IV. Measures to maintain financial stability

In 2013, under the circumstances of stable recovery in the global and domestic economies and moderate inflation, Taiwan's financial market performed smoothly. Profitability of financial institutions kept trending up, and asset quality continued to improve, while most financial institutions maintained satisfactory capital levels except for a few life insurance companies. The three systemically important payment systems also operated soundly. As a whole, Taiwan's financial system remained stable.

The CBC has been closely watching the changes in global and domestic economic and financial conditions and noted several issues, especially the spillover effects of the US gradual exit from its easy monetary policy, slowing economic growth and rising shadow banking risks in Mainland China, and the potential impacts of domestic house price movements on the asset quality of real estate loans of financial institutions. The CBC will continually monitor the influence of those issues on the domestic economy and financial system and implement appropriate monetary, credit and foreign exchange policies. Meanwhile, the FSC also continues to amend financial laws and regulations and undertakes measures to strengthen financial supervision, aiming at maintaining the soundness of financial institutions and improving financial stability.

4.1 Measures taken by the CBC to promote financial stability

4.1.1 Adopting sound monetary policies to address the changes in economic and financial conditions

Policy rates remained unchanged in 2013

Considering the moderate prospects for domestic economy growth and inflation, as well as the uncertainties in the global economic outlook, the CBC kept policy rates unchanged[69] in 2013 so as to maintain price and financial stability and promote economic growth.

[69] From 1 July 2011, the CBC has kept the discount rate, the rate on accommodations with collateral, and the rate on accommodations without collateral unchanged at 1.875%, 2.25%, and 4.125%, respectively.

Reserve money growth remained moderate

The CBC adopted open market operationsto keep reserve money at appropriate levels. In 2013, the total loans and investments of all banks grew by 5.60%, while M2 grew by 4.78% year on year, both of which were higher than the GDP growth of 2.11% in the same period. This illustrated that market liquidity was sufficient to support economic activity.

The CBC will implement appropriate monetary policies in a timely manner

The CBC will keep closely monitoring inflation, the output gap, as well as global and domestic economic and financial developments and undertake appropriate monetary policies in a timely manner.

4.1.2 Continually implementing risk management policies for real estate loans to promote the soundness of banks and financial stability

To maintain financial stability and urge financial institutions to control the risks associated with real estate loans, the CBC has implemented targeted prudential measures against housing loans in specific areas, land collateralized loans and high-value housing loans since June 2010. The effort has come to fruition.

In 2013, the CBC continued to implement risk management policies for real estate loans. Firstly, the CBC urged banks to strengthen their risk management for real-estate lending in “non-specific areas” with considerable housing price surges in March. To follow the CBC’s policies, most big banks adopted self-restraint measures, such as expanding the scopes of specific areas, lowering loan-to-value ratios, removing grace periods and raising mortgage interest rates. In December, to prevent banks’ funds from being used for real estate speculation, the CBC further urged those banks with greater business volumes in collateralized industrial land lending to rigorously comply with credit regulations.

4.1.3 Stabilizing the NT dollar exchange rate under a managed float regime

Implementing flexible foreign exchange rate policies

Taiwan adopts a flexible managed floating exchange rate regime, and the exchange rate of the NT dollar is in principle guided by the market mechanism. Only when there are aberrations, such as an abnormally large inflow or outflow of short-term capital, and seasonal changes causing the exchange rate to over-fluctuate with adverse implications that could destabilize the domestic economy and financial markets, does the CBC step in to maintain an orderly foreign exchange market. The exchange rate of the NTD against the USD has been relatively stable since the onset of the global financial crisis.

4.1.4 Maintaining an orderly foreign exchange market and improving its sound development

To prevent excessive volatility of the NTD exchange rate from endangering financial stability, the CBC continued to adopt management measures targeting massive short-term capital inflows and outflows, mainly including (1) implementing a Real Time Reporting System for Large-Amount Foreign Exchange Transactions to closely monitor the inflows and outflows of foreign capital; (2) overseeing the usage of NTD demand deposit accounts of foreign capital to ensure the funds were invested in domestic securities as declared and not placed in demand deposit accounts for a long time.

The CBC urges authorized foreign exchange banks to strengthen their foreign exchange rate management in order to mitigate the risk exposures of individual banks and systemic risks of the whole market.

The CBC strengthens on-site inspections on foreign exchange forward transactions to ensure they were undertaken for real demand purposes in order to restrain foreign exchange speculation. Moreover, target examinations on foreign exchange transactions were implemented when necessary to maintain an orderly foreign exchange market.

4.1.5 Continually opening the market for new foreign currency derivatives and expanding foreign currency call loan and swap markets

In order to expand the services provided by financial institutions and satisfy customer demand for risk hedging and portfolio management, the CBC has continually granted licenses to investment trusts, investment consulting firms, securities firms and bills houses to provide onshore and offshore financial services and products. At the end of 2013, 24 foreign currency derivative products and five NTD-linked derivative products had been approved. The transaction volume of these products totaled US$4.54 trillion in 2013.

Furthermore, the CBC has appropriated US$20 billion, €1 billion, and ¥80 billion as seed funds from its foreign exchange reserves to participate in the operation of the Taipei Foreign Currency Call Loan Market. The CBC also continued to extend foreign currency call loans to banks and conduct currency swaps with banks to meet corporate funding needs and maintain foreign currency liquidity in the domestic banking system. In 2013, the turnover amounts of the Taipei foreign currency call loan and interbank USD/NTD currency swap markets were US$1.36 trillion and US$1.13 trillion, respectively, and the outstanding of both markets at the end of the year registered US$24.2 billion and US$158.8 billion, respectively.

4.1.6 Continually developing financial stability assessment tools

To strengthen its function of financial stability assessment, the CBC continued to collect and study the new assessment tools developed around the world, and explored the possiblities to incorporate them into the domestic financial system for reference. Among them, the Bank Health Index (BHI) and Health Assessment Tool (HEAT), developed by the IMF,[70] have the merits of easy operation and effectively testing bank soundness.

Referring to HEAT, the CBC conducted a practice run using domestic banking data from 1998 to 2013. The result showed that, in general, the HEAT assessment tool could capture the influences of severe financial events and banking M&A on banks' soundness. Meanwhile, it should be noted that the BHI index only reflected the relative but not absolute soundness or weakness of individual banks. In addition, HEAT may have some room for improvement when implemented in Taiwan, such as including more financial indices and considering the appliance of different weights on individual banks based on their importance to the whole banking sector.

4.2 Measures undertaken by the FSC to maintain financial stability

From 2013 onwards, the FSC launched several policy measures to facilitate financial development and financial deregulation, including, among others, expedited promotion of a Taiwan-centric wealth management platform, development of financial services with cross-strait characteristics, and inclusion of the financial industry in the government's free economic pilot zones plan. Concurrently, the FSC continually revised financial laws and regulations and undertook supervisory reforms to preserve financial stability.

[70] Li Lian Ong, Phakawa Jeasakul and Sarah Kwoh, (2013) "HEAT! A Bank Health Assessment Tool, "*IMF Working Paper*, WP/13/177, August.

4.2.1 Strengthening surveillance of the risks related to banks' real estate loans

Continued supervision of the banks overly concentrating in real estate lending

For those banks with higher concentrations in real estate loans, the FSC consistently urged them to set aside additional provisions for loan losses based on the principle of differentiated supervision. Moreover, the FSC required that banks should not increase the loans to real estate development projects in the name of working capital financing or other types of loans by way of pledge or transfer of the beneficiary rights of real estate asset trusts. In 2013, there were nine banks under close surveillance, less than the 17 in 2011, showing that the surveillance of those banks was effective.

Implementing stress testing to evaluate banks' ability to respond to house price declines that could cause potential losses

In order to address potential risks resulting from house price declines, the FSC required domestic banks to carry out stress tests in April 2014 using financial data as of the end of 2013. The tests focused on credit exposures associated with housing loans and lending to the construction industry based on three risk factors including a fall in house prices, a rise in the interest rate, and a decrease in borrowers' incomes under adverse scenarios in differing degrees.[71] The test result showed that all banks' capital adequacy ratios were higher than the minimum standard of 8% under the stress scenarios, indicating that banks were still able to react to potential losses arising from house price declines.

4.2.2 Persistently enhancing banks' risk bearing and managerial ability

Raising banks' regulatory capital ratios and loan loss provisions

Domestic banks have implemented the Basel III requirements since 2013, raising capital and improving its quality year by year. The FSC issued the *Regulatory Measures to Strengthen the Credit Risk Management of Domestic Banks* in January 2013, adopting differentiated incentive rewarding and supervision to guide banks to raise the loan loss provision ratios for credit assets classified as category one (i.e., normal credit assets), to be at or above the 1% minimum. Subsequently, the FSC, in January 2014, revised the *Regulations Governing the*

[71] The adverse scenario assumes a 20% drop in house prices and a one-percentage-point increase in the interest rate while the more adverse scenario assumes a 30% drop in house prices and a rise of two percentage points in the interest rate. Both scenarios additionally assume a decrease in borrowers' incomes to make the stress testing effects stronger.

Procedures for Banking Institutions to Evaluate Assets and Deal with Non-performing/Non-accrual Loans, which stipulated that the minimum loan loss provision and guarantee reserve shall be the sum of 1% of the outstanding claim balance of category one credit assets by the end of 2014. The *Regulations* added a requirement that, the FSC, if necessary, may require banks to raise loan loss provisions and guarantee reserves of specific credit assets, so as to strengthen the ability of banks to bear risks and ensure their loss absorbency.

Reinforcing the oversight of banks' exposures to Mainland China

By way of total investment control, capping risk exposures and imposing a ceiling on credits undertaken by OBUs or overseas branches of financial institutions (Box 4), the FSC strengthened its oversight of banks' exposures to Mainland China and urged banks to earnestly fulfill risk management.

4.2.3 Strengthening the supervision of the insurance industry

Improving the financial structure and loss absorbency of insurers

In order to improve the financial structure of life insurance companies, the FSC required that the special reserve set aside for the real estate revaluation increment under the IFRSs in 2013 should first of all offset any shortfall after the reserves for in-force business have been calculated on the assigned basis of fair value. If there is a remainder after the offsetting, it should be recognized as a special surplus reserve under stockholders' equity and should not be distributed without approval.

In February 2014, the FSC further issued rules that allow insurers to opt for subsequent measurement of investment property at fair value and set out the relevant package measures, such as requirements on outsourced professional appraisal, case-by-case reviews by certified public accountants (CPA), and appropriation of special surplus reserves for related capital gains along with limiting their distribution for the purpose of offsetting any subsequent liabilities that might arise due to a shortfall in reserves.

Moreover, in order to raise insurers' loss absorbency, the FSC revised regulations in October 2013, requiring them to set aside sufficient provisions for loan losses not lower than 1% of their outstanding loan assets.

Broadening the channels for insurers' uses of funds

In order to raise insurers' capital efficiency and broaden the channels for the uses of funds, the FSC successively promoted and guided their funds towards investments in public infrastructure projects and long-term care facilities. Furthermore, the FSC loosened restrictions, allowing insurers that meet certain conditions to be eligible to invest in foreign corporate bonds, offshore (covering Mainland China) real estate, and RMB-denominated financial products.

Enhancing the resolution regime for troubled insurers

In order to strengthen the resolution regime for and supervision of troubled insurers, the FSC put forward a draft for partial revision to the *Insurance Act* in 2013, which was passed by the Legislative Yuan on 20 May 2014. The focal points of the revisions include enhancement of supervisory measures on insurers experiencing operational difficulties: for example, ordering them to submit a plan to improve their finances and business and take disciplinary actions. The revisions also include the strengthened resolution regime for troubled insurers, which contains that a receiver may deliberate a bridge plan for recovery and resolution of a failed insurer.

4.2.4 Improving securities market order and facilitating its development

Strengthening the supervision of backdoor listings

To protect the rights of shareholders, the TWSE and the GTSM have been implementing the enhanced supervisory measures for backdoor listings since December 2013. For example, in the case of listed companies which underwent a transfer of management rights and significantly changed the scope of their operations within one year before or after that transfer, their stocks may be suspended from trading for up to a maximum of six months. Such companies will also be required to fully disclose all information pertaining to the transfer of management rights, the change in the scope of business, and their future business plans. Furthermore, the Market Observation Post System (MOPS) set up a specific compilation table related to changes in management rights (namely, information about major shareholdings of directors, supervisors and high-ranking managers) in December 2013, providing investors with the relevant information.

Promoting the RMB Formosa Bond Market and creating GISA

In order to promote the development of the offshore RMB bond market in Taiwan, the FSC, subsequent to the first public listing of Formosa Bonds in March 2013, announced policy measures in November on the expansion of the scale of issuance and scope of participation in the Formosa Bond market. Mainland Chinese banks and their overseas affiliates or branches, overseas branches of Taiwanese financial institutions in Mainland China, and Taiwan's listed companies' affiliates in Mainland China are allowed to issue RMB-denominated common corporate bonds that can only be sold to professional institutional investors. Moreover, to enable micro and small innovative companies to raise needed capital, the FSC approved the GTSM's *Regulations Governing the Go Incubation Board for Startup and Acceleration Firms* (GISA) in November 2013, which enabled the GISA to start operation from January 2014.