

APEC Policy Dialogue on Deposit Insurance

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Since the 1980s, financial liberalization and internationalization have become major trends throughout the world. The global financial system is as a result becoming more integrated, new financial technologies and products are being promoted, and cross-border financial activities are becoming increasingly common. Thus the scope for financial activities is continuing to be enlarged. At the same time, competition between financial institutions is becoming increasingly fierce, and banking operations are becoming increasingly risky. It is for these reasons that financial supervisory authorities around the world are paying careful attention to the ability of financial institutions to control and manage risk.

Moreover, the deposit insurance mechanism has an important role to play in financial supervision in terms of allowing problem financial institutions to smoothly withdraw from the market. In designing their deposit insurance systems, many countries have gradually shifted their emphasis from serving as the pay box to taking on the role of risk-minimizer and loss-minimizer. In this way,

they have conferred upon the deposit insurance organizations the powers to control deposit insurance risk and handle problem financial institutions. The effectiveness of the deposit insurance mechanism can be fully revealed.

In the early days of deposit insurance in Taiwan, participation in deposit insurance was voluntary. The Central Deposit Insurance Corporation (CDIC) was able to control deposit insurance risk through those financial institutions that applied to participate in deposit insurance or else ceased to be part of the deposit insurance system. The government also asked the CDIC to examine certain insured institutions (including some of the banks and trust companies), as well as all of the credit cooperative associations and the credit departments of farmers' and fishermen's associations. While its powers were far-reaching, some of the larger state-owned banks and other financial institutions with sound operating structures were unwilling to participate in the deposit insurance system. Furthermore, some of the weaker financial institutions did not comply with the conditions for participation, with the result that the scope for the deposit insurance system to expand its operations was limited.

Beginning in 1999, the government on the one hand revised relevant laws and regulations, and strengthened the work of financial supervision as well as the regulations concerned with the handling of problem financial institutions. On the other hand, it also amended the Deposit Insurance Act so that participation in deposit insurance was made mandatory. The result was that all deposit-taking financial institutions have to participate in the deposit insurance system. Furthermore, in 2001 the Parliament approved the establishment of a Financial Restructuring Fund amounting to NT\$140 billion(US\$4 billion). The CDIC was also entrusted with implementing the work of financial restructuring, in the hope that, by means of the deposit insurance mechanism, those poorly-performing financial institutions would be able to smoothly withdraw from the market. In this way, a financial crisis could be avoided, and any potential problems quickly dealt with.

Taiwan is currently in the process of implementing large-scale financial reforms. Besides promoting a single financial supervisory system for banks, securities companies and insurance companies, a new agency--the Financial Supervisory Commission -- is to be established in July 2004, to handle the work of supervising and

examining all financial institutions. Furthermore, in view of the credit departments of farmers' and fishermen's associations are weak financial institutions that are in need of special assistance from the government. An independent agricultural financial subsystem was established in January 2004, so that the spreading of the financial crisis to the rest of the financial system can be avoided.

According to the new regulations, all financial institutions, including those in the agricultural financial sector, are required to participate in the deposit insurance system. In addition to shouldering the responsibility for providing deposit insurance, the CDIC will also be responsible for dealing with failed financial institutions. Therefore, in order to reduce the losses to the deposit insurance fund, thereby safeguarding the rights and interests of depositors and maintaining financial order, the CDIC must play both a proactive and a preventative role.

In exercising such a role, apart from controlling the new financial institutions' entry into and exit from the deposit insurance system, implementing the differential risk premium system, terminating failed financial institutions and fulfilling its pay-off function, the CDIC should also be vested with the authority to control deposit

insurance risk. As regards the indemnification for employees, interrelationships among financial safety-net players, and prompt corrective actions and trigger mechanisms for the early closure of troubled financial institutions, our views include the following:

(1) Conferring upon the deposit insurer independent and separate status in order to avoid manipulation by third parties and supervisory forbearance

Since the deposit insurance became a part of the financial supervisory mechanism, making profits has not been the objective, but it has rather had a key role to play in maintaining the soundness and stability of the financial system as a whole. In order to avoid its being influenced by large depositors, major shareholders and other related parties in the execution of its policies, and not be affected by political parties and other outsider forces, it is essential that the deposit insurer remain separate from and independent of all of these influences, so as to guard itself against possible manipulation by outsiders. In addition, deposit insurer with the role of risk-minimizer and loss-minimizer, could exert its function to avoid supervisory forbearance in order to protect insurance fund.

(2) Financial supervisory agencies should closely work

together by dividing their duties and having a mechanism in place for reaching agreement, to help control risk and deal with problem financial institutions.

The deposit insurer needs to fully understand the financial and business information of insured financial institutions, if it is to take appropriate action and protect the deposit insurance fund. Therefore, for the deposit insurer to complement its work, and share information or coordinate with other financial supervisory agencies, the regulatory framework needs to be clearly defined, and in order to facilitate the handling of failed financial institutions.

(3)The deposit insurer should have the power to conduct specific examinations and take prompt corrective actions in order to control deposit insurance risk.

The deposit insurer needs readily to maintain a firm grasp of the operating conditions of financial institutions. If there are unsound or unsafe business practices, the deposit insurer needs to understand the situation in greater depth. If there is a crisis or any events possibly endangering the deposit insurance fund, the deposit insurer should first of all notify relevant financial supervisory agencies so that appropriate corrective

measures can be taken. If the relevant financial supervisory agencies are unable to adopt the necessary corrective measures in a timely manner, the deposit insurer should have the right to take the necessary corrective actions.

(4) An environment and conditions for establishing prompt corrective action (PCA) need to be established.

Financial institutions should, in accordance with guidelines for the sound operations of financial institutions, improve corporate governance, the management of their internal controls and their accounting systems. In this way, their business information can become more transparent, thus making the adoption of the capital adequacy ratio as a basis for taking prompt corrective actions and withdrawing from the market more meaningful.

(5) Appropriate safeguards to protect financial safety-net employees from legal action taken against them should be put in place.

When the deposit insurer pursuant to law acts as a receiver or conservator or deals with a failed financial institution, it will affect the rights and interests of parties related to the financial institution, especially large depositors or shareholders. For this reason, when taking

the above-mentioned action, no matter how careful they are, deposit insurer's employees may be sued by any of these related parties, and the lack of legal protection for employees can reduce incentives to be vigilant in carrying out their responsibilities. Therefore, in order to encourage deposit insurer employees to actively fulfill their responsibilities, laws should be put in place to protect them in the normal course of their duties. Unless there is concrete evidence that shows that they have intentionally violated the law or have major shortcomings, they should be granted immunity from legal action taken against them.