Box 3
Implementation of Basel II in Taiwan

After numerous revisions and quantified impact studies, the Basel Committee on Banking Supervision (Basel Committee) formally issued the International Convergence of Capital Measurement and Capital Standards: A Revised Framework (Basel II) in June 2004. Taiwan, like most countries around the world, responded by implementing Basel II from the beginning of 2007 in order to keep in synch with international trends and strengthen risk management practices in the domestic banking industry.

1. Timetable for phased implementation of Basel II

In compliance with directives issued by the Financial Supervisory Commission (FSC), Taiwan's banks commenced a phased implementation of Basel II in 2007. The key implementation phases are as follows:

- First Pillar (minimum capital requirements): Taiwan's banks began to calculate their regulatory capital requirements in accordance with the Basel II rules from 2007 Q1;
- Second Pillar (supervisory review): As of April 2008, Taiwan's banks are required to file internal capital adequacy assessment results and risk indicators self-assessment reports with the FSC on an annual basis; and
- Third Pillar (market discipline): As of April 2008, banks are required to establish a special section on their websites to disclose information on capital adequacy and risk management.

2. All banks opt for simple approaches in the first year of implementation

Taiwan's regulations on Basel II allow banks to choose among several different approaches to calculating minimum capital requirements. For credit risk, there are the standardized approach, the foundation internal ratings-based approach, and the advanced internal ratings-based approach. For market risk, there are the standardized approach and the internal model. And for operational risk, there are the basic indicator approach, the standardized approach, and the advanced measurement approaches. A bank must obtain approval from the FSC prior to adopting the internal ratings-based approaches to credit risk, the internal model to market risk, and either the standardized approach or the advanced measurement approaches to operational risk. In 2007, all banks in Taiwan used the standardized approach for both credit and market risk, and either the basic indicator approach or the standardized approach for operational risk when calculating minimum capital requirements.

3. Impact of Basel II implementation on domestic bank capital adequacy ratios

According to the results of Fifth Quantitative Impact Study (QIS 5) undertaken by the Basel Committee, the change in average minimum required capital under the Basel II standardized approach for different groups of participating countries relative to Basel I ranged from -3.0% to 38.2%[1]. In Taiwan, the average capital adequacy ratio[2] of domestic banks as of 31 March 2007 as calculated in accordance with Basel II rules was 10.14%, down 0.73 percentage points from the ratio of 10.87% as of 31 December 2006 using Basel I rules, and the average Tier 1 capital ratio declined by 2.02 percentage points from 9.88% to 7.86% during the same period. The primary reasons for the decreases include the following: (1) several capital deductions that used to be made from total capital under Basel I are now made directly from Tier 1 capital under Basel II; (2) investments in affiliated financial institutions and the amount of total expected losses exceeding eligible provisions are both required to be deducted from capital; and (3) Basel II requires additional capital charges for operational risk.

Notes: 1. The Basel Committee on Banking Supervision, "Results of the Fifth Quantitative Impact Study (QIS 5)," June 2006.
2. This capital adequacy ratio figure is based on a regulatory capital amount from which the unamortized deferred assets arising from losses recorded on the sale of non-performing assets have not been deducted.

Funding remained in good supply, liquidity risk was low

The deposit-to-loan ratio of domestic banks as a whole rose markedly between 2001 and 2004, driven by the fact that the annual growth in deposits significantly outpaced that of loans. As a result, the ratio of deposits to loans escalated to 117.98% at the end of 2007, while the funding surplus (i.e. deposits exceeding lending demand), stood at NT$3.22 trillion, reflecting ample liquidity in domestic banks (Chart 4.12).

The sources and uses of funds in domestic banks at the end of 2007 remained broadly unchanged, compared with that of one year earlier. On the sources side, customer deposits accounted for the largest share (73%), followed by interbank deposits and borrowings at 11%, while debt securities in issue contributed a mere 4%. On the uses side, customer loans accounted for the biggest share (62%), followed by investments in debt securities and equities at 13% and cash and due from banks at 10% (Chart 4.13).