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# Financial Examination and Supervision



**Chapter 9****Financial Examination  
and Supervision**

The central bank implements monetary policy by affecting changes in the behavior of financial institutions, financial markets, and payment systems. Therefore, to reinforce the effectiveness of monetary policy and to keep the payment system running smoothly, it is important for the central bank to adopt appropriate financial supervisory measures. This chapter begins with a review on the functions of the CBC's financial examination, followed by a brief introduction to Taiwan's financial supervisory system and the CBC's responsibilities. The final section describes two recent developments, the establishment of the Financial Supervisory Commission (FSC) and the implementation of the New Basel Capital Accord.

**Section 1 Functions of the CBC's Financial Examination***1. To Promote the Effectiveness of Monetary Policy*

The CBC conducts target examinations and takes actions to correct problems. These measures ensure that financial institutions comply with the CBC's policy, which in turn enhances the effectiveness of monetary policy.

*2. To Promote Financial Stability*

Promoting financial stability and guiding sound banking operations are among the CBC's major operational objectives. To this end, the CBC conducts financial examination to retrieve timely and accurate information regarding the operations of financial institutions, which is important in the making of the CBC's policy.

*3. To Promote Efficiency and Integrity of the Payment System*

The payment system is like the plumbing system of a city. Operational failure might lead to liquidity crises and subsequently trigger systemic risk and disrupt financial markets. Therefore, the central bank should monitor the operations of

the payment system to promote its efficiency and integrity. The CBC sets rules and standards for the payment system and monitors its operations to assess potential risks.

## **Section 2 Financial Supervisory Systems and Central Bank Responsibilities**

### *1. Financial Supervisory Systems*

#### (1) Financial Supervisory Systems before July 2004

Prior to July 2004, the CBC shared supervisory responsibilities with the Central Deposit Insurance Corporation and the Ministry of Finance (MOF). To ensure consistency and efficiency, the MOF set up a committee on banking supervision, co-chaired by a Deputy Minister of the MOF and a Deputy Governor of the CBC.

Under this supervisory structure, the CBC examined most of the domestic banks established before 1991, local branches of European, American and African banks, all bills finance companies, the Chunghwa Post Company, and several financial holding companies.

#### (2) Unified Financial Examination

To enhance the synergy of financial organizations and to cope with the trend of internationalization and conglomeratization that may complicate business operations in the financial services industry, the *Financial Holding Company Act* was passed on July 9, 2001, providing a legal basis for the establishment of 14 financial holding companies. Furthermore, after reviewing the experiences from countries that have already established a centralized supervisory institution such as Britain, Japan, and South Korea, the Financial Supervisory Commission (FSC) was established on July 1, 2004 to consolidate administrative resources and increase the efficiency of financial supervision. This unified supervisory body is responsible for the prudential supervision of the banking, insurance and securities industries.

### (3) Changes in the CBC's Role in Financial Examination

After the establishment of the FSC, the CBC no longer engages in general financial examination. Now it mainly conducts target examinations to fulfill its duties stipulated in the *Central Bank of China Act*. However, the CBC still retains investigative power on cases that might impede the implementation of monetary policy and generate systemic risks. Accordingly, the scope of financial examination of the CBC is redefined in the pending amendment of the *Central Bank of China Act*.

## 2. The CBC's Responsibilities in Financial Examination

### (1) Licensing

Banks should obtain approval from the CBC before engaging in foreign exchange business. The CBC reviews banks' applications and grants licenses to authorized foreign exchange banks.

### (2) Regulatory Responsibilities

The CBC formulates regulations regarding monetary policy in areas such as deposit and other liability reserves, liquidity reserves, and selective credit controls. The CBC also stipulates regulations governing foreign exchange business such as export/import related foreign exchange business, external/internal remittances, foreign exchange deposits, foreign currency loans, and foreign exchange derivatives.

### (3) Off-site Monitoring

In addition to routinely monitoring activities in the money market and the foreign exchange market, the CBC has also established a report-auditing system, collecting information on financial institutions regarding capital adequacy ratios, quality of assets, regulatory compliance, business strategy and stability, profitability, as well as liquidity management. The analysis drawn from this system may serve as a reference for supervisory authorities.

#### (4) On-site Examinations

As promoting financial stability is one of the CBC's primary objectives, the CBC still retains the authority to conduct target examinations related to its monetary, credit, foreign exchange and payment system policies.

#### (5) Enforcement Actions

Under the auspices of the *Banking Law*, the CBC may take enforcement actions against banks violating regulations. For banks violating any of the provisions in the *Foreign Exchange Control Act*, the CBC may suspend their foreign exchange business operations, in whole or in part, for a given period of time.

### **Section 3 The Financial Supervisory Commission**

In line with the government's objective to consolidate the financial supervisory framework, the FSC was inaugurated on July 1, 2004. The commission assumes ultimate responsibility for the prudential supervision of Taiwan's financial markets and financial services industry. Here "financial markets" refer to banking, bills, securities, futures, derivatives and insurance markets, as well as the clearing system, while "financial services industry" includes financial holding companies, the Central Deposit Insurance Corporation, banks, securities houses, futures brokerage firms, insurance companies, and companies engaging in electronic financial transactions. The CBC remains in charge of payment systems that involve financial transactions.

#### *1. Main Features of the Financial Supervisory Commission*

##### (1) Independence

The new commission exercises its authority independently. Each commissioner serves a fixed term of office. This, together with a commission system that features collective decision-making, ensures the integrity of the FSC's policy making. The commissioners are nominated by the Premier and appointed by the President. They are required to have academic expertise or

professional experiences in law, economics, banking, public finance, accounting, or management. Commissioners belonging to the same political party should not exceed one-third of the total number of commissioners, and all commissioners are prohibited from taking part in any political activities during their terms of office. A board resolution is reached only with the consent of the majority of commissioners present at a meeting attended by more than two-thirds of the commissioners.

## (2) Transparency

Explanations of serious enforcement actions taken by the commission for legal violations by financial institutions are announced at the appropriate moment. Commissioners and those who assist in the handling of cases should withdraw from cases that may involve potential conflict of interest.

## (3) Quasi-Judicial Power

The commission has quasi-judicial power to enforce supervisory regulations. The commission and its subordinate agencies may investigate suspected financial criminal cases with due legal procedure.

## (4) Establishment of a Financial Supervisory Fund

In addition to government budgets, the major source of income of the commission is annual fees including fees received for services provided to institutions under its supervision to support the FSC's independent operations. The annual fees are around 0.03 to 0.08 percent of the annual business revenues of financial institutions.

## 2. *The New Basel Capital Accord*

To improve the integrity and soundness of the financial system, the Basel Committee on Banking Supervision released the revised *International Convergence of Capital Measurement and Capital Standards* in June 2004. The new framework places more emphasis on banks' internal control and risk management, the supervisory review process, and market discipline. Major revisions are as follows:

- (1) The three pillars, minimum capital requirements, supervisory reviews, and market disciplines, are emphasized.
- (2) In addition to credit risk and market risk that have been addressed in the previous Accord, operational risk is also emphasized in calculating the capital ratio.
- (3) For the measurement of credit risk, two principal options are proposed: the standardized approach and the internal rating based (IRB) approach. The standardized approach is conceptually the same as the former Accord but is more sensitive to risk, while under the IRB approach (comprising the foundation approach and the advanced approach), banks are allowed to use their own internal estimates of borrower creditworthiness to assess credit risk in their portfolios, subject to strict methodological and disclosure standards.

The New Basel Accord will be implemented in Taiwan in late 2006. It is expected to have a significant influence on both Taiwan's banks and financial supervisory authorities. To address the risk-sensitive approach to capital requirements proposed by Basel II and to emphasize the risk-oriented supervisory approach, the CBC set up a task force in February 2002 to collect relevant information released by the Basel Committee, supervisory authorities, and financial services industries around the world. In the meantime, the CBC, the FSC, and the Bankers' Association have jointly established a research team to study issues regarding the revision of existing regulations and the applicability of new capital rules and risk models in Taiwan. These efforts are aimed at formulating policy recommendations to facilitate Taiwan's implementation of Basel II.