Department of Finance

"The Chinese and Taiwanese Banking Sectors, their Reforms and the Consequences of the WTO Accession"

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Table of Abbreviations

ABoC	Agricultural Bank of China
ADBoC	Agricultural Development Bank of China
AMC	Asset Management Companies
BoC	Bank of China
BOMA	Bureau of Monetary Affairs
CBC	Central Bank of the Republic of China
CBRC	China Banking Regulatory Commission
CCB	China Construction Bank
CDIC	Central Deposit Insurance Corporation
CIB	China Investment Bank
CIRC	China Insurance Regulatory Commission
CIT	China's Corporate Income (Tax Law)
CNY	Chinese Yuan
CPSB	China Postal Savings Bank
CSRC	China Securities Regulatory Commission
FASC	Financial Asset Services Companies
FEIT	Foreign Enterprise Income Tax
FSC	Financial Supervisory Commission Executive Yuan
ICBoC	Industrial and Commercial Bank of China
IEBoC	Import-Export Bank of China
IMF	International Monetary Fund
KMT	Kuomingtang
MOF	Ministry of Finance (Taiwan)
NPL	Non Performing Loan
OBU	Offshore Banking Units
PBoC	People's Bank of China
PCBoC	People's Construction Bank of China
PWC	PriceWaterhouseCooper
QDII	Qualified Domestic Institutional Investor
RMB	Renminbi (Chinese Currency)
ROC	Republic of China (meaning Taiwan)

RTC	Resolution Trust Corporation
SAFE	State Administration of Foreign Exchange
SFC	Securities and Futures Commission
SOE	State-owned Enterprise
SSE	Shanghai Stock Exchange
TAIMEX	Taiwan International Mercantile Exchange
TAMCO	Taiwan Asset Management Corporation
TSE	Taiwan Stock Exchange
WTO	World Trade Organization

$	always referring to U.S. Dollar (USD)
HK$	Hong Kong Dollar (Hong Kong Currency)
NT$	New Taiwan Dollar (Taiwanese Currency)

Abstract

This master thesis aims to explain the recent regulatory reforms in resolving the problems besieging the banking industry in Taiwan and China and to look at how banks are restrategising in view of the radical changes taking place in the banking sector. First of all I want to give a brief overview of the institutions and regulatory agencies existing in China and look back on the financial sector's history. In detail, this means the change from a mono banking system with little more than the People's Bank of China (PBoC) as the only commercial and central bank. Next I will focus on the transition/reform process and the problem of the existing Non Performing Loans as well as the regulatory reforms implemented to correct these problems, which were/are entirely led by the central government. The next part of this thesis will deal with the establishment of foreign banks and their special treatment in mainland China. Then the focus lies on the World Trade Organization (WTO) accession, the commitments the Chinese government had to fulfil and the consequences of the liberalization of the formerly (until 1979) totally closed market. After that a short outlook on the Chinese financial sector that forecasts the impacts of this liberalization in the next years.

Next I will shift my focus on Taiwan as it is officially called the Republic of China (ROC). Taiwan is also known as one of the four Asian tigers. Taiwan accessed the WTO on January 1, 2002 and therefore the government had to undertake important reforms to meet the requirements stated by the WTO. Again I will take a short look on the banking and regulatory system and its history and the continuous reform process starting with Kuomingtang's (KMT) power acquisition in Taiwan and leading to the before mentioned WTO-accession. Differently than the mainland China, did Taiwan welcome foreign investors a lot earlier and some Taiwanese banks even saw them as their saviours. Therefore the restrictions for foreign financial institutions were lower than those in the People's Republic of China being the reason for earlier, easier and better development of foreign banks, insurance companies and other organizations operating in the financial service sector. Like China, Taiwan also had/has problems with Non Performing Loans but was dealing with them in a similar but more efficient way, due to the private handling of the loans' repurchase. The WTO entry led Taiwan from having a quite conservatively closed banking sector to reform it to a highly liberal and modern one.

1 China

1.1 Introduction

China is the oldest major world civilization with records dating back 3,500 years and a population number of 1.25 billion or 21 percent of the world's population. From 1948 to the early 1980s, China's economy was closed to the rest of the world. In the 1980s China inaugurated a series of reforms to promote market forces in the economy. They established four Special Economic Zones, in which foreign firms were offered preferential tax and administrative treatment; they created a Law on Joint Ventures under which foreign firms are allowed to operate.

In the next 20 years China could outshine Japan as the world's second largest trading nation. And between 2020 and 2030 China could arise as the world's biggest economy. To do so, the People's Republic of China has to continue the liberalisation of its economy, establish a modern financial system and conform to international norms for protecting property rights.

China's interactions with the world financial system have undergone a change over the last 25 years. With the "Open Door Policy" in 1979 to promote foreign trade and investment, China's capital account has been reopened to some extent. The government set up Special Economic Zones in 1979 where foreign direct investment was allowed and in 1992 foreign investors were permitted onto the Shenzhen and Shanghai stock exchange, exclusively reserved for them with creating the B-shares. Since 1994, the PBoC (People's Bank of China, the Chinese Central Bank) manages the currency although its value has been allowed to float within very tight limits since 2005. Chinese banks still lend too much money to underproductive state-owned enterprises (SOEs) - a problem that makes it hard for the country to achieve its stated regulatory goals and makes it hard to adapt to economic changes.

The accession to the WTO (World Trade Organisation) in 2001 was conditional for the intention to liberalise the economy further, including the local currency banking market to foreign banks at the end of 2006.

1.2 An Institutional Overview of China's Financial System

Although China has gone through many reforms attempts since 1979 the banking sector still displays the legacy of the centrally-planned economy where the government works and influences, both at central and local levels, the credit allocation and pricing of capital. The domestic banking system is still the most important channel of financial intermediation between savings and investment. The role of stock and bond markets is still limited, although a slowly increase can be seen.

The next few pages will give a short description of the roles, characteristics and current standing of the different types of financial institutions of China.

1.2.1 The Banking Sector

There are four types of banks in China; wholly state-owned banks, commercial banks, credit cooperatives and foreign banks.

1) Wholly state-owned banks: they consist of state-owned commercial banks and policy banks

- State-owned commercial banks: the state-owned commercial banks are also called the "Big Four" or G4. Together they amount for around 60 percent of the banking sector's assets. It is needless to say that they are the most dominant and influential players in the Chinese banking sector.

(1) Agricultural Bank of China (ABoC), initially established to make loans available to the agricultural and rural sectors.

(2) Bank of China (BoC), specialised in international transactions like foreign exchange services and trade credit.

(3) China Construction Bank (CCB), specialised in financing construction and infrastructure projects using long term loans.

(4) Industrial and Commercial Bank of China (ICBoC), originally founded to hand out working-capital loans to the industrial and commercial sectors in the urban areas.

The BoC, the ICBoC and the CCB are as well noted at the Hong Kong stock market as at the Shanghai stock market.

These four institutions hold more than half[1] of the country's' total banking assets in 2006. Between the ICBoC, the CCB and the BoC they held 7.78 trillion RMB[2] in personal deposits in June 2006. The state-owned commercial banks have more than 75.000 branches throughout the whole country and benefit from close links to China's largest companies.

- Policy banks: in order to relieve the state-owned commercial banks in their lending position, the government established these three policy banks

(1) Agricultural Development Bank of China, this bank released the ABoC

(2) China Development Bank, was responsible for the lending role from the CCB and in some degree from the IBoC

(3) Import-Export Bank of China, took control over the trade policy of the BoC

- The policy bank takes few deposits and through issuing bonds they fund themselves. The presence of state-direct lending can be shown by combing the assets of the three policy banks which are worth 10 percent of the total banking sector at present.

2) Commercial banks: the equity ownership is divided up among private investors and the state. Although the commercial banks are not as known as the "Big Four" but the 120 existing commercial banks still play an important role and hold 18 percent of the banking sector's assets (e.g. Bank of Communications, China Mingshen Bank, China Merchants Bank, and Shenzen Development Bank).

Shareholding or joint-equity commercial banks:

These banks are incorporated as joint-equity limited companies under the People's Republic of China's Company Law. They are grant permission to engage in a huge variety of banking services e.g. accepting deposits, extending loans and providing foreign exchange. Joint-equity banks are more located in the areas where the state-owned banks are weak and have the tenting to be more profitable. This bank form is recently preferred for strategic partnerships in China especially for the foundation in China.

3) Credit cooperatives: they provide loans to small and medium-sized enterprises. This sector is separated into the rural and urban credit cooperatives which together count 50,000, which form around 11 percent of the total banking-sector assets. The ABoC formerly monitored the rural cooperatives and later the China's central bank, the PBoC was in charge. Both, the rural as well as the urban credit cooperatives are subject to state control and therefore under the influence of local policy considerations.

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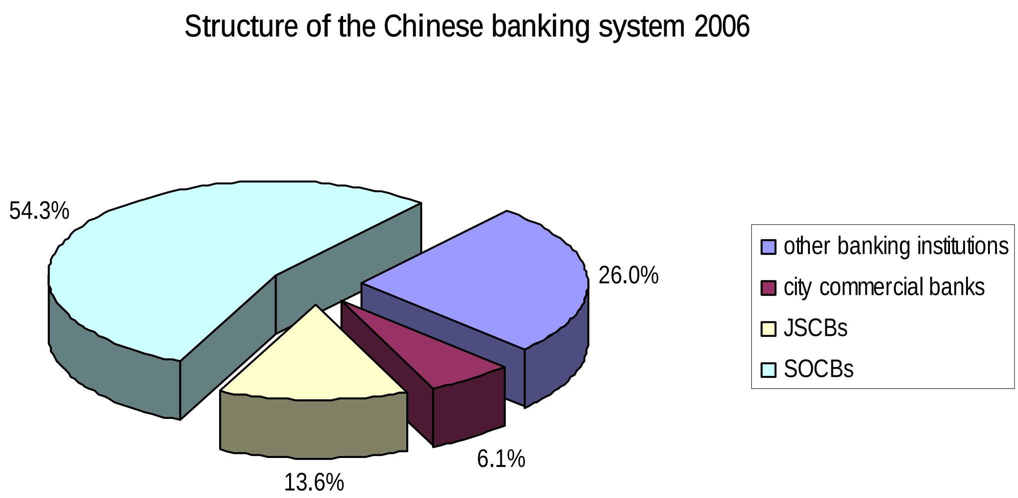
[1] CBRC Homepage

[2] ICBoC IPO prospect and company websites

4) Foreign Banks: foreign banks hold 2 percent of total banking-sector assets in 2006. Until a few years ago, the local currency business (CNY based in Chinese Yuan or more common RMB) was strictly closed to foreign banks. Originally, China needed the foreign banks as intermediates in foreign currencies to make operations of foreign investors and manufacturers in China easier. In 1996 the RMB system has been opened for foreign banks with the restrictions to do business only with foreign companies and individuals in Shanghai and Shenzen. Since the WTO access in 2001 the geographical restrictions should be totally lifted by the end of 2006.

5) China Postal Savings Bank (CPSB): the CPSB emerged of a restructuring of the regulatory functions of the form State Post Bureau and takes over the savings business of China Post. It also operates as China's fifth largest depository institution with deposits worth RMB 1,516 billion ($189.5 billion) after the "Big Four" banks. It was inaugurated on March 20, 2007 and has a massive network of 36,000 post offices across the country.

Table 1: Structure of the Chinese Banking System 2006



1) other banking institutions: include policy banks, rural commercial banks, foreign banks, urban and rural credit cooperatives, finance companies, trust and investment companies, postal savings.

3)JSCBs (joint-stock commercial banks): include Bank of Communications, CITIC Industrial Bank, Everbright Bank of China, Huaxia Bank, Guangdong Development Bank, Shenzhen Development Bank, China Merchants Bank, Shanghai Pudong Development Bank, Industrial Bank, China Minsheng Banking Co., Evergrowing Bank and China Zheshang Bank

4) SOCBs (state-owned commercial banks): include the Industrial and Commercial Bank of China (ICBoC), the Agricultural Bank of China (ABoC), the Bank of China (BoC) and the China Construction Bank (CCB).

Source :CBRC Statistics 2006: Total Liabilities and Total Assets of end 2006

1.2.2 Bond and Stock Market

Stock exchanges in Shanghai (SSE) and Shenzhen were established in December 1990. The stock exchanges have been mainly used for partial privatisations of state-owned enterprises (SOE).

The SSE is a non-profit institution administered by the China Securities Regulatory Commission (CSRC) with a market capitalization of nearly $915billion (always meaning USD) making it the largest in mainland China and fifth largest in the world. The securities listed at the SSE include the main categories of stocks, bonds and funds. Bonds traded on SSE include treasury bonds, so called T-bonds, corporate bonds and convertible corporate bonds. The most active market in

China is the SSE T-bond market. The Shanghai Stock Exchange issues two types of shares: A shares and B shares. A shares are priced in Renminbi currency and are restricted to domestic investors while the B shares, for foreign investors only are priced in U.S. Dollars or Hong Kong Dollars but since 2001 are available for domestic and foreign investors at the same time. H shares are shares in Chinese companies available to foreigners and are quoted in Hong Kong. "Red Chips" are shares in Hong Kong companies doing business principally in China and N shares are Chinese companies listed in the U.S:. After reforms in 2002 foreign investors are allowed to trade under limitations in A shares too. The Industrial and Commercial Bank of China (RMB 1,379.86 billion), the China Life Insurance (RMB 904, 78 billion) and the Bank of China (RMB 887,31 billion) are the top ten largest stocks at the SSE.[3] In January 1995 the Shenzhen Stock Exchange launched the blue chip composite index. The Shanghai and Shenzhen stock exchange list more than 1200 companies, standing in hard competition with the Hong Kong Stock Exchange as the second-biggest stock market in Asia.

Bond Market

The local bond market of China is closed to foreign investors. It has a total outstanding issuance of 34 percent of GDP (2002). China's domestic bond market is the second largest in non-Japan Asia, but still very small in relation to the size of the economy.

The bond market will only flourish when banks start to be more meticulous about risk-based loan pricing and claim higher rates to borrowers than the government- set floor rate[4] that predominates at present.

1.2.3 Regulatory Agencies

1) China Banking Regulatory Commission (CBRC): the CBRC[5] was established in April 2003 with the function to take over the regulatory function of the banking sector from the People's Bank of China (PBoC) in order to release the PBoC so that it can concentrate on monetary policy matters. The main functions of the CBRC[6] are to formulate supervisory rules and regulations governing the banking institutions and to authorize the establishment, changes, termination and business scope of the banking institutions. The CBRC reports to the State Council and it is entrusted with the regulation and supervision

[3] SSE Homepage updated 15 January 2007
[4] McKinsey Global Institute "Putting China's Capital to Work: The Value of Financial Reform", May 2006, p. 17
[5] CBRC Homepage
[6] see reference 5

of financial institutions. The regulatory objectives of the CBRC are to protect the interests of depositors and consumers through effective supervision. It also maintains the market confidence through prudential and effective supervision and aims to enhance public knowledge of modern finance. Its main criteria are to promote financial stability and facilitate financial innovation, to make the Chinese banking sector more capable of competing, to encourage fair competition and to set appropriate supervisory and regulatory boundaries. On November 24 2006 the CBRC promulgated the Rules for Implementing the Regulations of the People's Republic of China on Administration of Foreign funded Banks[7]. One of the relevant implementations is that with December 11, 2006 the geographic and clients restrictions on local currency business (Renminbi business) of foreign banks are to be removed completely. Also meaning that the foreign banks can expand to Chinese citizens within China without any geographic restrictions.

2) People's Bank of China (PBoC):

The PBoC[8] established on December 1, 1948 was given the status of a central bank by the State Council in 1983, which is in charge of drafting and enforcing relevant laws, rules and regulations, to formulate and implement monetary policy and regulates the financial markets. This includes the inter-bank lending market, the inter-bank bond market and the foreign exchange market. All capital of the PBoC is invested and owned by the State. The PBoC concentrates on regulations that concern monetary conditions and financial system liquidity having a focus on promoting the growth of economy and the stability of prices. The PBoC has to report to the State Council the decision it made on annual money supply, interest rates, and exchange rates. It needs the approval of the State Council before they can put them into effect.

3) State Administration of Foreign Exchange (SAFE):

SAFE[9] was established 1979 and is responsible for the planning and controlling of the foreign exchange in China. The SAFE is assigned to design and implement the balance of payments (BOP), analyzing the BOP and foreign exchange positions, supervise and monitor foreign exchange transactions and managing foreign exchange reserves of the country. Through its assignments the SAFE highly influences the financial system. All other duties and responsibilities have to be assigned by the State Council and the PBoC. The SAFE and the PBoC work closely together to ensure the goal of monetary stability.

[7] see reference 5
[8] People's Bank of China Homepage
[9] State Administration of Foreign Exchange Homepage

Table 2: Monthly Foreign Exchange Reserves 2007 (in billions of US dollars)

End of Month	Foreign Reserves
January	1104.692
February	1157.372
March	1202.031
April	1246.566
May	1292.671
June	1332.625

Source:SAFE 2007

4) China Securities Regulatory Commission (CSRC):

   The CSRC was established in 1997 and is an institution of the State Council of the People's Republic of China. It is the main security finance regulator of China. In 1999 it became the only regulatory and supervisory institution for the stocks and bonds market in the country. Its responsibilities include the formulation of policies, laws and regulations concerning markets in securities and futures contracts; overseeing issuing, trading, custody and settlement of equity shares, bonds and investment funds, and the supervision of listing, trading and settlement of futures contracts; futures exchanges; securities and futures firms.

5) China Insurance Regulatory Commission (CIRC):

   The CIRC is entrusted with the supervision of insurance companies and preparing them for the opening of the insurance sector to foreign players. The CIRC is like the CBRC and CSRC directly assigned to the State Council too.

2 Reforms Undertaken from the Government from 1979 until Now

2.1 The Chinese Banking System until the Reforms of 1979

Until the end of the 70ths China's banking system was structured as a highly centralised Mono banking system like the system of the Soviet Union. The People's Bank of China (PBoC) had the position of a Central bank and was simultaneously the only business bank. The PBoC was bound to political goals and determined plans of the government, therefore she was rarely a bank and moreover a public institution. The PBoC controlled 93 percent of the country's financial assets.

The assignment of the Central bank didn't only include supervision and regulation of the money supply but also the settling of the saving- and credit interest rates after agreement with the Chinese State Council and the fixing of the monetary parity. Next to the PBoC, two other banks existed: the People's Construction Bank of China (PCBoC) and the Bank of China (BoC), which was instructed with the realization of financial transaction with the foreign trade, which stood under the direction and control of the PBoC. These two banks were merely entrusted with special assignments like the foreign exchange transactions, settlement of international payments and clearing of foreign trade financing. The PBoC was not a bank in the true sense of the word because she was adjacent subordinated to the ministry of finance. The PBoC was assigned to allot or ration the financial funds of the national funds and to control the planned use of these funds in the corporations. One can say that the PBoC was more a paying office rather than a profit oriented bank itself. To conclude, in 1979 the Chinese banking system was marked by a highly centralised mono banking system with the PBoC as the central bank and the only business bank. The banks were not profit oriented and were assigned with the supervision of the suitable and effective use and the financing of the economic plans.

In 1978 China has gone through a few important reforms in the financial sector. After more than 20 years of reforms the banking system of China has been considerably reformed and restructured.

2.2 The first phase (1979-1984): the Recovery of the Banking System

This period is distinguished by the recovery of the banking system after the Cultural Revolution. The banking reform started with the hive off of the PBoC into several public special banks which was an important aspect in this period. After the first diversification of the banking structure China started with the building up of a two stages banking system within the first phase to eliminate the major disadvantages of a mono banking system. The Agricultural Bank of China (ABoC) has been reopened which was assigned to operate in the rural area for the PBoC. The PCBoC and the BoC separated from the PBoC and became independent.[10] The establishment of foreign banks was admitted again.[11] In 1980 the Japan Import and Export Bank established a representative office in Beijing and a year later Nanyang Commercial bank established a branch in Shenzhen, becoming the first foreign-funded bank[12] engaged in doing business in China since 1949. The non repayable allocations have been redeemed by interest bearing bank credits. In 1981 the China Investment Bank (CIB) has been founded to administer the credits of the World Bank and of the IMF (International Monetary Fund). Two years later the introduction of a system, which allowed keeping the returns after tax, made the banking system at least in theory profit oriented. In the same year, the abolition of the mono banking system has been agreed upon. In order to restructure the two stages banking system the Industrial and Commercial Bank of China (ICBoC) has been founded. The ICBoC has taken over the commercial banking business of the PBoC in the Chinese cities. Since then the PBoC lost the total function as a business bank and concentrated exclusively on the assignment and role as central bank. That way the prerequisite for a two stages banking system has been created. Until this point in time the state-owned commercial banks (ABoC, BoC, PCBoC and ICBoC) became established.

[10] Huang, Daiwei "Der chinesische Bankensektor im Zeichen des WTO Beitritts", October 2002, p. 8
[11] see reference 10
[12] PWC "Foreign Banks in China", May 2007

2.3 The Second Phase (1985-1993): Initiation of Competition

Apart from establishing more business banks, the second phase was also formed by the cautious initiation and introduction of free enterprise competitive mechanism into the banking sector followed by the commercialization of the Chinese banks. Except all the small rural and municipal credit cooperatives) in town, all Chinese banks remained without any exception in the hand of the central state until the mid 80ies. Additionally, to the new establishments, the banks were allowed to expand their businesses, which led the banks to slowly develop into universal banks. Besides, the branches within the existing banks became more independent through the decentralisation of the decision-making power and the complete banking system should obtain more independence of the state planning- and guidance authority. This step should create incentives for the individual policy banks to take bank economic and profit oriented considerations into account of their business activities.

2.4 The Third Phase (1994-1997): Expanding Market Orientation

Unstable development of the banking systems in 1992/93 and liquidity crises of the banks led to indispensable reforms. One of the actions was to reinforce the independence of the PBoC as central bank and the further commercialization of the state-owned commercial banks. Another essential step was the establishment of a Chinese banking law. On account of the financial chaos 3 economic banks have been founded in 1994. The State Development Bank (SDB), the Agricultural Development Bank of China (ADBoC) and the Import-Export Bank of China (IEBoC) should take over all businesses and transaction which are based on political decision and should release the state-owned commercial banks. Due to the central banking law of 1995 the subsidiaries of the PBoC were not allowed to grant credits to the commercial banks anymore. The PBoC got the legal authorization to realize the monetary policy and was now the only authority responsible for the bank supervision and monitoring. The main assignment of the PBoC was to maintain the currency stability and therefore the support of the economic growth. In the same year the business banking law was passed, which has mainly reformed the state-owned commercial banks. It was set, that they can operate independently, to operate at one owns risk, and to take responsibility for the own gains and losses. The commercial banks are only allowed to do/effect typical banking transactions.[13] In addition to that, the banks were obliged to keep equity capital at the height of 8 percent for the risk-adjusted investments. And apart from that they were not allowed to supply more of 10 percent of the capital to one single credit borrower.[14] In April 1995 the first pure private bank - the Minsheng Bank (MSB) was permitted. This was the first step towards the privatisation of the Chinese banks.

2.5 The Actual Phase (since 1997)

After the Asia crisis of 1997 the risks of nonperforming loans (NPL) and low equity ratio were much better noticeable. Since the banks were holding loads of NPLs in their portfolio, the Chinese government had to enforce reorganisation measures. They enhanced the supervision of the banks by intensifying further the independence and authority of the PBoC and monitoring the banks using the implemented international standards. To strengthen the corporate governance, strategic investors from home and abroad were permitted and a streamlining of the banks over closure and fusions was debated. As a result of the drastic reforms, the closure of insolvent institutions began.

In order to monitor the banks in a more efficient way the organisational structure of the PBoC has been changed to hinder that local government, administrations and single person can influence the central bank politically. The 31 branches were restructured into 9 supraregional branches.[15] The PBoC used to have one branch in each province lead by the head office of the PBoC in Beijing and the local government at the same time, which made it impossible to operate in an efficient way. With the restructuring of the PBoC there was one branch in each of the following cities Beijing, Tianjin, Shanghai, Shenyang, Nanjing, Jinan, Wuhan, Guangzhou, Chengdu and Xi'an. These new local branches are now homogenously managed by the head office in Beijing alone. The new achieved power of the PBoC can be shown by the closed down financial institutes. Between 1997 and 1998 42 financial institutes, 23 urban credit cooperatives and 18 rural credit cooperatives have been closed down by the PBoC.[16]

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[13] Huang, Daiwei "Der chinesische Bankensektor im Zeichen des WTO Beitritts", October 2002, p.12
[14] see reference 13
[15] Huang, Daiwei "Der chinesische Bankensektor im Zeichen des WTO Beitritts", October 2002, p. 14
[16] Huang, Daiwei "Der chinesische Bankensektor im Zeichen des WTO Beitritts", October 2002, p. 15

Another very important step was the restructuring of the state-owned commercial banks with the assistance of recapitulation. In August 1998 the "Big Four" were financially supported with RMB 270 billions ($33 billion) by the central government, which doubled their capital basis. At the same time the legal minimum reserve was decreased from 13 percent to 8 percent, which made it possible to set free RMB 337 billion liquid funds.

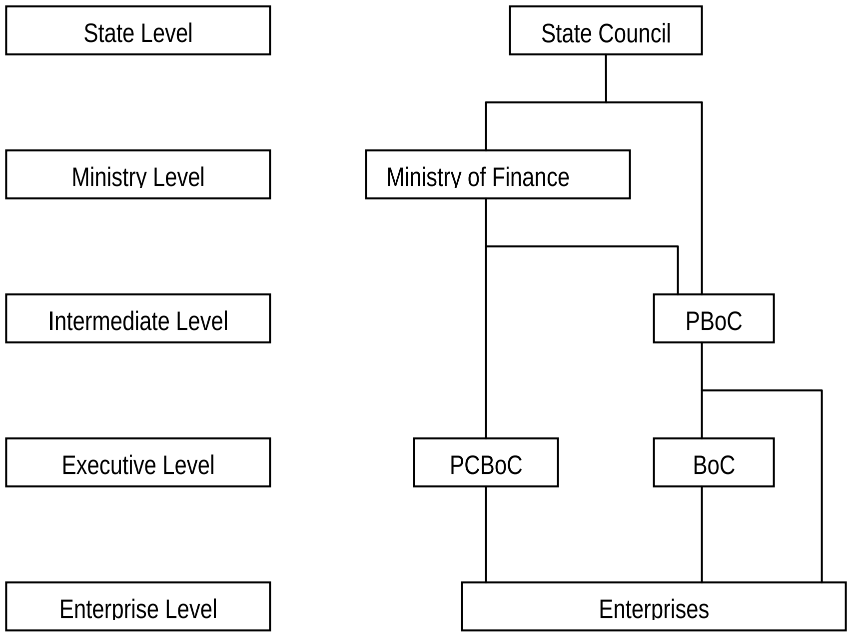
In 1999 four Asset management Companies (AMC) have been established, one for each state-owned commercial bank.[17] A change in the central banking law occurred in 2003 to establish the China Banking Regulatory Commission (CBRC) for the Chinese banking sector. With the WTO membership the reforms speeded up in the banking sector with a concrete goal: the full liberalisation until the end of 2006.

The banking system at present can be described as "the system of the six columns" under the roof of the PBoC. These are the 3 political banks, the G4s; dozens new established business banks, a multiplicity of urban cooperative banks or commercial banks, numerous credit cooperatives and a magnitude of foreign banks.

To be able to commercialize the state-owned commercial banks, the China Banking Regulatory Commission (CBRC) initiated performance targets for the minimum level of equity capital (which had to be 8 percent by 1st January 2007). For the transitional period all banks should hand out a plan how they want to realise this goal. Also did the banks have to calculate the equity capital quota taking into account needed reserves for loan losses and to evaluate higher risks for certain loan transactions. Meaning that loan risks of big government owned enterprises have to be re-evaluated to abolish gradually the distortions for the benefit of the public sector. Further do the regulations say that the bank managing boards are responsible for the equity ratio and have to report to the CBRC quarterly. As part of the restructuring they tried to enforce corporate governance. To reach this goal international standards and structure should be adapted.

[17] For the CBoC- China Xinda Asset Management Corp.; for the ABoC- China Great Wall Asset Management Corp.; for the ICBoC- China Huarong Asset Management Corp.; and for the BoC- China Orient Asset Management Corp.

Table 3: Structure of the Chinese Banking System before the Reforms 1979



Source: Huang, Daiwei, October 2002, p. 7

Table 4: Structure of the Chinese Banking System Now

Regulatory Institutions

The People's Bank of China (PBoC)	China Banking Regulatory Commission (CBRC)

Banking Institutions

State-owned Commercial Banks	- Agricultural Bank of China - Bank of China - China Construction Bank - Industrial and Commercial Bank
Policy Lending Banks	- Agricultural Development Bank of China - Export Import Bank of China - China Development Bank
Other Commercial Banks	- Joint-Equity Commercial Banks - City Commercial Bank
Credit Cooperatives	- Rural Credit Cooperative - Urban Credit Cooperatives
Foreign Banks	- Branches - Wholly foreign funded banks - Joint Venture Banks

Source: Liu, Caroline "Scaling the Great Wall: An Analysis of Foreign Banks' Entry into China", February 24, 2005, p. 401

3 The Weakness of the Banking System and the Consequences

Although China has gone through a lot of reforms to renew and improve the banking system there are still many problems unsolved in the financial sector. To install the PBoC as the central bank was an important step but still the PBoC is working inefficiently. The Chinese State Council is nevertheless influencing the money policy which makes it impossible for the PBoC to operate independently. Neither can the business banks remove themselves from the influence of the government. All the main decisions e.g. money offer, interest rates and the credit allocation, made by the PBoC had to be officially approved and controlled by the Chinese State Council.[18] Even the employment and release of main personnel of the PBoC is determined by the Chinese State Council. Inefficiency and infectivity are the resulting consequences since the PBoC and the public authority follow different goals. While the PBoC has the monetary stability in mind, the government puts its focus on the growth target.[19] Supplementary, the PBoC is missing on essential instruments to reach the goals. Although interference of the regional government in the decisions of the branches of the PBoC is basically prohibited, in reality it is still possible for the regional government to find a way e.g. through the manpower policy, to influence and manipulate the PBoC.[20]

According to the banking law, the banks should adjust their businesses as stated by economic points of view, however in practice they are not seldom more or less forced to operate their credit business according to social-developmental, and economic political guidelines. This conflict often becomes visible with the state-owned commercial banks because the government uses the banks as their own "country cash till"[21] to get loans for government owned enterprises or for their political goals.

In the 1990ths one of the most urgent problems in China's banking system was the high level of nonperforming loans (NPL).[22] The NPLs, especially those of the G4s were a left over of the planned economic past. Most of the NPLs in the past were due to directed lending policies by the government to fund state-owned enterprises, without paying any attention of their profitability. After the breakout of the Asia crisis the government tried to solve the highest problems of the banks using a recapitalization and the acquisition of NPLs through rescue companies. Since the end of the 90s the government supported the banks with $295 billion to increase the equity capital basis and to purchase NPLs. Besides the capital injections for the big national banks, the government even took over a part of the NPLs. In 2000 the Asset Management Corporation (AMC) received their first assignment in purchasing NPLs worth $169 billion and to convert them into tradeable securities.[23] But since that time they took over new NPLs worth $74 billion and it doesn't seem like there is an end. As a result of different estimations, one can say that NPLs were 25-40 percent of all open loans. In total they could be worth $200- $300 billion, depending on what is really impecunious. Most of the NPLs shares taken over by the AMC were past due over 2 years and more. But their achievements were not really impressive.

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[18] Huang, Daiwei "Der chinesische Bankensektor im Zeichen des WTO Beitritts", October 2002, p. 15
[19] Huang, Daiwei "Der chinesische Bankensektor im Zeichen des WTO Beitritts", October 2002, p. 16
[20] Central Banking Law, Article 9
[21] Schüller, Margit "Ausländische Banken drängen nach China – Marktchancen werden höher als Risiken eingeschätzt" China aktuell Volume 1 (2006)
[22] NPLs are credit arrangements, which became impecunious meaning that the debtor is delayed in his performance
[23] see reference 21

Table 5: Debt Collection Achievement of the four AMCs at the end of 2005

Asset Management Corporation	Total assets 2000 (RMB billions)	Discussed (RMB billion)	Debt collection (RMB billion)	Debt collection ration (%)
Huarong (ICBC)	408	243	54	22
Great Wall (ABoC)	346	263	27	10
Cinda (CCB)	373	201	63	31
China Orient (BoC)	268	132	32	24
Total	1394	839	177	21

Source: Shih, V. and Huang L. “China’s NPL Market Revealed” (2006), p. 31

Table 6: Disposal of NPLs by the four AMCs in 2006, RMB 100 million, %

	all 4 AMCs	Huarong	Great Wall	Cinda	Orient
Accumulated disposal	8663.4	2468.0	2707.8	2067.7	2707.8
Cash recovery	1805.6	546.6	278.3	652.6	278.3
Disposal ratio	68.61%	70.11%	80.11%	64.69%	80.11%
Asset recovery ratio	24.20%	26.50%	12.70%	34.46%	12.70%
Cash recovery ratio	20.84%	22.15%	10.28%	31.56%	10.28%

1. Accumulated Disposal refers to the accumulated amount of cash and non-cash assets recovered as well as loss incurred by the end of the reporting period.
2. Disposal Ratio = Accumulated Disposal / Total NPAs Purchased .
3. Asset Recovery Ratio = Total Assets Recovered / Accumulated Disposal.
4. Cash Recovery Ratio = Cash Recovered / Accumulated Disposal.

Source: CBRC Statistics 2006

NPLs have soared alarmingly. The CBRC (see CBRC-Homepage) reported that the value of bad loans were worth $205 billion - 13 percent of total banking assets, by the end of 2004.
Most banks are technically insolvent, as their NPLs far exceed their equity. But these institutions are still highly liquid thanks to a large retail deposit base that continues to expand as a result of a robust economy.

One can only speculate how high the shares of NPLs are in reality. A published report by Ernst & Young (3rd of May 2006)[24] had shown that the NPL debt of the Chinese financial system account for $911 billion, estimated there from 358 billion Dollars by the G4 and $230 billion by the 4 AMCs. A week later the report had been backtracked probably due to the pressure of the Chinese government and the official sites reported that the NPLs debt of the G4 is only worth $133billion. A survey by McKinsey[25] has found out that the NPL problem has cost the government more than $100 billion to recapitalize the banks and another $200 billion on transferring the NPLs to the AMCs. Although they show efforts to improve the big problem is still that loan pricing and the credit–assessment skills of loan officers continue to be poor in many banks and risk management is insufficient. Many credit takers indicated non existing addresses to gain loans, with no property as collateral, happening that some mortgage holders came into possession of money for properties, which did not belong to them at all.[26] Loan officers don't really have to face any negative consequences for issuing bad loans, in return the incentives for issuing loans with well calculated risks to small-businesses or consumers is not very high indeed. Managers do not lend enough to household and small-middle enterprises because the risks are higher but the average returns are potentially higher than lending to very large companies and state-owned enterprises (SOEs). Also did the banks not see the importance of developing credit scoring tools or keeping good records of borrowers' credit histories. Because of the diffuse structure of the local SOEs, it is hard for the banks to keep track of the enterprise's credit history and impossible to share information they gained in the past with other banks. Through this, it is easily possible for an existing corporate borrower who failed to fulfil its obligation of paying back the loan in one bank or region to obtain a loan in another place and bank. The reason for this is that the local governments still influence the banks of granting loans for projects, which are useful for the development of the local economy but totally uneconomic for the banks.

Today the lending decisions are founded on incomplete data with insufficient analysis. The government and the banks lack information from independent credit rating agencies and analysts like Moody's or Fitch that can equip the banks with essential information on potential borrowers. After displacement of the NPLs the positions of the banks improved tremendously. According to the estimates of the rating agency Fitch, the decline of the NPLs was not the result of an active reduction of debts, but to trace back to the debt relief of the biggest state-owned commercial bank, the ICBoC, through the government. If one disregards these facts one can see an increase of the

[24] Presseportal "Ernst und Young zieht Nonperforming Loan Report zurück", May 13, 2006
[25] Mc Kinsey Global Institute "Putting China's Capital to Work: The Value of Financial Reform", May 2006, p. 13
[26] "How to fix China's banking system", McKinsey Quarterly, February 2005

NPLs by 3.9 percent [27] in 2005. The NPLs are reduced in the banks but they are only displaced to the AMC. Table 7 shows that only parts of the NPLs can be made of use. There is no denying that the NPLs are a significant threat to the solvency of Chinese banks. In recent years, the financial restructuring of the Big Four does reduce very slowly the NPL problem. China's accession to the WTO has caused the initial of some bank reforms which helped that the NPLs have fallen from more than 20 percent to less than 5 percent of their portfolio.

Table 7: NPLs of Commercial Banks as of end 2006

	Quarter 1		Quarter 2		Quarter 3		Quarter 4	
NPLs by five-category classification	13124.7	8.03	12827.2	7.53	12736.3	7.33	12549.2	7.09
Substandard	3281.4	2.01	3066.7	1.80	2923.3	1.68	2674.6	1.51
Doubtful	5035.1	3.08	5038.9	2.96	5098.7	2.93	5189.3	2.93
Loss	4808.2	2.94	4721.6	2.77	4714.2	2.71	4685.3	2.65
By Institutions							.	
Major commercial banks	12068.4	8.26	11778.8	7.80	11726.7	7.64	11703.0	7.51
SOCBs	10588.2	9.78	10557.6	9.47	10558.1	9.31	10534.9	9.22
JSCBs	1480.2	3.92	1221.2	3.09	1168.5	2.91	1168.1	2.81
City commercial banks	865.1	7.59	845.4	6.72	807.3	6.07	654.7	4.78
Rural commercial banks	158.1	6.96	166.4	6.64	166.9	6.58	153.6	5.90
Foreign banks	36.7	0.95	36.6	0.87	35.5	0.81	37.9	0.78

1. The commercial banks include the state-owned commercial banks, joint-stock commercial banks, city commercial banks, rural commercial banks and foreign banks. The major commercial banks include the state-owned commercial banks (SOCBs) and the joint stock commercial banks (JSCBs). The SOCBs include the Industrial and Commercial Bank of China (ICBC), the Agricultural Bank of China (ABC), the Bank of China (BOC), the China Construction Bank (CCB) and Bank of Communications (BOCOM). The JSCBs include CITIC Industrial Bank, Everbright Bank of China, Huaxia Bank, Guangdong Development Bank, Shenzhen Development Bank, China Merchants Bank, Shanghai Pudong Development Bank, Industrial Bank, China Minsheng Banking Co., Evergrowing Bank, China Zheshang Bank and China Bohai Bank.

[27] Fitch Ratings 2005 Part 3 www.fitchratings.com

2. As the number of rural commercial banks and city commercial banks has increased in 2006, this year's figures of these institutions are incomparable with that of 2005.

Source: CBRC Statistics 2006

Chinese authorities tried to deal with that problem and in 2003 the central bank injected $22.5 billion into both the Bank of China and China Construction Bank due to bad portfolios.

Many Chinese banks have not yet introduced the most fundamental components of good corporate governance.[28] Therefore the promotion of the development of appropriate skills in assessing and pricing credit risks must be one of the highest priorities of the banking regulators.[29] Banking regulators should take into consideration to cooperate with industry leaders in the development and implementation of detailed risk-management guidelines.[30] If a bank doesn't recognize a loan as nonperforming, it will not take the appropriate charges on its books, and regulators, investors and customers are misled by the profits stated by the banks.[31] Banks should therefore start building up reserves in case the loans will not be repaid. Improvements in legal standards such as bankruptcy and foreclosure laws will also help the AMCs and the banks to reduce their NPLs faster. Regulators should also handle actively in monitoring compliance and make their findings public.[32] Banks are not completely free to set their own pricing adequate to the risks they take, which works against developing a credit culture.

The state's influence became more transparent over the years but officers still feel the pressure from local party officials to make uneconomic lending decisions. The Chinese government should start reducing its stake in the banking system which will be neither quick nor easy. Hansakul[33] believes that a more liberal interest regime would lead to more competition, making the banks more efficiency-orientated which would lead to a faster consolidation of the banking system.

Privatization is a chance for Chinese institutions to see and understand how foreign companies run the banks they acquire.[34] Foreign ownership should be permitted to inject fresh capital into the industry and to remove moral hazards by taking the state completely out of credit decisions.[35]

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[28] see reference 26
[29] see reference 26
[30] see reference 26
[31] see reference 26
[32] see reference 26
[33] Deutsche Bank Research "China's Financial Sector: Institutional Framework and Main Challenges" China Special (2004)
[34] see reference 26
[35] see reference 26

4 Developing Process of Foreign Banks in China

The first foreign bank in China was established in 1845. In the era of Mao the Chinese banking sector was closed for foreign banks in a large extend.[36] Until the implementation of the reform- and opening policy foreign banks were not allowed to enter China. But until 1982 it was only possible for foreign banks to establish representative banks in China. According to the Chinese regulations the representatives were not authorized to conduct any profit-making activities. Meaning that in their function as “liaison office” their business transactions are limited to initiate a deal for their head office. Geographically, they could only be permitted to take up residences in selected, bigger coastal towns, e.g. Beijing, Dalian, Guanghzou, Quingdao, Shanghai and Tianjin as well as the special economic areas. With the branch opening of the Nanyang Commercial Bank of Hong Kong in January 1982 in Shenzhen (a Special Economic Zone), other foreign banks were granted to establish branch offices in the 4 special economic areas Shenzhen, Zhuhai, Shantou and Xiamen.[37] Contrary to the representative offices they were authorized to operate deposit- and credit transactions in foreign currencies. This was the first step of opening the Chinese banking sector to the rest of the world. However, until the end of 1991 foreign credit institutions were only permitted to operate in these mentioned areas. Since 1992 foreign banks could establish branches in 7 other Chinese large cities next to the special economic areas. In 1955 this market opening was expanded to 5 special economic areas and 19 large cities in China. In comparison to the representative offices the foreign branches could offer a bride assortment of businesses but their business opportunities was still strictly limited. At this time they could only conduct transactions with foreign customers and only in foreign currencies. RMB business was strictly excluded. In December 1996 four selected branches of foreign banks were granted permission from the PBOC to operate in RMB in the special economic area Pudong near Shanghai on an experimental basis. Since August 1998 these privileged banks could also conduct RMB transactions in Shenzhen and 32 branch offices were able to do business in RMB by the end of 2004. In 2003 foreign banks which already held a RMB license were permitted to apply to trade RMB business with Chinese enterprises in the thirteen cities that had been opened by this time.[38] Four foreign banks (Citi Bank, SBC, Mizuho Bank from Japan and Hong Kong based Bank of East Asia) were given approval to begin RMB business in 2004.

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[36] only in Shanghai and Fujian 4 or 5 banks belonging to Overseas Chinese were allowed, but barely doing business Liu, Di “Der chinesische Bankensektor: Erschüttung von Auslandskapital” (2000), p.76-77

[37] since 1988 one has to add the island Hinand and since 1990 also Pudong to Shanghai

[38] “China Opens Banking Industry Wider to Foreign Banks”, in: People’s Daily; December 1, 2003

One can determine that the opening of the Chinese banking sectors processed slowly and also started very late.

4.1 Establishment of Foreign Banks

There are more than 70 overseas banks operating in China. Some entered the market through direct investments in domestic lenders, others by building their own franchises. Many of the largest foreign financial institutions have decided to invest directly in domestic banks as well as growing their own business.

According to the Chinese laws[39] foreign financial institutions can only begin their business tasks in four forms:

1) a foreign-capital bank with its headquarters incorporated within Chinese territory (wholly foreign-funded bank)
2) a branch incorporated within Chinese territory by a foreign bank (foreign bank branch)
3) a bank with joint capital operated within Chinese territory by a foreign financial institution jointly with any Chinese company or enterprise (joint-equity bank)
4) acquisition of equity stake in Chinese domestic banks (ownership in Chinese banks)

The establishment of foreign-invested banks and their branches is subject to the examination and approval of the banking regulatory institution of the State Council (CBRC).[40]

To be permitted to establish a wholly-foreign-fund bank or joint-equity bank the imperative prerequisite is that the applying foreign financial institution has to be a commercial bank and situated with a representative office in the Chinese market for over two years. Hence the first step for a market entry in China is a representative office, which only task is to act as intermediaries between the customers and the head office bank but is not allowed to handle any banking operations. Besides the just mentioned prerequisite the formation of a subsidiary is bound to other requirements. The applying bank has to exhibit total assets at the end of the year prior to the submission of minimum $10 billion and the capital adequacy-ratio shall not be lower than 8

[39] Regulations of the People's Republic of China on Administration of Foreign-funded Financial Institutions (Regulations on FFI) Article 2

[40] Implementation of Foreign-funded Financial Institutions (FFFI) Article 4

percent.[41] A foreign bank that wants to establish a bank branch in China has to fulfil the following requirements: they need to exhibit total assets of no less than $20 billion at the end of the year before the application and a capital adequacy ratio of 8 percent and a representative office in China for more than 2 years.[42]
For a short time great attention is paid to the sufficient quality of the prospective management. The bank manager of the bank branch needs to have more than 10 years of expert knowledge in the financial sector of which 5 years have to be officiated in a higher position e.g. department head. Furthermore does he have to show a "correct conduct/good behaviour". In addition, he neither should have filed a petition in bankruptcy as proprietor nor as a manager of an enterprise. Over and above he must not have a criminal record. Besides, at least one Chinese citizen has to be employed in the leading management in every branch.

It is possible for foreign banks to enter the market through wholly-foreign-funded banks or joint equity banks. The minimum registered capital for a wholly-foreign-funded bank or joint equity bank has to amount RMB 1 billion[43] in freely convertible currencies. The applying bank has to hold year-end asset value of no less than $10 billion[44] and again must have maintained a representative office in China for over 2 years. Further must the applicant be located in a country or region where a sound financial supervisory system exists and should meet other prudential requirements.

The joint-equity bank must have a minimum registered capital of RMB 300 million[45] in freely convertible currencies with a representative office in China and a year-end asset value of minimum $10 billion in the year prior to application. Additionally, the largest foreign shareholder of a joint-equity bank has to be a commercial bank. Further must the applicant be located in a country or region where a sound financial supervisory system exists and should meet other prudential requirements.

The wholly-foreign-funded bank or joint equity bank can only make an application for establishing a new branch having a year-end asset worth $20 billion, having a capital adequacy ratio of 8 percent and having practiced within the territory of China for not less than 3 years, and having

[41] Regulations on FFI Article 10
[42] Regulations on FFI Article 12
[43] Regulations on FFI Article 8
[44] Regulations on FFI Article 10
[45] Regulations on FFI Article 11

made profits for the two successive fiscal years before the application.[46] In addition, they have to allocate RMB 100 million as dotation capital for the establishing branch.[47] The operating capital of a branch of a foreign bank as provided by its head office should not be less than RMB 200 million. And the aggregate amount of the working capital may not exceed 60 percent of its registered capital.[48]

According to the "one town-one branch" policy,[49] before the WTO accession foreign banks were only allowed to establish one branch in each approved town. This significantly complicates the possibility to foreign banks to offer their services properly and area wide. Besides the regional restraints the foreign banks suffer strongly from the strict business constraints. As mentioned before, the foreign banks were only allowed to do business transaction in foreign currencies and only with foreign customers (except 32 privileged foreign banks on an experimental basis). But these 32 banks were allowed to operate in RMB but only with foreign customers. The prerequisites to get a license for RMB business are very high. The foreign branches had to operate for at least 3 years in China and before the application they had to realise a surplus in 2 consecutive years. But whether the application will be allowed or not laid naturally in the hands of the Chinese authorities. Above all, the equity capital for RMB business for permitted bank branches had to be build up to at least RMB 30 million. The share in total equity and liabilities in RMB in these institutions must not exceed 35 percent of the total equity and liabilities in foreign currencies. The minimum reserve ratio in this connection rested with 18 percent double as high as in the Chinese banks (8 percent) and even higher in the foreign currency businesses (5-10 percent).[50] Due to all these restrictions it was nearly impossible for the foreign banks to compete with the Chinese banks on the same starting basis. For this reason the foreign banks didn't account for a noteworthy business competition to the domestic banks before the WTO accession.

After the WTO accession foreign banks can operate all kind of foreign currency businesses including deposits, loans, foreign exchange dealings, bank cards and more.[51] The geographical restrictions are lifted by December 2006. To engage in RMB business, a foreign bank has to operate in China for more than 3 years prior[52] to application and the operations have to be

[46] Regulations on FFFI Article 12 and Implementation of FFFI Article 17
[47] Implementations of FFI Article 15
[48] Implementations of FFFI Article 17(3) and Regulations on FFI Article 8
[49] Liu, Di „Der chinesische Bankensektor : Erschüttung von Auslandskapital" (2000), p. 12
[50] Liu ,Di „Der chinesische Bankensektor : Erschüttung von Auslandskapital" (2000), p. 224
[51] Regulations on FFI Article 29
[52] Regulations on FFI Article 34(1)

profitable for the 2 consecutive years before the application.[53] Further does the foreign financial institution have to meet the prudential supervisory requirements demanded by the CBRC.[54] If the solely-foreign-funded bank or joint-equity bank wants to provide RMB business to Chinese domestic enterprises then it has to exhibit a registered capital of more than RMB 600 million.[55] The registered capital must be higher, RMB 1 billion,[56] if the bank wants to provide RMB business to Chinese individual customers, of which the capital in RMB shall not be less than RMB 600 million and that in a foreign currency shall not be less than RMB 400 million in freely convertible currencies. If a foreign bank branch provides RMB business to Chinese domestic enterprises, the working capital must value at least RMB 300 million[57] and RMB 500 million[58] when it conducts RMB business with individual Chinese customers. It is not allowed for foreign financial institutions to underwrite securities or act as securities or insurance agents.

4.2 Business Control Ratio

Foreign banks have to formulate business rules and principles, improve risk management and internal control system[59] and they should lodge deposit reserve funds[60] and bad debts reserve funds[61] in accordance with the provisions.

Foreign financial institutions also need to fulfil several capital ratios. 30 percent of the working capital of a foreign bank should be maintained in interest-bearing accounts designated by the PBoC, including deposits in PBoC designated banks.[62]

The ratio of the proportion of RMB in the totality of operating capital and reserve of a foreign bank branch to the risk assets of RMB shall not be less than 8 percent.[63] A foreign bank branch must ensure liquidity. The ratio of the balance of liquid assets and the balance of liquid debts must not be less than 25 percent.[64]

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[53] Regulations on FFI Article 34(2)
[54] Regulations on FFI Article 34(3)
[55] Implementation of FFFI Article 35(2)
[56] Implementation of FFFI Article 36(2)
[57] Implementation of FFFI Article 35(1)
[58] Implementation of FFFI Article 36(1)
[59] Regulations on FFI Article 35
[60] Regulations on FFI Article 39
[61] Regulations on FFI Article 41
[62] Regulations on FFI Article 44
[63] Regulations on FFI Article 45
[64] Regulations on FFI Article 46

4.3 Management Requirements

The CBRC has to approve the chairman, president and general manager of foreign banks whereas other members of the senior management will be accepted by the local offices of the CBRC. The CBRC might interview the president or general manager candidates.

4.4 Tax treatment

Earnings made from foreign currencies enjoy the preferential tax treatment which is granted to all foreign-invested enterprises. That is, foreign banks in Special Economic Zones benefit from a corporate income tax rate of 15 percent.[65] Those banks that have a working capital of a minimum of $10 million and a period of operations of at least 10 years enjoy a tax benefit, commencing from their first profit-taking year, from corporate income tax in the first year and subject to corporate income tax at a rate reduced by one half for the second and third year.[66] Foreign banks which do RMB business are subject to 33 percent tax.

A newly enacted China's Corporate Income Tax Law ("CIT Law")[67] will bring new changes to foreign invested enterprises and foreign investors. This law will take effect from January 1, 2008. The new CIT rate for foreign investors are 25 percent, especially for foreign invested insurers, foreign invested asset management companies and security firms which are subject to the Foreign Enterprise Income Tax ("FEIT") rate which is 33 percent. Foreign invested banks, in the form of foreign bank branches or joint ventures with local partners could also enjoy an immediate reduction of CIT rate of 25 percent on the RMB business they are doing. Whereas, revenues of foreign currency will be subject to a tax rate of 25 percent instead of 15 percent, this will be gradually increased over a 5 year period.[68]

Foreign financial institutions are not only able to establish their own banks and branches they are also permitted to invest in Chinese financial institutions. To be permitted to invest or hold shares

[65] Rules for the Implementation of the Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises Decree [1991] No.85 of the State Council Article 73(3)
[66] Rules of the Income Tax Law Article 75(5)
[67] PWC "China Tax/ Business News Flash" Issue 8, April 2007
[68] see reference 65

in Chinese financial institutions,[69] the foreign financial institutions have to fulfil some conditions.[70] To invest in a Chinese commercial bank, the overseas financial institution needs total assets worth of $10 billion, for shares in rural or urban credit cooperatives totals assets worth $1 billion are necessary. A total asset of $1 billion is prerequisite when it concerns a non bank financial institution.[71] In addition, the foreign institution must have realized profits the last 2 consecutive years.[72] In case the foreign financial institution is a commercial bank, the capital adequacy ratio should be at least 8 percent.[73] If it is a non bank financial institution, the total capital they hold should be no less than 10 percent of total risk-weighted assets.[74] The foreign financial institutions should present a good long-term credit rank given by an international ranking institutions which is recognized by the CBRC.[75] And again, the foreign financial institution should be domiciled in a country or a region where a sound financial supervisory system exists and the economic status is adequate and it should meet other prudential requirements.[76]
The maximum equity of a single foreign investor or single foreign financial institution may acquire is 20 percent of the equity of a Chinese-funded financial institutions.[77] If the equity share of the total foreign investment in a non-listed financial institution does not exceed 25 percent[78] then the nature and the business scope of the institutions continues to be unchanged. But if the proportion of the investment by several overseas-funded financial institutions exceeds the 25 percent then it will be considered to be a foreign financial institution.[79] To continue, if foreign investors altogether acquire more than the critical value of 25 percent of the listed financial institution, then it will be treated as a domestic financial institution.[80]

If the Chinese financial institution is a state-owned commercial bank, a joint equity commercial bank or a non bank financial institution is directly controlled by the CBRC and wants to accept an investment from a foreign financial institution it should apply to the CBRC beforehand.[81] All other Chinese financial institutions should apply to the provincial agency of the CBRC.[82] After receiving

[69] Measures for the Administration of the Investment and Shareholding in Chinese-funded Financial Institutions by Overseas Financial Institutions (Measures in CCFI) Article 2
[70] Measures in CFFI Article 7
[71] Measures in CFFI Article 7(1)
[72] Measures in CFFI Article 7(3)
[73] Measures in CFFI Article 7(4)
[74] Measures in CFFI Article 7(4)
[75] Measures in CFFI Article 7(2)
[76] Measures in CFFI Article 7(5) and 7(6)
[77] Measures in CFFI Article 8
[78] Measures in CFFI Article 9
[79] Measures in CFFI Article 9
[80] Measures in CFFI Article 9
[81] Measures in CFFI Article 10(1)
[82] Measures in CFFI Article 10(2)

the approval by the CBRC, the foreign financial institution must transfer the full capital to the account of the CBRC within 60 days.[83]

5 China and the WTO

The World Trade Organization was founded in 1995 and is the successor organization to the GATT with 151[84] members today. The special focus of the WTO is on the rules governing world trade, the reduction of tariffs and non-tariff barriers. To open the markets and foster growth, prosperity and a rising standard of living; the rule of law and peaceful settlement of disputes which ensure fair play and shared interests and mutual benefits which should foster peace and stability are the main principles of the WTO. China used to have a huge amount of high formal and informal trade barriers and countless unfair trade barriers. Their key service sectors such as distribution finance and telecommunication continued to be closed to the foreign investors. As a non-member of the WTO, China always got the impression that its exports were often subject to discriminatory treatment in the overseas markets. After 13 years of negotiation China was allowed to join the WTO on December 11, 2001. As a result of negotiations, China has agreed to undertake a few important commitments to open and liberalize its regime to better integrate in the world economy. China will provide non-discriminatory treatment to all WTO members. Dual pricing practices will be eliminated as well as differences in treatment according to goods produced for sale in China in comparison to those which are produced for export. China will not use price controls to protect the domestic industries or service providers. Within the next 3 years after the accession all enterprises will gain the right to import and export all goods and be able to trade those throughout the customs territory with some limited exceptions.

Overseas funded banks in China will be permitted to handle business services of foreign currencies for Chinese enterprises and individuals in the year of China's accession to the WTO. Two years later, they will be granted permission to deal with RMB business for Chinese enterprises and in 5 years, the banks will be able to carry out RMB business for Chinese individuals and full ownership of Chinese banks will be permitted. Additionally, the minimum working capital of a foreign bank branch conducted in RMB business with Chinese enterprises has been lowered from RMB 400 million to RMB 300 million. And the required capital for a foreign

[83] Measures in CFFI Article 13
[84] WTO Homepage

bank branch to do RMB business has been cut down from RMB 600 million to RMB 500 million[85]. Furthermore it cancelled the one-year waiting period[86] for foreign banks to open a new bank branch, giving foreign banks the freedom to manage their expansion. The application process has been speeded up by limiting the time the regulator gives the approval or rejection[87] in comparison to the “no-time” limit for regulators to approve the applications for domestic banks.

The limit value of a single foreign financial institution in a Chinese financial institution was lifted from 15 percent to 20 percent and for foreign ownership from 20 percent to 25 percent. And the holding period in which the investors where not allowed to sell their shares has been cut down from 5 to 3 years.[88]

Foreign fund management companies and investment banks will be permitted to establish joint ventures with up to 49 percent equity in Chinese ventures. Overseas non-banking financial institutions may apply to establish companies in China specializing in car credit purchase services and overseas investors will also be permitted to apply to establish companies providing financial leasing services.

And as mentioned before, foreign institutions enjoy a special tax treatment, whereas Chinese domestic banks have to pay 33 percent corporate income tax, foreign banks in China are subject to a 15 percent corporate income tax in Special Economic Zones.[89]

By the end of December 2006 China will fully liberalize its banking sector.

There are five commitments on foreign financial institutions’ entry into China published by the State Council, which will come into effect on February 1, 2002:[90]

1) China will revoke the original regulation that establishment of foreign-funded institutions must get approval by the State Council. Under the premise of meeting the requirements, foreign financial institutions can apply for setting up commercial institutions in any city within China.
2) Control of targets on foreign exchange service by foreign financial institutions is to be lifted.
3) China will abolish the current business scale limitation as regulated for foreign firms in RMB market admission but 3 basic requirements have to be met before foreign financial institutions can run RMB business: first, they must have done business in China for more

[85] Implementation of FFFI Article 36(1)
[86] Implementation of FFFI Article 14
[87] Implementation of FFFI Article 21
[88]Delegations of German Industry and Commerce German Industry and Commerce Co. Ltd
[89] see reference 65
[90] “Five Commitments on Foreign Financial Institutions’ Entry into China”, in: People’s Daily Online; December 31, 2001

than 3 years, second, they must have made profit for 2 consecutive years and the meeting requirements of caution as stipulated by the PBoC have to be met.

4) China will loosen up the control on setting up joint venture banks or joint venture financial firms. Meaning that the Chinese need not be a financial institution anymore and the foreign financial provider can select any Chinese company as their partners.
5) China will enlarge business scope for RMB operations by foreign funded companies and will open wider on RMB business services in regions and targets to foreign firms.

The opening of the Chinese banking sector will bring a lot of improvement to the sector: enhance the capital structure of Chinese banks, increase capital inflow, bring in modern management and the essential expertise and standardize credit and financial transactions.

By the end of August 2004, 216 representative offices, 62 branches and 14 subsidiaries or joint venture entities have been established by foreign banks[91] and in 2006 there were 71 foreign banks represented in China. The total assets of foreign-funded banks in China had a value of $105.1 billion at the end of September 2006, which accounts for 1.9 percent[92] of the total assets of all baking institutions in the country.

[91] Mingkang, Liu "Creating a Favorable Environment for the Further Opening of China's Banking Industry", 2004
[92] Deloitte "Opening the Door: New Chinese banking Regulation Opens the Market", December 2006

Table 8: Timetable for Opening the Chinese Financial Sector under the WTO Commitment

Time Frame	By Geography	Foreign Banks can offer services to
December 2001 WTO accession	Open Tianjing, Dalian (in addition to Shanghai and Shenzen)	Foreign companies and foreign individuals
2002	Open Guangzho, Qingdao, Nanjing, Wuhan	Foreign companies and foreign individuals
2003	Open Jinan, Fuzhou, Chengdu, Chongqing	Chinese domestic companies
2004	Open Kunming, Zhuhai, Beijing, Amoy	Chinese domestic companies
2005	Open Swatow, Ningbo, Shengyang, Xian	Chinese domestic companies
2006	Lift all geographical restrictions	Chinese individuals (all restrictions lifted)

Source: WTO, DBResearch (2004)

6 Changes after the WTO Accession

China's banking sector today is looking much better, it improved its financial fundamentals and structural changes happened, especially in the ownership structure. The WTO opening has a positive long-term impact. The central government has welcomed greater foreign ownership in banks. These strategic partnerships are assumed to help Chinese banks in product knowledge and innovation, to expand businesses and markets and to achieve international know how and management. It was not difficult for the Big Four to find major foreign investors or strategic partners. The Royal Bank of Scotland, Merrill Lynch, Li Ka-Shing,[93] Singapore's Temasek Holdings, Union Bank of Switzerland and Asian Development Bank hold together around 16 percent of the BoC's capital. The major foreign investors of the CCB are the Bank of America and the Singapore's Temasek and together they hold 14 percent stake of CCB. Goldman Sachs, Allianz and American Express hold 10 percent of the stake of ICBoC's.

Listing on the stock market is expected to keep banks focused on increasing the shareholder's value and to install financial restructuring with capital injection and corporate governance by forming joint-stock companies.[94] Among the Big Four, the CCB has been listed as the first bank on the Hong Kong stock market in October 2005. It issued 26.49 billion[95] shares priced at HK$2.35 on the Hong Kong stock market and raised $9.2billion, where $25.16 billion were officially distributed to institutions and the remaining $1.32 billion set aside for retail investors. The shares have performed well, since their launch they have gone up more than 40 percent (end of September 2005). CCB is also listed on the Shanghai stock exchange. In May 2006 the BoC has listed its shares on Hong Kong's stock market and in July 2006 on the Shanghai stock market. The IPO took in $9.7 billion in Hong Kong, the biggest IPO worldwide since 2000.[96] In late October 2006 the ICBC has followed the other Big three and listed its shares on the two stock exchanges, raising $19.1 billion in its IPO, the largest in the history. The IPO was oversubscribed and the share price closed 15 percent higher on the first trading day.

Statistics, done by the CBRC have shown that 71 foreign banks from 20 different countries and regions have established a number of 238 business branches in China, worth a total amount of $84.5 billion in financial assets, which accounted for about 2 percent of the Chinese financial institutions' total capital.[97]

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[93] a prominent Hong Kong business man
[94] Chinese banks reap rewards of reform", in: Asia Times Online ; June 7, 2006
[95] "CCB sees "milestone" debut, trading ends flat", in: China Embassy ; October 27, 2005
[96] see reference 94
[97] see reference 94

The China Construction Bank proposed as the first of the Big Four a restructuring plan to the State Council in February 2003.[98] The central government investment arm, the Central Huijin Investment Co. Ltd. injected $22.5 billion into the bank in 2003.[99] In September 2004, the bank established a joint-stock company.[100] The Bank of America (see table below) purchased 9 percent of the stakes of the CCB, investing $2.5 billion in June 2005. The Singapore's Temasek Holding Ltd. invested $1.4 billion in order to get 5.1 percent of the bank. On September 11, 2006, the Bank became the first issuer of H-shares to be included in the Hang Seng Index. The bank commanded a 2.45 percent capitalisation share in the index and the H shares closed at HK$ 4.95 with a rise of 110.64 percent over the IPO price at December 29, 2006.
A major breakthrough[101] was obtained in overseas expansion through the successful acquisition of a 100 percent interest in Bank of America (Asia) Ltd. and its subsidiaries for a value of HK$ 9.71 billion. Due to the acquisition, the size of their operations in Hong Kong doubled.

In 2003, the BoC received a capital injection of $22.5 billion from Huijin and launched a joint-stock company in August 2004. To come into possession of 10 percent of the BoC, the Royal Bank of Scotland invested $3.1 billion. Other strategic investors are Switzerland's UBS, the Asian Development Bank and the Singapore's Temasek Holdings Ltd.[102]

The Industrial and Commercial Bank of China came into possession of $15 billion from Huijin in April 2005 and launched a joint-stock company 2 months later.[103] For an 8.89 percent stake American Express and the Allianz Group together invested $3.78 billion, being the biggest amount of foreign investment in a Chinese bank.

The Agricultural Bank of China
At present, ABoC owns 32 provincial level branches, 5 directly affiliated branches, 1 banking department head office, 3 training colleges, and has set up branches in Singapore and Hong Kong and established offices in London, Tokyo, and New York, etc.

[98] see reference 94
[99] see reference 94
[100] see reference 94
[101] CCB annual report 2006
[102] see reference 94
[103] see reference 94

Table 9: Foreign Investments in Chinese banks

Chinese Banks	Foreign Investment	Shares in %	Date of Time
Industrial and Commercial Bank of China (ICBC)	Goldman Sachs, Alllianz Group, AMEX	10.0	August 2005
Bank of China Limited (BoC)	Consortium, leaded by Royal Bank of Scotland	10.0	August 2005
Nanchong City Commercial Bank	DEG; Sparkasse International Development Trust; Savings Bank Foundation for International Cooperation	10.0	July 2005
China Construction Bank (CCB)	Bank of America Temasek	9.0 5.1	June and July 2005
Hangzhou City Commercial Bank	Commonwealth Bank of Australia	19.9	April 2005
Bank of Beijing	ING IFC	19.9 5.0	March 2005
Bohai Bank	Standard Chartered Bank	19.99	January 2005
Jinan City Commercial Bank	Commonwealth Bank of Australia	11.0	September 2004
Xian City Commercial Bank	Bank of Nova Scotis IFC	2.3 2.5	September 2004
Bank of Communications	HSBC	19.9	August 2004
Shenzhen Development Bank	Newbridge Capital	17.89	June 2004
China Minsheng Banking Corp.	IFC Temasek	1.6	April 2003
Industrial Bank	Hang Seng Bank GIC IFC	15.98 4.0 5.0	December 2003
Shanghai Pudong Development Bank	City Group	5.0	January 2003
Nanjing City Commercial Bank	IFC	15.0	November 2001
Bank of Shanghai	HSBC IFC Shanghai Commercial Bank	8.0 7.0 3.0	September 1999 and December 2001
China Everbright Bank	Asian Development Bank	1.9	1996
	Standard Chartered	no information	no information
Dalian City Commercial Bank	SHK Financial Group	10.0	no information
Huaxia Bank	Oppenheim Sal	4.5	2006
	Deutsche Bank	9.5	2006
Guangdong Development Bank	Citigroup	20.0	2006

	IBM	4.74	2006

Source: Schüller, Margit (2006) p. 49 and own research

There are 14 joint-stock banks with a sizeable national business scope and more than a half has foreign strategic partners. 5 out of 13 banks are listed in the domestic stock markets[104]. The joint-stock banks have strengthened their capital by injecting funds through foreign partners, IPOs and subordinated debt issues. In comparison with the Big Four, the government is not playing an active role in the reform of these banks. They occupy mainly the help of their new partners in the design of improved risk management and internal control system.

The reforms started by the city commercial banks, including recapitalisation, internal reform, IPOs and getting strategic partners. The recapitalisation was made possible because of the strong relation to the local governments. On that account, their deposits have the specific tendency to come from local governments and corporations. Eleven of the city commercial banks have foreign financial institutions as their strategic partners e.g. Bank of Shanghai with HSBC and IFC. The city commercial banks arouse the interest of SMEs because of their strong local network and their knowledge. On the reverse side they tend to have high loan concentration and party-related transactions.

Even the rural credit cooperatives could not get away without any changes. Some of the rural credit cooperatives had to become rural commercial banks and rural cooperative banks, where some of them have attracted the interest of foreign investors. The Australia and New Zealand Banking Group (ANZ) has bought a 19,9 percent stake of the Shanghai Rural Bank. However, to reform this sector will definitely take more time considering that there are 30 000 rural credit cooperatives and that political sensitivity is a main issue here.

In June 2006, the CBRC approved the launch of the China Postal Savings Bank (CPSB) and inaugurate on March 20, 2007.[105] It also stated that the CPSB would belong to the China Post Group to 100 percent, a $10 billion stand alone company formed out of the State Post Bureau.[106] This establishment is part of the development of the rural economy as most of the postal savings

[104]China Merchant Bank, Huaxia Bank, Minsheng Bank, Shanghai Pudong Development Bank and Shenzhen Bank
[105]"The CBRC approved China Postal Savings Bank to prepare for the incorporation of Guangdong branch and Shenzhen branch as well as their local offices", in: CBRC Press Release; 2007
[106] "New Postal savings bank gets approval", in: China Daily; January 3, 2007

outlets lay in the rural areas. The bank weighted worth $2.66 billion[107] wants to apply to become a qualified domestic institutional investor (QDII), which would allow it to invest overseas on behalf of its account holders. The bank should immediately benefit from the nationwide network of 36,000 post offices, 60 percent of which are in the countryside. The CPSB prepares for incorporation of branch offices in Guangdong and Shenzhen City. The postal saving bank is further allowed to set up another 1151 outlets.[108] The latest news is that ING Group has the intention to invest in the CPSP according to Hans van der Noordaa, the Chairman of the ING Bank for the Asia-Pacific area.

Some foreign banks expected that certain restrictions would carry on. Changes happen very slowly but most executives are satisfied that the reform process moves in the right direction. The CBRC approved 9 foreign banks for local incorporation: ABN AMRO; Bank of East Asia, Bank of Tokyo-Mitsubishi, Citigroup, DBS Group Holdings, Heng Seng Bank, HSBC, Mizhuo Corporate Bank and Standard Chartered.[109] The table 10 below shows the benefits of incorporation of foreign banks. Many banks are also strengthening and "expand" their strategic partnerships and alliances with Chinese domestic banks. A consortium led by Citigroup bought an 85 percent stake worth $3.1 billion[110] to win control of the southern China's Guangdong Development bank. This process took longer than a year and shows how much time is necessary for overseas bank to break into the Chinese market. Citigroup has further the purpose to increase its stake in Shanghai Pudong Bank from its current level of 4.6 percent to the limit value of 19.9 percent.
HSBC for instance bought 19.9 percent of the Bank of Communcations and the life insurer Ping AN Insurance, and an 8 percent stake in Bank of Shanghai to enlarge its network of more than 30 mainland locations.
Bank of America has put all its hope in the 9.1 percent stake of CCB.

[107] "ING Group will bei China Postal Savings Bank einsteigen", in: EMFIS; October 9,2007
[108] 1 operational management department, 19 sub-branches , 1038 field offices in Guangdong and 93 sub-branches in Shenzhen (CBRC Press Release)
[109] "Nine foreign banks get first China registration", in. Reuters News; December 24, 2007
[110] "Citigroup wins $3.1 bln battle for Guangdong Bank", in: Reuters News Update; November 16, 2006

Table 10: Benefits of Incorporation

Benefits of incorporation		
	Foreign bank branch	Locally incorporated wholly-foreign-funded bank or joint venture
Access to local RMB business	Cannot provide retail RMB business to Chinese citizens except for acceptance of deposits in excess of RMB 1 million	No restrictions
Minimum registered	RMB 200 million minimum operation funds	RMB 1 billion in freely convertible currency
Statutory reserves	Most set aside 30 percent of operating fund for statutory reserves	No requirement
Loan to deposit ratio	No restrictions	Must be less than 75 percent (however a grace period to 31 December 2011 is provided)

Source: KPMG report „Retail Banking in China: New Frontiers“, 2007

7 China's Banking Sector: Outlook

Although all the geographical restrictions have been lifted many restrictions still remain. A slow and complex change from branch status to locally-incorporated bank awaits foreign banks who want to enter the market. Through improvisation it was possible for Morgan Stanley to buy 100 percent of Nan Tung bank as the bank is not considered a foreign-funded bank and not a local lender and formerly owned by a Macau- based unit of BoC.[111]

Due to many forecasts, foreign banks are unlikely to become a strong competition to Chinese banks since it is still very hard for foreign financial institutions to attain a license. Licenses are granted after a long qualification period[112] and then they are still subject to certain regulations e.g. foreign banks have to fulfil certain profitability requirements in order to derive a license. Requirements which are very difficult to attain without the desired local currency license.

[111] "Morgan Stanley buys bank to gain China access", in: Reuters News UPDATE; October 3, 2006
[112] Details on FFFI Article 21

Furthermore are foreign bank is subject to demanding reporting requirements which are very time consuming as well. According to Article 13 for foreign financial institutions [113] it is required to translate all materials into Chinese and the annual report must be audited and a Chinese or English version must be enclosed. Although all the restrictions are lifted by December 2006, the most effective way of entering the Chinese banking sector still might be to acquire equity stakes in Chinese domestic banks and to establish foreign bank branches for foreign financial institutions. The advantage is that with the establishment of foreign bank branches the capital requirements are lower than with a wholly-foreign-funded bank or joint-equity bank but is still engaged in the same business activities. Chinese banks don't have to worry about their clients abandoning them for foreign banks since they have an extensive branch network and existing relationship with local clients. More cooperation between foreign banks and Chinese banks in partnerships are expected being a typical win-win situation for both. The Chinese banks can improve on credit and risk management, internal controls and IT system whereas the foreign banks can gain more distribution channels and use a wider customer networks.
Although 2006 was an outstanding year, it will still take many years to reach the full benefits of the market reforms.[114]

Recently the development moves towards foreign interest in Taiwan. Standard Charted took over a local bank and Citigroup investigating similar opportunities. Taiwan companies started to invest heavily in China, where their home banks are forbidden to operate due to the political situation.[115]

At the moment, foreign banks enjoy lower corporate income tax rates and therefore the government wants to harmonise the tax gap between foreign investors and domestic companies but this will be changed in 2008 due to the new CIT law.

According to KPMG, due to intense competition it could take 10 to 20 years to make profits. Also saying that overseas lenders need to find creative distribution channels e.g. mobile phone banking or partnerships with large insurance companies.

To open branches all over the country can be very cost-intensive, very slow and the public will not be delighted to see the largest state-owned banks to be totally acquired by foreigners and therefore joint-equity banks will probably become hot targets for foreign acquisition or increase in

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[113] Details on FFFI Article 13
[114] Poole, R. "WTO is only the Warm-up", May-June 2006, China Business Review
[115] KPMG report "Retail Banking in China: New Frontiers" 2007

ownership of current overseas shareholders. Joint-equity banks are a flexible form to enter the market and banks can react positively to the changing environment.

ICBoC plans to expand outside of China. According to Chairman Jiang Jianqing the bank wants to establish subsidiaries in New York[116] and Moscow, take over a bank in Sydney, and open branches in Dubai and Qatar. And at the end of August 2007, the bank reported that it intends to buy a 79.9 percent stake of Macao's Hang Seng Bank for HK$ 4.55 billion, where the acquisition should be done by March 2008. This month, the ICBoC is to acquire a 20 percent stake, paying $5.5 billion in Standard Bank, the largest bank in Africa according to the assets.

In a survey done by PWC (PricewaterhouseCoopers)[117] with 40 foreign banks, the CEOs stated the changes and outlook on the Chinese banking sector. When asking what the major concerns of the Chinese banking system are at the present mainly all bankers expressed their concerns about the nature of regulation. It often lacks clarity of coordination for foreign banks. Further, they noticed that the currency is not fully convertible and there is also a lack of comprehensive credit history which is a shortcoming when planning to enter the retail market. The most important changes taking place in China's financial market are definitely the local incorporation. But there are also pressures on the banks. A few are the increasing number of new regulations, the recruiting of office staff and the operation risk management. Over two-thirds of the banks cited that they have experienced a staff turnover above 15 and 35 percent. Even Asian banks have problems to recruit and keep their staff. Another major problem in this issue is that due to so much competition, banks lose their only good office staff to other banks which offer higher salaries.

The product areas which might become important in the Chinese retail banking sector are expected to be credit cards, investment products and mortgages. The foreign banks expect a range of new entrants, which could become a threat over the next three years: auto finance companies like Ford Credit, large international insurance companies, private equity firms like Carlyle Group, leasing firms such as VW Leasing and global retailers like Carrefour and Wal-Mart. The banks clearly see growing opportunities in the Chinese market and stress that the foreign banks market share will still be less than 2 percent.

[116] "ICBC beginnt mit Übersee-Expansion", in: EMFIS; October 18, 2007
[117] PWC "Foreign Banks in China", May 2007

8 Taiwan

8.1 Introduction

Taiwan was declared a Japanese colony after the Sino-Japanese war in 1895, and remained a Japanese colony until the end of World War II in 1945. In 1947 the Constitution of Taiwan was adopted. Two years later the Chinese nationalist forces under Chiang Kai-Shek retreated from the Communist armies and took power in Taiwan. From that time one Taiwan was officially in a state of war with the Peoples' Republic of China.

Between 1962 and 1985, Taiwan's economy experienced its most rapid growth in history: an average annual growth rate of nearly 10 percent, or more than twice the average economic growth rate of industrialized countries during this period. Beginning of the 80s, the economy started to begin to open and free and the ROC government announced to liberalise and globalise the economy. In the past, due to such a dynamic economy its development was often referred to as "The Taiwan Experience or Miracle". Taiwan was at that time known as one of the Asian Tigers or Dragons.

At present does Taiwan's business show signs of acceleration and for the first half year in 2007 the estimated GDP growth rate of Taiwan is 4.40 percent with an annual forecast of 4.38 percent. With 3.84 percent unemployment rate, Taiwan has achieved a new low since 2000.

8.2 An Institutional Overview of Taiwan's Financial System

In the next few pages I will give a short description of the roles, characteristics and current standing of the different types of financial institutions in the Taiwanese banking sector.

8.2.1 The Banking Sector

Commercial banks, trust and investment companies, credit departments of farmers and fishermen's associations, credit cooperatives, the Postal Remittances and Savings Bank, bills finance companies, financial holding companies and local branches of foreign banks are involved in indirect financing and activities of the money market.

1) Domestic commercial banks: at the end of 2001, Taiwan had in numbers 53 commercial banks, which decreased to 39 by 2006 through mergers. [118]

26 of the Taiwanese banks rank among the top 500 banks in the world in terms of capital.

Taiwanese domestic banks offer a various range of services which includes receiving deposits, making loans, handling trade financing, providing guarantees and discounting bills and notes. Mostly they are also involved in underwriting and trading securities, managing bond and debenture issues and in providing savings-account facilities. One can divide the domestic banks into two categories:

- State owned banks/government banks: this group of bank refers to those that are wholly owned (100 percent) by the government or where the government has an ownership percentage more than 20 percent.

There used to be 5 government banks which are wholly owned by the government but by the end of 2005 there are only 3:

(1) Central Trust of China ➡ were merged July 1, 2007 into Bank of Taiwan
(1) Bank of Taiwan
(2) Land Bank of Taiwan and
(3) Export-Import Bank of ROC

The Ministry of Finance planned to privatize all government banks, except the Bank of Taiwan by the end of 2006 by reducing government ownership in Land Bank of Taiwan, Central Trust of China and Taiwan Co-op Bank to less than 50 percent. According to the Premier Chang Chun-Hsiung, the “Big Three” will be incorporated into a fully-state owned “Taiwan Financial Holding Company” by the end of 2007.[119] The “Big Three” have combined assets of $158.8 billion, which would rank the new holding company as the 18th largest bank in Asia and the 89th largest bank in the world in term of their assets, according to the London-based “The Banker”. The Bank of Taiwan is ranked 121st and the Land Bank of Taiwan 184th in The Banker’s ratings. In 2008 the government wants to reduce the number of government banks even further through the sell-off of government shares.

[118] Central Bank of the Republic of Taiwan Statistics Financial Monthly September 2007
[119] “Future holding company to merge state-owned banks”, in: Taiwan Headlines; August 16, 2007

There are 8 banks where the ownership percentage ranges between a bit below 20 percent and under 100 percent:

(1) Bank of Kaohsiung

(2) Chang Hwa Bank

(3) First Commercial Bank

(4) Hua Nan Bank

(5) Mega International (CTB+ICBC) Bank

(6) Taiwan Business Bank

(7) Taiwan Cooperative

(8) Bank of Overseas Chinese (under 20 percent ownership)

- Private banks: all the other banks are referred to private banks.

Table 11: Taiwanese Banks in Overview 2006

Code No.	Name / Address	Date Founded
0040000	Bank of Taiwan	1946/05/20
0050000	Land Bank of Taiwan	1946/09/01
0060000	Taiwan Cooperative Bank	1946/10/05
0070000	First Commercial Bank	1898/11/26
0080000	Hua Nan Commercial Bank	1947/03/01
0090000	Chang Hwa Commercial Bank	1904/06/05
0100000	Bank Of Overseas Chinese	1961/03/01
0110000	The Shanghai Commercial & Savings Bank	1965/06/16
0120000	Taipei Fubon Commercial Bank Co., Ltd.	1969/04/21
0130000	Cathay United Bank	1975/05/20
0150000	The Export-Import Bank of the Republic of China	1979/01/11
0160000	Bank of Kaohsiung	1982/01/30
0170000	Mega International Commercial Bank Co., Ltd.	1912/02/05
0180000	Agricultural Bank of Taiwan	2005/05/26
0400000	China Development Industrial Bank	1999/01/01
0480000	Industrial Bank of Taiwan	1999/09/02
0500000	Taiwan Business Bank	1976/07/01

0520000	Standard Chartered Bank (Taiwan) Limited	1948/09/16
0530000	Taichung Commercial Bank	1978/01/01
0540000	King's Town Bank	1948/11/01
1010000	First Capital Commercial Bank	2007/07/01
1020000	Hwatai Bank	1999/01/01
1030000	Taiwan Shin Kong Commercial Bank Co., Ltd.	1997/01/01
1080000	Sunny Bank	1997/09/01
1180000	Bank of Panhsin	1997/09/30
1470000	Cota Commercial Bank	1999/01/01
7011616	Remittances & Savings Department of Taiwan Post Co., Ltd.	1930/01/06
8030000	Union Bank of Taiwan	1992/01/21
8040000	The Chinese Bank	1992/01/25
8050000	Far Eastern International Bank	1992/04/11
8060000	Yuanta Commercial Bank Co., Ltd.	1992/02/12
8070000	Bank SinoPac Company Limited	1992/01/28
8080000	E. Sun Commercial Bank, Ltd.	1992/02/21
8090000	Cosmos Bank, Taiwan	1992/02/12
8100000	Bowa Bank	1992/03/04
8120000	Taishin International Bank	1992/03/23
8140000	Ta Chong Bank Ltd.	1992/04/02
8150000	Jih Sun International Bank	1992/04/09
8160000	EnTie Commercial Bank	1993/04/15
8220000	Chinatrust Commercial Bank	1971/07/09
8250000	Chinfon Commercial Bank	1971/07/28

Total unit :41

Source :CBC 2006

2) Credit cooperatives: the credit cooperatives in Taiwan play an active role in providing banking services in the regional community and therefore they have an important function among local financial institutions. They participate in clearing operations, regardless of whether they have branch offices or not.[120] In Article 15 of the Credit Cooperatives Act of the Republic of China, [121]

[120] Regulations Governing the Administration of Negotiable Instrument Clearing Business by the Central Bank of the Republic of China, Date of Issuance: July 31, 2002

the services which can be provided are precisely written down e.g. accept checking deposits, demand deposits, term deposits and saving deposits; provide short-, medium- and long-term loans. Due to the reorganization of credit cooperatives the number is steadily going down from 74 in 1999 to 39 in 2001 to 27 at present.

3) Credit Departments of Farmers' and Fishermen's Association: the credit departments of farmers still have 260 units[122] whereas the credit departments of fishermen are very limited in size with 25 units.[123] They accounted for 6.06 percent[124] of total deposits and 3.25 percent[125] of total lending in 2003, although they are not really noteworthy in size, they still serve all the financial needs in the areas where the farmers, fishermen and their families live.

4) Investment and Trust Companies: Investment and Trust companies manage trust funds and trust properties and provide non-discretionary and discretionary account services. In recent times many investment and trust companies have been transformed into commercial banks therefore only two companies are left nowadays: China United Trust and Investment Corporation and Asia Trust and Investment Corporation.[126]

5) Postal Savings System: The Postal Savings System of Taiwan has more than 1,600 post offices throughout the country where people can remit or deposit money. Money may be withdrawn and re-deposited into banks, or reinvested in different financial instruments. But it is prohibited to use the deposits made with the Postal Saving System to draw up immediate loans. The Postal Savings System accounted for 14.78 percent[127] of total deposits outstanding in 2003.

6) Bill Finance Companies: Bill Finance Companies were tries to equip efficient short-term funds raising channels and to smooth the operations of Taiwan's money market operations. To help bills finance companies implement and allocate funds in a more efficient way, authorities amended the "Regulations Governing Bills Finance Company's Investment in Bonds and Stocks" on August 12, 2005. Due to that, bills finance companies are authorized to invest in bonds, listed stocks and bills for a value commensurate to 15 percent of their net worth. In 2001 Taiwan had 15

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121 The Credit Cooperatives Act Of The Republic Of China, Date of Issuance: February 4, 2004
122 Central Bank of the Republic of China Statistics (List of Financial Institutions)
123 Central Bank of the Republic of China Statistics (List of Financial Institutions)
124 Financial Supervisory Commission, Executive Yuan (Release) "Financial Institutions"
125 see reference 118
126 Central Bank of the Republic of China Statistics (List of Financial Institutions)
127 Financial Supervisory Commission, Executive Yuan (Release) "Domestic Institutions"

bills finance companies with NT$1,701 billion in total assets spread across 48 branches, now there are 12 companies left.

7) Financial Holding Companies: The government has encouraged companies which offer financial services to consolidate in order to increase their competitiveness. On June 27, 2001 a Financial Holding Company Law was passed which should encourage companies to diversify their services, integrate them and expand their economies of scale. At present there are 17 companies, which show an increase of 4 companies compared to 2001.

Cathay Financial Holdings is the largest holding company in Taiwan at the moment with total assets worth $105 billion,[128] ranked 343 out of 500 companies in 2007 by Fortune Global 500. Composed of insurance, securities, banking and other diversified financial institutions, Cathay Financial Holdings has become a full-functioning financial platform[129] Cathay's mission is to improve its cross-selling strategy and provide a one-stop shopping convenience[130] for its customers.

On April 27, 2004, Cathay Life Insurance Co. and the China Eastern Air Holding Company received permission from the China Insurance Regulatory Commission (CIRC) to set up a joint venture life insurance company and they seek to commence operations before the end of the year. This is an important milestone in the cooperation between both partners in mainland China's insurance market. It is also the first successful step for Cathay Financial Holdings as it seeks to become a regional financial services provider.

8) Foreign banks: In order to strengthen Taiwan's trade relation with other countries and to raise the quality of financial services, the government allowed foreign banks to enter the market as early as 1959. The Banking Law and the Regulation Governing the Foreign Banks' Branches and Representative Offices regulate foreign banks. The key requirement to establish a branch in Taiwan is that the banks have to be under the top 500 banks globally concerning their assets or shall have run transactions with Taiwanese corporations equivalent to $1 billion during 3 years prior to their application[131] of which as many as $180 million[132] shall have been medium or long term credits. Although the total number of branches of foreign banks has declined from 53 to 44, the total assets held by them had risen to US$7,110 million by 2006.

[128] Fortune Global 500 Year 2007
[129] Cathay Holdings Homepage
[130] see reference 129
[131] Regulations Governing Foreign Bank Branches and Representative Offices Article 2 (2)
[132] WTO "Accession of the Separate Customs Territory of Taiwan, Penghu, Kinmen and Matsu", December 14, 1994

Table 12: Listing of Foreign Banks with Branches in Taiwan 2006

Country	Name
US	American Express Bank Ltd.
	Bank of America N.A.
	JPMorgan Chase Bank
	Bank of New York
	Citibank N.A:
	Wells Fargo Bank Minnesota N.A.
	State Street Bank & Trust Co.
	Wachovia Bank N.A.
	Caylon Corporate & Investment Bank
Europe	ABN AMRO Bank N.V.
	BNP Paribas
	Deutsche Bank AG
	Fortis Bank
	ING Bank N.V.
	KBC Bank N.V.
	Societè Generale
	Standard Chartered Bank
	UBS AG
	Barclays Bank
Japan	The Bank of Tokyo-Mitsubishi Ltd.
	Sumitomo Mitsui Banking Corporation
Canada	Bank of Nova Scotia
East & South Asia	Bangkok Bank Public Company Ltd.
	Metropolitan Bank & Trust Company
	United Overseas Bank Ltd.
	The Bank of East Asia Ltd.
	The Development Bank of Singapore
	The Hong Kong & Shanghai Banking Corporation Ltd.
	Overseas-Chinese Banking Corporation Ltd.
Other	The Standard Bank of South Africa

Source: CBC Statistics

9) Offshore banking activities: in 1983 the government promulgated the Offshore Banking Act with the intention to encourage the development of international financial activities.

OBUs (Offshore banking units) can take foreign currency deposits, extend credits in foreign currencies, sell foreign currency financial debentures, buy or sell foreign currency denominated securities and more. Natural persons who hold a foreign passport and have no residential place in Taiwan, governments and financial institutions can be clients of the OBUs. Through the years OBUs have become an important financing channel for overseas subsidiaries of Taiwan enterprises. Domestic as well as foreign banks can establish an OBU within the ROC. Foreign banks can set up OBUs without undertaking any businesses in Taiwan itself. At the end of September 2007, there were 65 OBUs (27 of them established by foreign banks) including 38 domestic banks and 27 foreign banks.[133] The assets of all OBUs counted together have a value of $85.847 billion of which $64.373 billion accounted for domestic banks.

The government planned to allow Chinese tourists to visit Taiwan by the end of 2006. According to this plan, the Financial Supervisory Commission (FSC) grants Chinese people the permission to open accounts at OBUs of Taiwanese domestic banks.[134]

8.2.2 Bond and Stock Markets

The Taiwan Stock Exchange (TSE) was incepted in 1961 and is regulated by the FSC. At the end of 2005 a number of 691 companies were listed at the TSE and market capitalization has a value of NT$15.6 trillion. The TWSE, or TAIEX (9300.22 on November 7, 2007), is a capitalization-weighted index of all listed common shares traded on the Taiwan Stock Exchange. The index was based in 1966. The index is also known as the TSEC Index. The Taiwanese stock market is opened to foreign investors with minimal restrictions.

The main participants in the Taiwanese bond market are securities firms, bills finance corporations, banks, insurance companies, mutual funds and institutions investors.

According to Regulations Governing Investment in Securities by Overseas Chinese and Foreign Nationals Article 4 foreign investors are allowed to invest in government bonds, time deposit, money market instruments and funds, futures for hedging purpose, options, NT dollars interest rate derivatives.

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[133] Central Bank of the Republic of China Homepage Press Release “Overview of OBUs”, September 2007

[134] “OBUs permitted to take deposits from Mainland China“, in: Taiwan.com.au; September 29, 2006

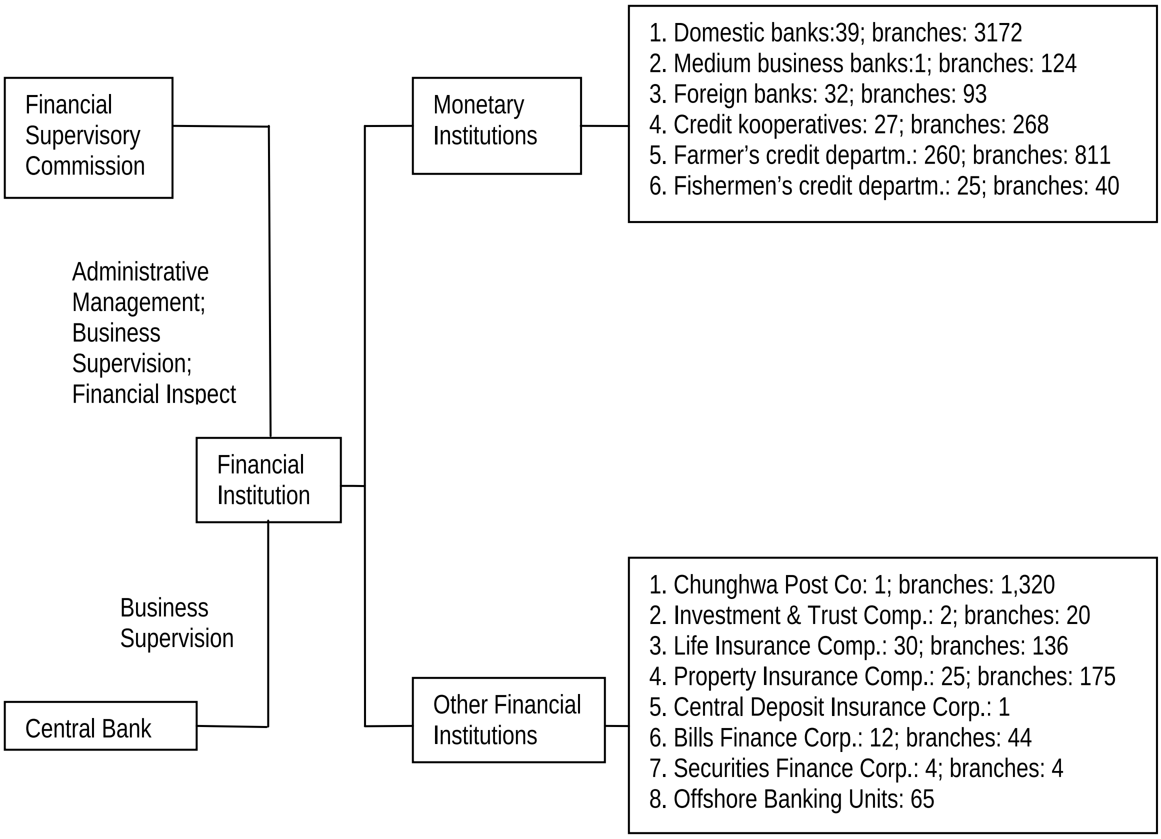
8.2.3 Regulatory Agencies:

1) Financial Supervisory Commission (FSC) was set up as a single financial regulator on July 1, 2004. It is an independent authority at cabinet level and is able to carry out vigorous law enforcement and comprehensive supervision. The FSC consolidates the functions of regulatory monitoring for the banking, securities, futures and insurance industries and leads the financial examinations across these sectors. Its mission[135] is to maintain financial stability, to accelerate internationalization and deregulation and to increase market confidence. The FSC and the Central Bank must hold financial supervisory cooperation meetings. According to the FSC organic Act, the FSC[136] is in charge of managing financial systems and supervisory policy issues, drafting financial laws and regulations, supervision and regulation of financial markets, examination of financial institutions etc.
2) Ministry of Finance (MOF): additional to its Taxation, Customs and Treasury jurisdictions, the MOF is also in charge of the supervision of the financial markets in the ROC through three major subordinate agencies: the Bureau of Monetary Affairs (BOMA), the Securities and Futures Commission (SFC) and the Department of Insurance.
3) The Central Bank of the Republic of China (CBC): according to the Central Bank of China Act, the bank's mission is to promote financial stability, maintain the stable internal and external value of the currency and to ensure sound banking operations. The bank functions as the major operator of the payment system in Taiwan. It is responsible for the efficiency of the payment system and has to supervise the clearing houses. And it has the power to examine the operations of all financial institutions.
4) The Bureau of Monetary Affairs (BOMA): the BOMA is the banking authority under the MOF in the ROC. It was set up in 1991 and according with the Banking Law, the BOMA regulates and supervises banks including specialized banks, commercial banks, local branches of foreign banks and trust and investment companies. The BOMA can grant bank license, review the applications for new branches, can take disciplinary actions against banks that act against laws and regulations and can examine banks.
5) Central Deposit Insurance Corporation (CDIC): the CIDC is government-owned and was established on September 27, 2007 with capital invested by the MOF and the Central Bank of the Republic of China. CDIC is the only institution which is in charge of managing the deposit insurance system. The mission of the CDIC is written down in Article 1 of the

[135] Financial Supervisory Commission Homepage
[136] see reference 135 (FSC Homepage)

Deposit Insurance Act. The CDIC is responsible of handling deposit insurance, managing deposit insurance risk and has to deal with failing and failed insured institutions.

Table 13: Interaction of the Financial Institutions in Taiwan



Source: CBC Monthly Financial Statistics September 2007

9 Taiwanese Banking Sector under Reforms

Taiwan banking goes back to the colonial times when Japan restructured the banking system to gain control of the economic activities on Taiwan. They established the credit cooperatives and colonial banks for which the Kuomintang retained after Taiwan returned back to China in 1945.

For example the First Commercial Bank was established in 1899 and is the outgrowth of the Savings Bank of Taiwan, the Chia-I Bank (established in 1905), the Commercial and Industrial Bank of Taiwan (established in 1910) and the Hsin-Kao Bank (established in 1916) and after 1945 the bank was taken over by the Japanese and in 1949 it was renamed into the First Commercial Bank of Taiwan.

A civil war followed as a consequence in China between the Kuomintang and the Chinese Communist party. To be able to finance the war, the Kuomintang (KMT) oversupplied money which led straight to a hyperinflation. Having learned their lecture from this incidence, the ruling party restructured and had great emphasis for government-controlled banks. In this period, most public banks were set up.

The Republic of China (ROC) economy grew rapidly through the 1960s and 1970s where more private banks were established to complement the public banks. In order to control the sector, the banks were more or less related to the government. At that time, the financial sector was highly protected from outside competition. The entry of new banks into the market sector was limited and the entry of foreign banks rather a diplomatic gesture, especially the US. But through the rapid growth and the increase in financial activity the ROC had to liberalize itself to attract foreign investors and financial institutions.

Since 1987 the ROC has undergone some reforms. Among the changes were the interest rate liberalization, the relaxation of restrictions on cross-border capital flows and the extension of including deposit interest rates. The Banking law of 1989 ended Taiwan's long story of interest rates control and lifted all restrictions on interest rates. Furthermore has the ROC developed a short-term money market and a long-term money capital market to satisfy the requirements of supply and demand.

When setting up its money market in 1975, the ROC was restricted to inter-bank call loans and other short-term monetary instruments, but since then it developed into the second largest money market in Asia with a turnover of more than $1.6 trillion. The revised Securities Transaction Law of 1989 allowed new entries in the stock market into the brokerage business and loosened restrictions on inward remittances of foreign capital for portfolio investment.[137] The ROC has strengthened the financial regulation and supervision due to the changes in the financial environment in the recent years. In accordance to the Bank of International Settlements, the government set a capital adequacy ratio of 8 percent of risk assets. In 1987 the ROC set up the

[137] Government Information Office, ROC Homepage

Central Deposit Insurance Corporation to grant a better safety net for depository institutions. The Banking Law of 1989 granted access into the financial banking sector but also tightened up regulations covering problem banks. After the revision of the Banking Law in 1991, entry into the ROC's financial sector became relatively unconstrained over all granting new banking licenses, which suddenly brought 16 new banks to the surface. The reforms however, have only increased competition for banks which were already struggling with their financial survival but at that time no one seemed to have any reservations since deregulation and liberalization where the words of these days. The banking reform turned out to be a continuous progress during the 1990s.

In order to promote the active market of corporate bonds and to announce more competition between the banking institutions, the first credit rating company opened its doors in May 1997. Credit cooperatives were further allowed to transform into banks. In October 1997 the local futures exchange was opened and the Taiwan International Mercantile Exchange (TAIMEX) was inaugurated in 1998. In order to mobilize the domestic stock markets and to increase international competitiveness the Ministry of Finance (MOF) eased the regulation of foreign capital. In February 1999, the limited ratio of domestically listed firms, which can be held by a single foreign investor was increased from 15 percent to 50 percent and for foreign investors from 30 percent to 50 percent.[138] Even the quota of portfolio investment by a single foreign investor has been raised twice, once from $600 million to $1.2 billion in November 1999 and then again to $1.5 billion in October 2000. Based on the Act for the Establishment and Administration of the Financial Restructuring Fund, the ROC set up a Resolution Trust Corporation (RTC) to ease the restructuring or liquidation of poor-quality assets and to cease insolvent institutions to exit the market. Therefore a public capital of NT$140 billion was needed, where NT$120 billion were coming from business taxes. In order to help strengthen the clearing, settlement and depository system the Act Governing Bills Finance Businesses were established and the Amendments to the Banking Act and the Trust Enterprise Act in 2000. These financial reforms have the target and focus on the improvement of the quality of assets, enhancing the confidence of investors in the banking system and giving way for the establishment of asset management companies (AMC) and financial asset services companies (FASC), which grant permission to purchase and unite between banks and other financial institutions. After the laws became effective end of 2001, 14 financial holding companies integrated with financing and banking services have been set up.
On January 1, 2002 Taiwan became the 144th member of the WTO after fulfilling requirements in the financial service sector and other sectors:

[138] "Why Taiwan's being easier on foreigners", in: Asia Times Online, December 15, 2000

- “Deregulation of requirements restricting foreign banks in establishing branches and representative offices in Taiwan;
- Elimination of the ceiling on the level of New Taiwan dollar-denominated deposits which foreign banks may hold;
- Allowing foreign insurance companies to operate in Taiwan;
- Elimination of bans prohibiting banks from providing underwriting and certification services for commercial paper;
- Allowing foreigners to establish billing companies in the financial services sector;
- Relaxing limitations on foreign investment in foreign currency brokerages.” [139]

10 Developing Process of Foreign Banks in Taiwan

10.1 Establishment of Foreign Banks

In order to encourage and motivate foreign financial institutions, the FSC (Financial Supervisory Commission) permitted foreign financial institutions to take over domestic financial institutions by public tender offer.[140] It is allowed to take over domestic financial institutions by establishing subsidiary banks either through merger or assuming the latter’s entire operations, assets and liabilities.[141] As mentioned before, a foreign bank which wants to apply for the establishment of a branch office within the ROC has to be ranked under the top 500 of the world or shall have conducted transactions with corporations of the ROC equivalent to $1 billion.

A bank which received the approval to establish branch offices shall procure a minimum operating capital of NT$150 million[142] for the first branch and NT$120 million[143] for every additional branch office it wants to set up.

A foreign bank can also apply to establish one representative office in Taiwan only when meeting the following requirements: the bank must be ranked among the top one thousand banks in terms

[139] “Trade and Investment Opportunities Presented by Taiwan's Accession to the World Trade Organization”, Board of Foreign Trade, August 27, 2001
[140] Financial Supervisory Commission Press Release “FSC Allows Foreign Banks to Take Over Domestic Financial Institutions”, July 11, 2007
[141] see reference 140
[142] Regulations Governing Foreign Bank Branches And Representative Offices Article 3
[143] see reference 142

of their capital or assets or should have conducted transactions with Taiwanese corporations with a value over $300 million.[144] Additionally, the banks must have a good credit rating and the competent authorities in its home country must have given approval to establish a representative office in Taiwan.[145] But the representative offices, like in China, are not allowed to engage in any business transactions. They function as liaison department and information gathering.

The regulations also give a limit concerning the aggregate amount of credit that may be extended by a foreign bank branch to the same person or entity in foreign currency which should not pass 25 percent of the global net value of the foreign bank. Article 14 (1) says that if a foreign bank branch has a net value under NT$300 million then the aggregate amount should not be greater than 10 percent of the aggregate amount of all credit extended in New Taiwan Dollars and NT$1 billion. And if a foreign bank branch has a net worth of NT$300 million or more than the aggregate amount should not surpass 15 percent of the aggregate amount of all credit extended in New Taiwan Dollars and NT$2 billion.[146]

To be able to set up a commercial bank as a foreign bank, the foreign bank must establish a financial holding company first and then establish a subsidiary, which takes over all the liabilities of the local lender before one can proceed with the merger. The UK Standard Chartered Bank[147] received the permission as the first foreign bank to establish such a financial holding company in order to simplify its acquisition of Hsinchu International Bank. Citibank, the largest foreign bank in Taiwan in terms of assets, was granted permission to set up a commercial bank with the intention to merge with a local lender with a capitalization of NT$66 billion ($1.99 billion). Citibank wants to merge 10 of its 11 local outlets with 55 branches of Bank of Overseas Chinese, which it had acquired for NT$14 billion or $424 million in April.[148]

[144] Regulations Governing Foreign Bank Branches And Representative Offices Article 5 (2)
[145] Regulations Governing Foreign Bank Branches And Representative Offices Article 5 (3)
[146] Regulations Governing Foreign Bank Branches And Representative Offices Article 14 (2)
[147] “Citibank gets green light to set up commercial bank“, in: Taipei Times; August 17, 2007
[148] see reference 147

10.2 Tax Treatment

Foreign banks enjoy the same status as the domestic banks in Taiwan.

Taiwan withholding tax rate on dividends, interests and royalties payable to a non-resident is 20 percent. Enterprises which are incorporated according to the Corporate Law in the ROC are entitled to tax incentives provided by the Statue for Upgrading Industries

Financial institutions are subject to a special business tax on the basis of their gross business receipts at rates ranging from 0.1 percent to 25 percent. A separate business turnover tax applies to banking, insurance and investment services at a 2 percent rate.[149] In article 10 of the Value-Added and Non-Value-Added Business Tax Law it says that “the business tax rate shall be 2 percent for enterprises engaged in banking, insurance, investment trust, securities, futures, commercial paper and pawnshops, but 5 percent for all other operations which are not connected exclusively with their authorized business, and 1 percent for reinsurance premiums of insurance enterprises”.

11 The Existing NPL Problem

Due to over-banking and extreme competition the credit quality declined. Heavily dependence on the mortgage of real estate made the value decrease.

Whenever the financial sector of Taiwan needs an infusion of capital to be able to survive, they search for foreign investment. The domestic banks of the ROC have lost NT$7.4 billion in 2006 as a group. To be able to keep their capital adequacy ratio above 8 percent, which is defined by the Bank for International Settlements, Taiwan needs foreign capital injections. Let us have a look on the problems which might have caused these problems.

“If Asian economies deal with their Non performing loans, they will emerge as an engine of growth” stated in an Ernst & Young Report about Asia in 2002.

[149] Deloitte “Taiwan International Tax and Business Guide“ (June 2006)

Since the Asia Crisis in 1997 the NPLs in the banking sector have raised severely. To handle this problem the banks have reinforced credit risk management and used the provision of loan loss reserves to write off bad loans. But NPLs continued to build up. The government decided to help the banks reducing their NPL problems to prevent a financial crisis. First of all, the Central Bank announced the decrease in the reserve ratio on deposits. In July 1999, the Ministry of Finance decreased the gross business receipt tax (GBRT) for banks from 5 percent to 2 percent (as mentioned before) and should be reduced to zero by 2006 (no information found). On November 24, 2000 the government enacted The Merger Law of Financial institutions (MLFI), which offers several benefits for disposal of non-performing loans to an Asset Management Corporation (AMC). In September 2001 Taiwan established the Taiwan Asset Management Corporation (TAMC or TAMCO) and in 2002 15 local and international AMCs had been established to dispose over NT$160 billion in NPLs.

TAMCO's assignments are the purchase of NPLs from financial institutions, the management of NPLs and other related activities e.g. reorganization, planning of financial management etc. there are two methods for financial institutions to sell their NPLs. One method is to sell to AMCs by an auction institution; the other is for financial institutions to negotiate the prices with the AMCs in a direct way.

Two years later the government allowed insurance companies[150] to invest in AMCs. These companies had bought NT$161.2 billion ($4.7 billion) worth of bad assets. Taiwan's NPL problem seems to become better over the years. Some local financial institutions set up subsidiary AMCs in 2004.

NPLs decreased from NT$432 billion in December 2004 to NT$394 billion in June 2005[151], meaning that the NPL ratio declined from 2.78 percent in December 2004 to 2.46 percent in June 2005 but increased to 2.87 percent in the following month.[152]

Deutsche Bank Taipei[153] recently has seen its NPL ratio climbing up to 22.64 percent due to NT$2.2 billion outstanding loans by Asia Pacific Telecom Co. Under these circumstances the Bureau of Monetary affairs limited the bank's hedging position for selling and buying derivative financial products. The outstanding loans of foreign banks in Taiwan amount NT$593.3 billion

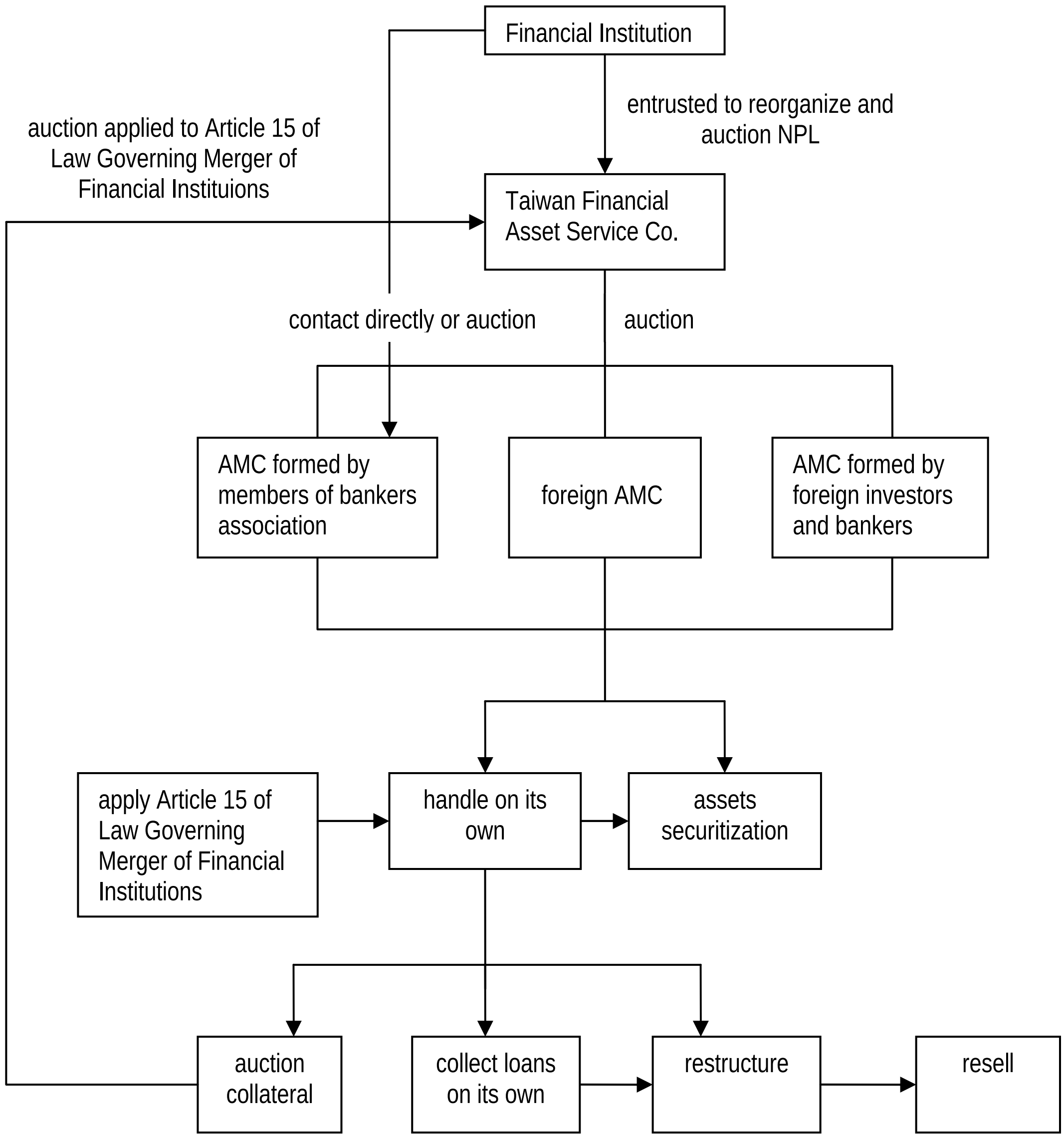
[150] "Banking Sector Checkup", in: Taiwan Review; July 1, 2003
[151] PWC "NPL Asia" Issue 6, November 2005
[152] see reference 151 (PWC NPL Asia)
[153] "Deutsche Bank Taipei has highest NPL ratio of 22.64% among foreign banks in Taiwan", in: Taiwan Headlines; August 23, 2007

($17.98 billion) with a NPL ratio of 1 percent[154] still lower than the domestic banks. But Bangkok Bank has a NPL ratio of 3.87 percent and American Express Bank follows with 3.52 percent.
Many banks try to dispose their NPLs: the Bank of Overseas Chinese sold NT$6.5 billion to TAMCO or Taiwan Business Bank disposed NT$8 billion to Colony in 2005. In March 2007, the NPL ratio dropped to 2.32 percent, which means a decrease of NT$8.9 billion. The NPL ratio of 33 banks out of the 41 domestic banks was below 5 percent.[155]
The government has set up changes in form of incentives to those banks which can handle their NPL ratio below 2.5 percent whilst banks with a ratio over 15 percent will receive a penalty of having their top management dismissed from duty.

So one can say that the disposal of NPL have been the sale to AMCs, both foreign and domestic through auction process with special banks. The AMC structure is largely private and decentralized. To participation of the private sector in combination with the government and regulatory reforms was a main reason for the development of the NPL market.
The FSC sorted out that the selling of non performing assets by financial institutions should be operated in a transparent way with open biddings to amplify market transparency. Additionally, banks should never just conclude auctions with just one bidder. This policy might influence the NPL situation of Taiwan in the near future.

[154] see reference153
[155] Financial Supervisory Commission Press Release “Non Performing Loans of Domestic banksi n March 2007”, May 3, 2007

Table 14: Diagram of Handling NPLs



Source: The Second Forum for Asian Insolvency Reform (FAIR), December 2002 (www.oecd.org/dataoecd/42/27/2490917.pdf)

Table 15: Non Performing Loan Ratios of Domestic Banks from 2000 to 2006

Year	Non Performing Loans (NT$ million)	Total Loans (NT$ million)	NPL Ratio (%)
2000	773,522	14.474,639	5.34
2001	1.087,013	14.527,437	7.48
2002	864,350	14.130,749	6.12
2003	630.628	14.563,210	4.33
2004	436,991	15.558,302	2.81
2005	370,530	16.566,573	2.24
2006	366,093	17.195,956	2.13

Non performing loans include: payment of principal is past due three months or more, repayment of interest is past due six months or more and instalment repayment loans for medium to long-ter, is past due six months or more.
Definition of “non performing loans”:

1. Loans which repayment or interest have been overdue for more than 3 months
2. Any loan of which the debtor has been sued for non-payment , although the repayment has not been overdue for more than 3 months

Source: CBC Financial Statistics Annual

12 Taiwan and Its Market Liberalization due to the WTO Accession

In order to meet all requirements to enter the WTO, the government has to come across with some changing reforms.
From January 2002, Taiwan announced to lift off limits on foreign investment in the domestic market to liberalize its economy and improve its investment environment. The limit on New Taiwan dollar (NT$) deposits that a branch of foreign bank is allowed to take has been put an end to.[156] Non-residents have been granted permission to open NT dollar bank accounts and limits on branch banking have been removed too, although approval must be obtained to open new branches. Also the restrictions on capital flows linked to portfolio investment have been lifted.[157]
Foreign investors are also allowed to trade NT dollars derivative products with financial institutions and permitted foreign investment institutions to subscribe to securities in private

[156] U.S. Department of State Taiwan “2005 Investment Climate Statement -- Taiwan”
[157] see reference 156

placement which are issued by companies who are listed on the Taiwan Stock Exchange and the Gre Tai securities market.[158]

The securities and insurance industries have been liberalized and are now open to foreign investment.[159] Furthermore, foreign financial institutions have a more vast access to the Taiwanese securities markets. In July 2003 the government removed the restriction of $3 billion on inward remittances by a qualified foreign institutional investor (QFII). A few months later Taiwan abolished the QFII system to attract more foreign investors into Taiwan's securities market and to extend its scale and integration with international markets. In the past, only such approved "qualified foreign institutional investors" like large banks, insurance companies, securities firms and mutual funds received approval to engage in portfolio investment.[160] Futures, money market funds and bank deposits are limited to 30 percent of total inward remittances. All offshore foreign portfolio investors can trade in Taiwan's stock market albeit of their size, with the exception for investments in hedge funds and investors from the People's Republic of China. But onshore foreign investors as well as other individuals living in Taiwan are still subject to portfolio investment limits of $5 million for an individual foreign investor and $50 million for a non-QFII-foreign company.[161]

The ROC has opened up its stock market to foreign investors with only minimum restrictions and the capital markets are opened to increase foreign investors, who are not permitted to manage derivative financial products instead of spot commodities. And in addition the Securitization of Financial Assets Law was implemented in July 2002, to improve and increase the liquidity of financial assets, including the total liberalization of foreign investments in the public and private placement of securitized financial assets.

At the end of 2002, Taiwan distinguished all legal limits on foreign ownership in companies listed on the Taiwan Stock Exchange with the exception of certain industries e.g. airline companies, power distribution.[162]

The implemented Financial Institutions Merger Law, Financial Holding Company Law and Trust Business Law expanded operating space and strengthened the competitiveness. The Business Tax Law has been cut down from 5 percent to 2 percent and the government shows intention to cut it even down to zero percent.

[158] Securities and Futures Bureau (SFB), January 21, 2003
[159] see reference 156
[160] see reference 156
[161] see reference 156
[162] see reference 156

Taiwan presents following key advantages and market strengths in the financial services area which makes it attractive to foreign investors:

- The Taiwanese financial holding companies are already in action across several financial services areas.
- The overdue loan situation in Taiwan has improved significantly, which provides good circumstances for mergers and acquisitions.
- Many of the corporations in Taiwan are highly competitive with very flexible organisational structures and qualified, English speaking personnel. The flexible structure makes it possible for the corporations to respond quickly to new market opportunities and changes in the environment.
- Taiwan enjoys low external debts, a high level of foreign reserves and furthermore abundant capital resources.

Taiwan is Asia's 5th biggest economy and the residents have $1.3 trillion in non-financial assets. Last year 2006, the wealth management revenues grew by nearly 40 percent and asset securitization products grow 150 percent a year. Besides Taiwan's trade network is intertwined, because more than half of Taiwan's exports are targeted to Hong Kong, China and South Korea. These are some important reasons why foreign banks love Taiwan. The Taiwanese trade with China increases by year but Taiwan's banks are barred from opening bank branches in mainland China because of the legacy of a civil war that effectively ended in 1949 when Mao forces drove Chiang Kai-Shek into exile on the island. This gap can be filled by foreign banks. In addition, Taiwanese employees are skilled and speak Chinese and English, which can help foreign banks to expand their presence in China. Many people think that it is easier to transfer Taiwanese bankers to China than to train Chinese bank staffers there.

Although some see foreign banks and investors as saviours, others see these circumstances as dangerous because nearly all smaller banks in Taiwan are looking to sell out shares to foreign investors. Citigroup, HSBC and Standard Chartered have gained more than 100 branches over the past 3 years offering a wide package of worldwide products to local customers. So the question arises: What will happen to Taiwanese banks, how will they be able to compete against these financial giants?

The "foreign invasion" has also an important impact on Taiwan's economic policy. Many specialists worry what will happen when another Asian financial crisis hits Taiwan again and Taiwan is only left with foreign banks, which do not take on money-losing ventures.

But Taiwanese banks have found a way how to “use” foreign institutions. The E. Sun Company has developed partnerships with Temasek and the English Prudential Plc., which are strongly present in China and the future lies in the regionalization and definitely in China.

Foreign banks can, in comparison to Taiwanese banks, open up branches in China and can offer a full range of financial services and employ Taiwanese staffers there, which is a situation that cannot be influenced and observers view these circumstances with high nervousness. Taiwan’s banks are losing out to overseas rivals because Citigroup and Standard Chartered for instance took over two local banks and can exploit offices in China to win Taiwanese customers. Taiwan companies and individuals are the biggest investors in China, pouring $150 billion into the country. About 1 million of Taiwanese live and work in China, a big group of potential customers to compete about. The foreign competitors can combine their operations in China, Hong Kong and Taiwan, which put the Taiwanese banks even more under pressure. Citigroup for instance bought 86 percent of Guangdong Development Bank in China and wants to increase its shares from 3.78 percent to 19.9 percent in Shanghai Pudong Development Bank[163].

But in 2001 China has allowed commercial banks of Taiwan, United World Chinese Commercial Bank, Chang Hwa Bank and Hua Nan Commercial Bank to set up representative offices in China. They have established offices in Shanghai and the Jiangsu Province.[164] Taiwan Cooperative Bank,[165] one of Taiwan’s biggest leading financial institutions, opened up a representative office in Beijing on November 7, 2002 which is the first step to loosen up the “aggressive” relationship between China and Taiwan and the start to open commercial operations in China after having representative offices for two years. In the meantime, the representative offices are limited to non-profit activities. But as seen over the intervening years, Taiwanese banks have been rejected of being upgraded to branches due to the lack of cross- Taiwan Strait financial supervisory agreement.[166]

In 2003 China Merchants Bank, Industrial Bank, Industrial & Commercial Bank of China and Pudong Development Bank received permission from Chinese regulators to establish representative offices in Taiwan but they are still waiting for approval from Taiwan.[167] Legally it is permissible for Chinese banks to set up representative offices in Taiwan but due to its policy the government of the ROC still keeps the ban in place.[168]

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[163] “Taiwan Bank hamstrung in fight with foreign rivals“, in: China Post; May 11, 2007

[164] “PBoC Approves Two Representative Offices of Taiwan Banks“, in: People’s Daily; March 11, 2002

[165] “Taiwanese Banks Poised to Tap Mainland Market”, in: People’s Daily; November 7, 2002

[166] “New Statue Said to Erode Banks’ Effort to Tap China Market”, in: Taiwan Headlines; November 10, 2007

[167] “Chine Banks May Gain Taiwan Foothold”, in: Herald Tribune; February 25, 2005

[168] “Restrictions on Taiwanese Branches of Foreign Banks with Chinese Stakes Under Review”, in: Taiwan Headlines; November 10, 2007

The PBoC has also granted permission that allows banks in Taiwan to hold shares of commercial banks in China.[169]

13 Taiwan's Banking Sector: Outlook

Local banks are operating in a tough environment in which severe market fragmentation and a flattened yield curve. That's the reason why many domestic banks search for foreign investors. In 2006 Standard Chartered took over Hsinchu International Bank for $1.2 billion[170], Newbridge Capital purchased 22.3 percent of Taishin FHC, Temasek invested in 15 percent in E.Sun Commercial Bank and the Japanese Shinsei Bank bought a 31.8 percent stake in Jih Sun International Bank.[171] In April 2007, Citigroup made the announcement that it intends to purchase the Bank of Overseas Chinese, which would bring Citi Taiwan more than a million new clients and would increase its branch network from 11 to 66.[172] The opportunities opened through privatisation, consumer demand are increasing international investment in financial services in Taiwan. In turn, demand for foreign capital and expertise carry on to grow. The advantage of acquisition is that it can help foreign investors to build on existing connections and to overcome restrictions concerning new branch opening.

The political relations between China and Taiwan remain strained. However, through exports from Taiwan to China the economies are growing closer and Taiwanese firms are very important investors in China. These factors offer growth potential in corporate banking services.

Taiwan's domestic banks have suffered due to a "credit card crisis", where lenders gave consumers credit cards without doing credit checks. But the problem became stable and many foreign investors want to invest in Taiwan in order to increase their influence in China.

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[169] "Chinese Mainland Banks Hope to Establish Themselves in Taiwan", in: People's Daily; October 19, 2002
[170] "StanChart Sees Taiwan Operations Return to Profits", in: Reuters News; March 27, 2007
[171] PWC "Entering the financial services market in Taiwan"
[172] "Citigroup to buy out local bank", in: Taiwan Times; April 10,2007

14 Conclusions

To conclude one can say that the liberalization of the Taiwanese financial sector saved some banks but did not only bring advantages with it. The Taiwanese banks cannot stop other foreign competitors of entering the market. Therefore they have to increase their skills and in the meantime learn from foreign banks in order to be better prepared to take on any challenges. It is unsure what will happen in case of a financial crisis. Will foreign banks take over insolvent domestic banks like domestic banks used to do so? What happens to domestic banks in general if all the banks sell their stakes to foreign banks? The financial market in Taiwan is unstable but profits can be achieved. Most of the investors who put money into the Taiwanese financial sector are trying to increase their market competitiveness in China, hoping to reach Taiwanese citizens living and working in China.

Due to the WTO accession, China has started important reforms and lifted many restrictions for foreign investors. But although all the geographical restrictions are lifted and foreign investors line up to invest, the Chinese domestic banks do not have to feel threatened by the foreign banks. Because of the close network of domestic banks, especially in the rural area, it will be hard for foreign banks to increase their market shares. Foreign banks enter the market and leave the market. There are opportunities to make profit but not as easy as imagined and it will take time. Also do foreign banks have the problem of finding the right banking officer, who can speak English and has the needed skills.

Overall one can say that the Chinese as well as the Taiwanese banking sector have undergone a lot of important reforms in order to fulfil the WTO commitment by time. Both have lifted restrictions and made it easier for foreign investors to enter the market but foreign investment has not only brought the best with it.

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Appendix:

Zusammenfassung (Abstract):

Diese Diplomarbeit zielt darauf ab die jüngsten regulativen Reformen bezüglich der Problemlösungen im Bankensektor in Taiwan und China aufzuzeigen und wie die Banken versuchen sich zu restrukturieren um mit den radikalen Veränderungen im Bankensektor Schritt zu halten.
Zu allererst möchte ich einen kurzen Überblick über die in China existierenden Institutionen und Behörden geben und einen Rückblick auf die Geschichte des Finanzsektors geben. Im Detail bedeutet das die Umwandlung von einem Monobankensystem mit kaum mehr als der "People's Bank of China" als der einzigen Geschäfts- und Zentralbank. Danach beschäftige ich mich mit dem Transitions-/Reformprozess und dem Problem der nicht einbringbaren (notleidenden) Krediten, als auch mit den regulativen Reformen, die die existierenden Probleme korrigieren sollen. Der nächste Teil der Arbeit handelt von der Neugründung von ausländischen Banken und deren Spezialbehandlung in China. Dann liegt der Fokus auf dem Welthandelsorganisations Beitritt (WHO), die Zugeständnisse der chinesischen Regierung und die Konsequenzen der Liberalisierrung auf den bis dahin (1979) völlig für das Ausland geschlossenen Markt. Darauf folgt ein kurzer Ausblick auf den chinesischen Finanzsektor, der die Auswirkungen der Liberalisierung in den kommenden Jahren vorhersehen soll.
Danach wende ich mich der Republik China (Taiwan) zu, auch bekannt als einer der vier Tigerstaaten. Taiwan ist am 1. Jänner 2002 der WHO beigetreten und um dieses Ziel zu erlangen, musste die Regierung einige wichtige Reformen durchführen. Auch in Taiwans Fall beschäftige ich mich kurz mit den Banken- und Regulierungssystem, deren Geschichte, dem gleitenden Reformprozess, beginnend mit der Machtübernahme der Kuomingtang Partei in Taiwan und dem daraus folgenden WHO Beitritt. Im Unterschied zu China, hat Taiwan ausländische Investoren schon sehr viel früher willkommen geheißen. Deswegen waren die Restriktionen gegenüber ausländischen Finanzinstitutionen niedriger als in China. Mit ein Grund für die frühere, einfachere und bessere Entwicklung von ausländischen Banken, Versicherungsunternehmen und anderer Organisationen, die im Finanzdienstleistungsektor tätig sind. Wie in China, hatte/hat auch Taiwan mit notleidenden Krediten zu kämpfen. Taiwan hat dieses Problem in einer ähnlichen aber effizienteren Art und Weise gehandhabt. Dies war/ist nur aufgrund des privaten Rückkaufs von Krediten möglich. Der Beitritt zur WHO hat dazu geführt, dass der taiwanesische Bankensektor von einem sehr konservativen geschützten zu einem hoch liberalen und modernen Bereich reformiert wurde.

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