 14%. A proposal in this regard has already been submitted to the Ministry of Finance for approval, and it is expected that it will start to be implemented at the same time as participation in deposit insurance becomes mandatory.

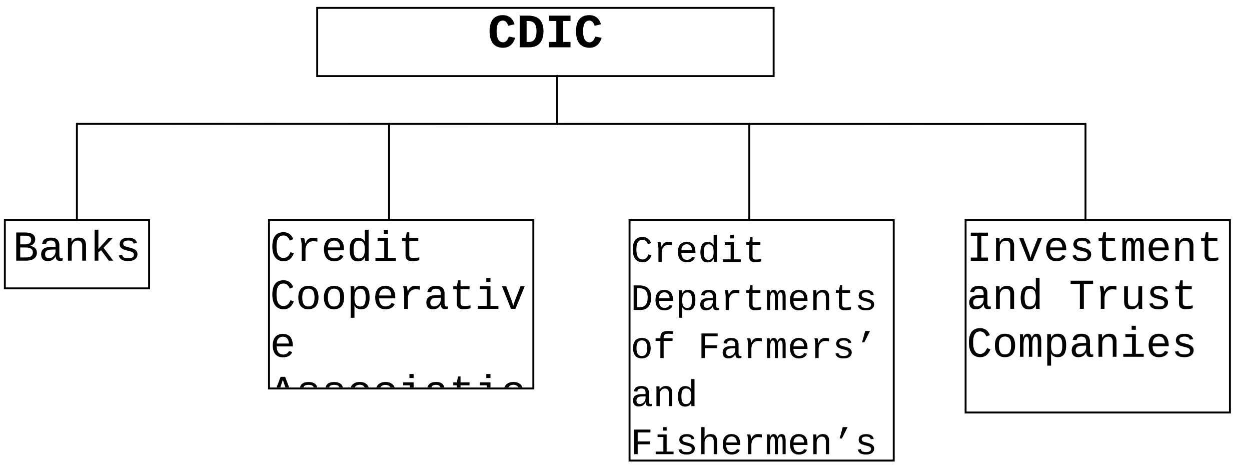
Table 9 Numbers of Deposit-taking financial Institutions both Participating and Not-Participating in Deposit Insurance

May 31,1998

Category	Participating		Not-Participating		Total
	Number	Proportion(%)	Number	Proportion(%)	
State-owned Domestic Banks	5	62.5	3	37.5	8
Private-sector					

Domestic Banks	34	89.5	4	10.5	38
Local Branches of Foreign Banks	30	66.7	15	33.3	45
Investment and Trust Companies	4	80.0	1	20.0	5
Credit Cooperative Associations	54	94.7	3	5.3	57
Credit Departments of farmers' Associations	249	86.8	38	13.2	287
Credit Departments of fishermen's Associations	27	100.0	0	0	27
Total	403	86.3	64	13.7	467

Table 10 Summary of the 387 Financial Institutions Examined by the CDIC as of May 31, 1998



13	57	314	3
14%	100%	100%	60%

Notes:

1. Total Financial institutions in Taiwan：467, including:

   91 Banks (including 45 branches of foreign banks)

Table 11 Major Differences between the *Deposit Insurance Act* in its Current Form and the Revised Version

System Adopted Item	Current Deposit Insurance System (1985---now)	Revised Deposit Insurance System(after legal process)
Nature of participation	Voluntary	Mandatory
Participating institutions	1. All domestic deposit-taking financial institutions except the Postal Savings System 2. The local branches of foreign banks that accept deposits which are already guaranteed by the home countries of these foreign banks may also participate in the local deposit insurance system	1. All domestic deposit-taking financial institutions including the Postal Savings System 2. It is not mandatory for the local branches of foreign banks that accept deposits which are already guaranteed by the home countries of these foreign banks to participate in the local deposit insurance system
Location of Deposit Insurance Funds	Restricted to the Central Bank of China	1. Central Bank of China 2. Financial

		Institutions approved by the competent authority
Scope of coverage	Principal and interest	Principal only
Compensation method	1. Cash compensation 2. Deposit account transfers 3. Temporarily continuing to operate in the name of the CDIC	In addition to the three methods on the left, financial assistance is also provided to encourage an insured institution to merge with or be taken over by other financial institutions
Provision of advances in relation to uninsured portions of deposits and to non-depositors	N/A	Based on the principle that costs do not increase, advances may be made.
The exemption of handling problem and failed financial institutions from being required to submit bids for tender, compare offer prices and negotiate prices in accordance with the *Budget Law*	No	Yes
Institutions eligible to receive financial assistance	Limited to those that receive assistance to resume operations or else to terminate their operations	1. Insured institutions that receive assistance, or are handled by a conservatorial task force or a receiver 2. Other insured institutions that receive assistance in relation to a merger or a takeover, or are handled by a conservatorial task force or a receiver or whose status as insured institutions are terminated

Method used to provide financial assistance	1. Loans 2. Purchase of assets	1. Providing funds 2. Loans 3. Deposits 4. Guaranteed debt
Obtaining accomodation through borrowing from other financial institutions	N/A	Applicable
Regulations regarding the provision of collateral when applying to the Central Bank of China for accommodation	It is necessary to provide sufficient collateral.	1. For that portion for which collateral has not been provided, the National Treasury should provide collateral. 2. In the case where the portion for which collateral has been provided exceeds net worth, the competent authority in conjunction with the Central Bank of China should seek to obtain the ratification of the Executive Yuan.
Enforcement rules regarding refusal to participate in deposit insurance	N/A	Imposing a civil penalty of two times the insurance premium and including this in the Deposit Insurance Fund
Enforcement rules regarding refusing deposit insurance assistance or not carrying out the recommendations resulting from the assistance	N/A	Imposing civil penalties ranging from NT$360,000 to NT$1.8 million.
Enforcement rules	N/A	Imposing civil penalties

regarding not making necessary improvements within the prescribed period after having been punished		of between 1 and 5 times for similar violations by institutions or individuals