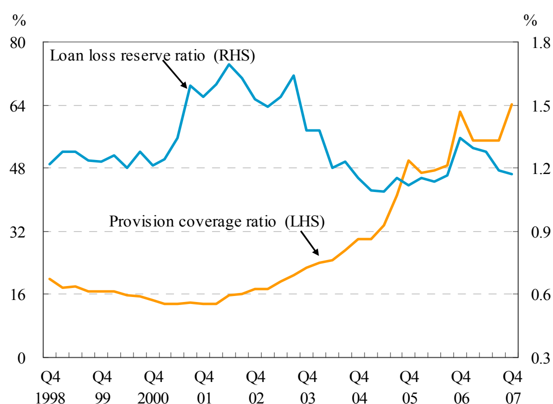
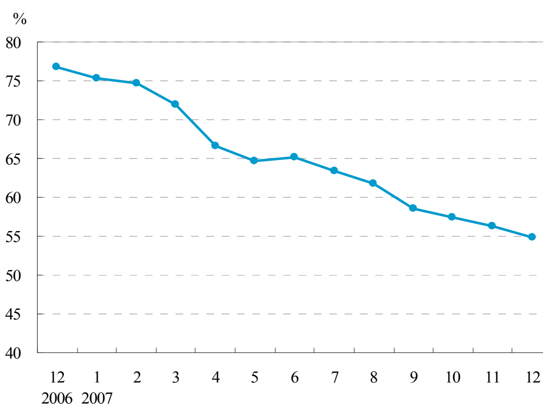
the implementation on 11 April 2008 of the Consumer Debt Clearance Act could trigger a new round of defaults, so the situation needs to be watched closely (Box 2).

Chart 4.7 Provision coverage ratio and loan loss reserve ratio of domestic banks



Notes: 1. Provision coverage ratio = loan loss provisions / non-performing loans. Loan loss reserve ratio = loan loss provisions / total loans.
2. Excludes interbank loans.
Source: CBC.

Chart 4.8 Repayment rate on modified debts of domestic banks



Notes: 1. Modified debts refer to the debts generated from credit card and cash card credits and unsecured consumer loans that were currently in the workout process.
2. Repayment rate = monthly repayment cases / total modified debt cases.
Source: CBC.

Box 2
Potential impact of Consumer Debt Clearance Act on banks

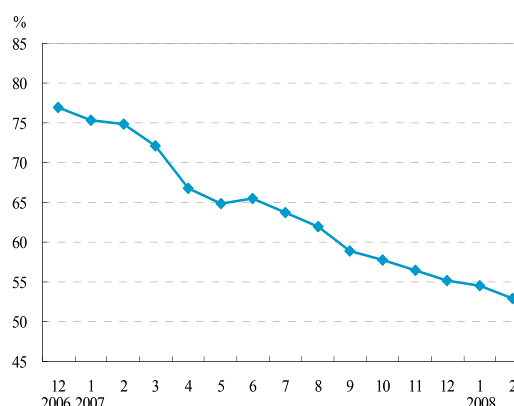
The Consumer Debt Clearance Act, which was promulgated on 11 July 2007 and entered into force on 11 April 2008, is intended to enable debtors who are unable to repay their debts to clear up their debts by opting for either credit rehabilitation or debt liquidation, provided that certain statutory requirements are met. However, in order to avoid encouraging abuse of the mechanism and to safeguard the right of creditors to repayment on fair terms, there are restrictions on who is eligible for relief under the Act. Before applying for credit rehabilitation or debt liquidation under the Act, a debtor must first go through a pre-negotiation process with the biggest financial creditor. Debtors who are approved to apply for rehabilitation or liquidation are also subject to certain restrictions on their rights. Implementation of the Consumer Debt Clearance Act could affect financial institutions in the following ways:

1. Possibility of moral hazard

Under the previously existing Individual Debt Restructuring Program, principal could

not be forgiven for a debtor who went through a workout process for unsecured debt with a member of the Bankers Association. Since implementation of the Consumer Debt Clearance Act, however, a debtor who applies successfully for credit rehabilitation or debt liquidation can have principal forgiven. In addition, businesses have sprung up promising to arrange for rehabilitation or liquidation on behalf of debtors, and in the process have pushed inflated expectations that could lead to moral hazard. Statistics compiled from data reported by card issuers[1] indicate that the repayment rate at the end of 2006 under the existing Individual Debt Restructuring Program was over 70%, but it has steadily dropped since then to 52.97% as of 29 February 2008 (Chart B2.1), and part of the decline is attributable to debtors' undue expectations about how they might benefit from the Consumer Debt Clearance Act.

Chart B2.1 Repayment rate on modified debts of all card issuers



Notes: 1. Definitions of modified debts and repayment rate are same as chart 4.8.
2. Card issuers include domestic banks and local branches of foreign banks.
Source: CBC.

2. Arrears mounted, bank profits declined

Card issuers had NT$15.1 billion in non-performing credit related to their credit card and cash card businesses on the books as of 29 February 2008. On that same day, the banks were also owed another NT$45.6 billion on consumer loans (which include credit card and cash card credits and unsecured consumer loans) that were currently in the workout process but did not have to be reported as non-performing credit. Assuming a default rate of 70% on the latter, total non-performing credit would increase to NT$47.6 billion. Given the fact that the aggregate loan loss provisions of all card issuers currently stands at NT$22.9 billion, a 70% default rate also means that banks would have to set aside another NT$24.7 billion in loan loss provisions to maintain a coverage ratio of 100%. This in turn would result in a decline in profitability.

3. Bottleneck at the pre-negotiation stage

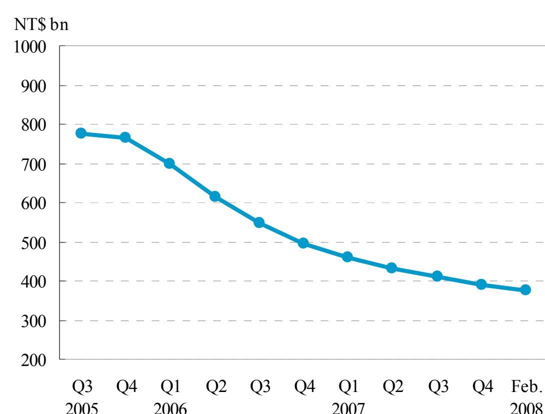
Now that the Consumer Debt Clearance Act has entered into force, applications for credit rehabilitation or debt liquidation must be preceded by a pre-negotiation process with

financial institutions, which should cause a spike in the number of applications for pre-negotiation. In particular, those banks that make relatively large numbers of mortgage loans often tend to be the biggest creditors and have to deal with more pre-negotiation cases. They have to assign more specialists who are intimately familiar with the procedures called for under the Consumer Debt Clearance Act to carry out pre-negotiation with debtors. During the early stages of implementation, banks are expected to have problems in training and staffing sufficient personnel.

4. Consumer credit squeeze could spur black market lending

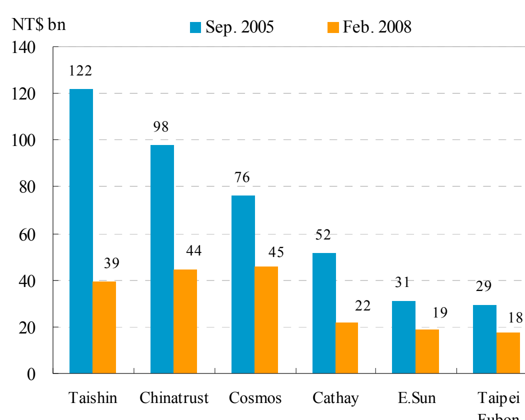
Problems with payment on card debt first came to the fore in September 2005. The aggregate outstanding card debt loans owed to card issuers (including both domestic banks and the local branches of foreign banks) eventually peaked at NT$776.7 billion before dropping by 51.4% to NT$377.1 billion in February 2008 (Chart B2.2). Outstanding card debt receivables have fallen especially dramatically for leading card issuers like Taishin International Bank (68.0%), Cathay United Bank (58.5%), Chinatrust Commercial Bank (54.6%), Cosmos Bank (40.6%), Taipei Fubon Commercial Bank (40.5%), and E.Sun Commercial Bank (39.7%) (Chart B2.3). Moral hazard arising from implementation of the Consumer Debt Clearance Act may continue to expand, and prompt risk-conscious banks to rein in on their card businesses and unsecured consumer loans. This in turn could push debtors who are in relatively shaky financial conditions to turn to black market lenders for credit.

Chart B2.2 Outstanding credit card and cash card debts of all issuers



Notes: 1. End of period figures.
2. Includes credit cards revolving credits and cash card loans.
Source: CBC.

Chart B2.3 Outstanding credit card and cash card debts owed to principal issuers



Note: End of period figures.
Source: CBC.

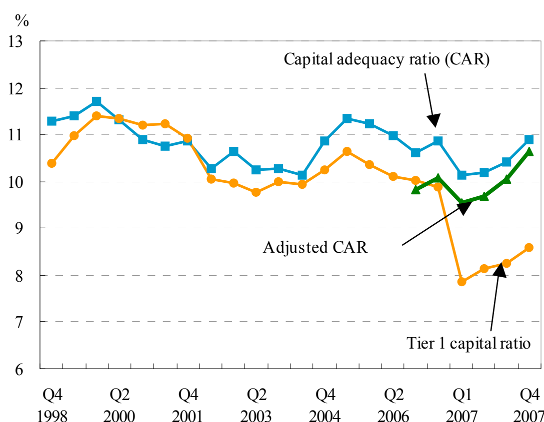
To lower the impact of implementation of the Consumer Debt Clearance Act, banks could take the bull by the horns by actively working with delinquent debtors on repayment plans, encouraging them to continue performing their obligations, and enhancing their pre-negotiation mechanisms in order to reduce the percentage of debtors who end up applying for credit rehabilitation or debt liquidation proceedings. In the meantime, in order to decrease the likelihood of debt workout talks falling through on account of failure to conclude within the mandated time period, the FSC Banking Bureau has consulted with related parties to streamline the procedural and data requirements for investigation, so as to cut down on the length of time it takes for a primary creditor involved in debt workout discussions to contact other parties to get needed information regarding the debtor's property, income, business, and credit status.

Note 1: The term "card issuers" includes both domestic banks and the local branches of foreign banks.

Capital adequacy ratios increased gradually

The capital adequacy ratios of domestic banks fell markedly upon implementation of the Basel II Accord in early 2007 (Box 3), but recovered gradually since then due to improving profitability and foreign capital infusions into some weak banks. By the end of 2007, the

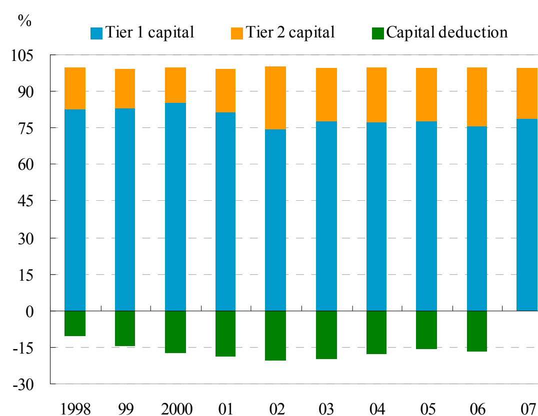
Chart 4.9 Capital adequacy ratios of domestic banks



Notes: 1. End of period figures.
2. The data are on semiannual basis before June 2006 and on quarterly basis after September 2006.
3. Adjusted capital adequacy ratio = (eligible capital - unamortized deferred assets arising from losses recorded on the sale of non-performing assets) / risk -weighted assets.

Source: CBC.

Chart 4.10 Structure of Eligible regulatory capital of domestic banks



Notes: 1. End of period figures.
2. Capital deductions are deducted directly from Tier 1 and Tier 2 capital from the beginning of 2007 when implementing Basel II, and are not showed herein after then. Tier 3 capital is not showed herein as it is less than 1% of total capital.

Source: CBC.