IV. Measures to maintain financial stability

In 2014, against a backdrop of moderate growth in the global and domestic economies and modest inflation, Taiwan's financial markets and infrastructure maintained smooth operations and sound development. Financial institutions' profitability strengthened, asset quality continued to improve simultaneously, and capital levels largely rose. As a whole, Taiwan's financial system remained stable.

As a result of uneven economic recovery and the divergence of monetary policies among major economies, international financial markets fluctuated significantly, which, in turn, heightened uncertainties over global economic recovery. Facing changes in global and domestic economic and financial conditions, especially slowing economic growth in Mainland China, expanding quantitative easing monetary policies by the ECB and the spillover effects likely induced by the US monetary policy normalization in the future, the CBC will continue to closely monitor the influence of these issues on the domestic economy and financial system and adopt appropriate monetary, credit and foreign exchange policies. Meanwhile, the FSC also continues to update 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

The CBC continued to approve new foreign exchange financial products prudently to foster a more diversified market, and to appropriately review and relax restrictions on foreign exchange business to allow financial institutions to expand their business scope. In addition, the CBC also implemented appropriate monetary, credit and foreign exchange policies to improve financial stability.

4.1.1 Adopting appropriate monetary policies to cope with domestic and global economic and financial conditions

Policy rates remained unchanged in 2014

The uneven pace of economic recovery and the divergence of monetary policies in major economies resulted in greater fluctuations in international financial markets and heightened uncertainties over global economic recovery. Coupled with a negative domestic output gap and manageable inflation expectations, the CBC kept policy rates unchanged[84] in 2014 so as to maintain price and financial stability and promote economic growth.

Reserve money growth remained moderate

The CBC accommodated financial markets with funds to keep liquidity at appropriate levels through open market operations. The total loans and investments of all monetary institutions steadily increased, growing respectively by 4.96% and 5.66% year on year in 2014, higher than the GDP growth rate of 3.74% in the same period, while the monetary aggregate M2 maintained growth within its targeted range. This indicated that market liquidity was sufficient to support economic activity.

The CBC will implement appropriate monetary policies and macro-prudential policy tools as needed

The CBC will continue to closely monitor price conditions, the output gap, as well as changes in global and domestic economic and financial conditions, and undertake monetary policies and macro-prudential policy tools flexibly to achieve its statutory mandates.

4.1.2 Continually implementing targeted prudential measures for real estate loans

In order to prevent banks' funds from being used for housing and land speculation and urge financial institutions to control the risks associated with real estate loans, thereby protecting the rights of depositors and promoting financial stability, the CBC has continually implemented targeted macro-prudential measures against house-purchase loans in the designated Specific Areas, land collateralized loans and high-value house-purchase loans

[84] 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.

since June 2010. Since the implementation of these measures, concentration in real estate loans and loan-to-value (LTV) ratios have both declined, and mortgage interest rates have increased. The effort has come to fruition.

In view of the developments in the housing market and credit risk management of financial institutions, the CBC further amended the relevant regulations in June 2014, which included: (1) expanding the scopes of Specific Areas (adding four more districts in New Taipei City and another four in Taoyuan City); (2) requiring an additional LTV ratio cap of 50% on the third or more house-purchase loans taken out by natural persons, applicable to properties across the country; (3) revising the definition of high-value housing[85] and lowering its LTV ratio ceiling to 50%; (4) lowering the LTV ratio ceiling on house-purchase loans taken out by corporate legal entities to 50% for properties across the country. Moreover, to prevent borrowers from using banks' funds for industrial land speculation and to encourage the use of industrial land, the CBC called on banks to exercise rigorous self-discipline on land collateralized loans of idle land in industrial zones in February 2015, so as to urge banks to implement risk management of industrial land collateralized loans and assist industrial development in Taiwan (Box 3).

4.1.3 Implementing a managed float regime to stabilize the NT dollar exchange rate

Adopting 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 and move in a disorderly fashion with adverse implications that could destabilize the domestic economy and financial markets, will the CBC step in to adjust the market in a timely manner.

Maintaining an orderly foreign exchange market and improving its sound development

The divergence of monetary policies in the US, Japan, the euro area, etc. since 2014 has resulted in rising uncertainties and volatility in international short-term capital movements.

85 The definition of high-price housing is revised to the appraised values or purchase prices of houses above NT$70 million in Taipei City, above NT$60 million in New Taipei City, and above NT$40 million in other areas.

The CBC will continue to closely monitor their dynamics and influence on the NT dollar exchange rate. Should there be an inordinate inflow or outflow of capital, leading to the foreign exchange rate over-fluctuating, the CBC will undertake appropriate management measures to maintain an orderly foreign exchange market.

1. To prevent excessive volatility of the NT dollar exchange rate from endangering financial stability, the CBC implements the Real Time Reporting System for Large-Amount Foreign Exchange Transactions to monitor the latest transaction information in the foreign exchange market.

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

3. The CBC strengthens targeted examinations on foreign exchange businesses and forward transactions to ensure they are undertaken for real demand purposes, in order to restrain foreign exchange speculation and maintain discipline in the foreign exchange market.

4. To avoid interruption in the market from foreign speculative funds, the CBC requires authorized foreign exchange banks to follow the sum of position limits for NTD non-delivery forwards (NDF) and foreign exchange options such that the combined amount may not exceed one-fifth of the total position limit.

4.2 Measures undertaken by the FSC to maintain financial stability

From 2014 onwards, the FSC launched several policy measures to facilitate financial development and deregulation, such as relaxing business restrictions on OBUs, opening up the establishment of OSUs and OIUs, as well as promoting the Financial Import Substitution Program, the Digital Financial Environment Building Program and the program to boost securities markets, etc. Concurrently, the FSC has continued to strengthen financial supervision to maintain financial stability.

4.2.1 Continually adopting related supervisory measures on real estate loans

From 2011 onwards, the FSC has required banks with high credit concentration in housing loans or construction loans[86] to undertake control measures and set aside additional provisions for loan losses, as well as lifting the risk weights of housing loans for non-self-use properties from 45% to 100% in April 2011. Moreover, from 2014 onwards, the FSC continuously adopted additional supervisory measures, which included：(1) requiring domestic banks to conduct stress tests in May 2014, based on adverse scenarios of falling house prices, rising interest rates and declining borrowers' incomes,[87] to assess banks' loss absorption abilities;[88] (2) strengthening the identification of self-use residential loans according to the one-person-one-house principle; (3) requiring banks to raise loss provision ratios of housing loans and construction loans to 1.5% or more before the end of 2016.

4.2.2 Strengthening banks' risk controls over exposures to Mainland China

In addition to current risk limit requirements,[89] the FSC further undertook the following measures since 2014 to enhance banks' risk controls over exposures to Mainland China：

1. Requiring banks to conduct stress tests of risk exposures to Mainland China based on unified stress scenarios[90] to assess banks' loss absorption abilities.[91]

2. Adopting five more measures at the end of 2014, namely (1) reinforcing on-site examinations of banks' credit risk management related to exposures to Mainland China; (2) urging banks to formulate measures regarding claims protection suited to local

[86] The concentration levels for real estate loans are advised to stay below the standards as follows:

Regulated loans to total	Top ten banks on real estate loans	Other banks
Housing loans / total loans	30%	40%
Construction loans / total loans	10%	15%
Real estate loans / total loans	70%	

[87] The minor scenario assumes a 20% drop in house prices and one percentage point increase in the interest rate; while the severe scenario assumes a 30% drop in house prices and two percentage point rise in the interest rate. Both scenarios additionally assume a decrease in borrowers' incomes.

[88] The stress test results showed that potential losses under the minor and serious scenarios were NT$37.4 billion and NT$73.8 billion, respectively, which could result in average capital adequacy ratios falling to 11.71% and 11.56%, respectively. However, the ratios of all banks were still above the regulatory minimum of 8%.

[89] Current regulatory risk limits of banks' exposures to Mainland China include: (1) the cumulative allocated operating capital of a Taiwanese bank's branch in the Mainland Area combined with its total amount of investment in the Mainland Area shall not exceed 15 percent of the bank's net worth; as for a Taiwanese financial holding company, the total amount of investment in the Mainland Area shall not exceed 10 percent of its net worth; (2) the aggregate amount of credit that third-area branches and OBUs of a Taiwanese bank may extend in the Mainland Area shall not exceed 30 percent of its net assets; (3) the aggregate amount of credit, investment and interbank loans and deposits of a Taiwanese bank's business activities in the Mainland Area shall not exceed 100 percent of the bank's net worth as of the end of the preceding fiscal year.

[90] The minor scenarios were 7% Mainland China GDP growth, 2.5% non-performing loan ratio and a one percentage point interest rate rise; the severe scenarios were 5.5% Mainland China GDP growth, 4% nonperforming loan ratio and a 2.5 percentage point interest rate rise.

[91] The stress test results showed that potential losses under the minor and severe scenarios were approximately NT$34.4 billion and NT$72.9 billion, respectively, with average capital adequacy ratios falling to 12% and 11.85%, respectively. The ratios for all banks under stress scenarios were above the regulatory minimum of 8%.

conditions; (3) asking banks to prudently review overseas credit policies; (4) taking the performance of credit risk management into consideration for approving or rejecting a bank's application for establishing an overseas branch; (5) enhancing related regulatory reports and requiring the Central Deposit Insurance Corporation (CDIC) and the Joint Credit Information Center (JCIC) to help monitoring credit risks in Mainland China.

3. In April 2015, the FSC further adopted the following measures: (1) requiring banks to sufficiently verify the authenticity of related documents of short-term trade financing; (2) asking banks' audit departments to conduct internal audits on the authenticity of short-term trade financing, which should otherwise be counted into exposure to Mainland China; (3) including new interbank loans/deposits, of which the maturity is extended to more than 3 months, into the calculation of exposure to Mainland China; (4) increasing the regulatory loss provision ratio of performing credit assets exposed to Mainland China to at least 1.5% by the end of 2015. The FSC will review the effectiveness of the first three aforementioned measures at the end of 2015.

4.2.3 Establishing an exit mechanism in the insurance industry and strengthening the functions of the Taiwan Insurance Guaranty Fund

1. In February 2015, the FSC amended the *Insurance Act*, establishing a prompt corrective action mechanism for the insurance industry. The amendment classifies insurance companies by RBC ratio into four tiers, including capital adequate (RBC ratio above 200%), capital inadequate (RBC ratio above 150% but under 200%), capital obviously inadequate (RBC ratio above 50% but under 150%), and capital seriously inadequate (RBC ratio under 50% or negative equity), and requires the FSC to adopt different supervisory measures for companies in each tier. For those companies classified as "capital seriously inadequate," the FSC should take them over, close them down or dissolve them within a limited period (90 days), so as to enhance supervision on and establish an exit mechanism for the insurance industry.

2. In order to strengthen the functions of the Taiwan Insurance Guaranty Fund (TIGF) and improve the operations of the exit mechanism for insurers, the FSC amended the *Regulations Governing Organization and Management of Insurance Guaranty Fund* and the *Regulations Governing the Conservatorship and Receivership of Insurance Enterprises* in November 2014. They provide the TIGF with claim rights over its advance funds on behalf of a troubled insurer, regulate the duties of receiver and rehabilitator,

require the TIGF to establish a risk management division, and initiate a transitory insurance mechanism if necessary. In addition, to urge insurers to mitigate business risks and implement differential supervision, the FSC released rules in April 2014 to adopt a risk-based contribution regime that requires insurers to contribute to the TIGF based on risk assessment results.

4.2.4 Other supervisory measures

1. To better safeguard the interests of financial consumers, the FSC amended the *Financial Consumer Protection Act* in February 2015 to augment the responsibilities of financial institutions on the sale of financial products and services, as well as expanding the scope of consumer claims for compensation.[92] In addition, the FSC revised the *Banking Act* to cap the interest rate of cash cards and the revolving interest rate of credit cards both at 15%, with a view to effectively reducing the interest burden of card holders.

2. In view of the inadequate implementation of know-your-customer practices, product suitability assessment and full disclosure of risks when conducting complex financial derivatives businesses, the Bankers Association revised related self-discipline guidelines in June 2014. Moreover, the FSC amended the *Directions for Banks Conducting Financial Derivatives Business* in December 2014, to strengthen banks' risk management and customer protection regarding complex and high-risk products. The amendments also require banks to improve review procedures for launching new types of products and reinforce employee compensation programs and product suitability rules, so as to facilitate the sound development of the derivatives business.

3. To enhance regulatory compliance of financial institutions, the FSC revised related regulations on internal audits and internal controls of financial holding companies, banks and insurance companies in August 2014. It reinforces the independence and obligations of compliance divisions, empowers chief compliance officers to sign off on any plans for launching a new product or business and evaluate compliance performance of each division, and upgrades the position of the chief compliance officers.

4. The FSC strives to continuously improve corporate governance of listed companies,

[92] For example, when financial institutions violate regulations and invade the rights of financial consumers, the competent authority may impose enforcements, such as warning, suspension of product sales or revoking business licenses, depending on how serious the violation is. In addition, for those seriously violating regulations, the competent authority may fine them up to an unlimited amount within the scope of gains from the violation. Moreover, to prevent salespersons at financial institutions from improperly selling financial products and services, the amendment also requires that salespersons' remuneration programs and the selling of new, complex and high-risk products should get approval from the board of directors. This helps to raise more attention and enhance responsibility of executives of financial institutions to financial consumer protection.

which includes: (1) supervising the Corporate Governance Center of the TWSE to build a corporate governance evaluation system in March 2014 and releasing the outcome of the first evaluation in April 2015; (2) requiring certain listed companies such as food makers, chemical manufacturers, banks, insurance companies and other qualified companies to compile and disclose corporate social responsibility (CSR) reports by the end of June or December 2015.