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TAIWAN'S BANKING SECTOR REFORMS: RETROSPECTIVE AND OUTLOOK

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The Taiwanese banking system has evolved significantly since the government amended the *Banking Law* in 1989 to promote internationalization and liberalization of the banking sector. Since their first introduction in the early 1990s, private banks have grown quickly and now play a significant role in the financial system. Concurrently, many state-owned banks have been partially privatized and now operate largely along commercial lines. These reforms were essential in helping Taiwan's economy and financial system modernize. Despite much progress, Taiwan's banking sector is marked by low profitability and excessive competition that are potential threats to the long-term health and stability of the financial system. This *Asia Focus* outlines the history of financial and banking reforms in Taiwan, analyzes problems that developed in the banking sector after liberalization, and evaluates current initiatives by regulators to address those problems.

Financial and Banking Reforms in Taiwan

Financial Liberalization Accelerated in the 1980s

Until the late 1980s, Taiwan's banking sector remained predominantly state-owned. The leadership of the large state-owned banks retained close links to the ruling political party. Additionally, the government exerted significant influence over the allocation of capital through administrative measures on bank lending and regulation of interest rates.

In such a tightly controlled banking environment, only a handful of borrowers—typically large industrial conglomerates—had access to bank loans, resulting in a rapidly expanding informal financial sector that provided credit to underbanked businesses and individuals but was fraught with predatory lending, insider trading, and other illegal activities.[1]

The inefficient structure of the financial system stood in sharp contrast to the remarkable transformation of the rest of the Taiwanese economy. Starting in the 1970s, Taiwan's manufacturing and export sectors had evolved to become highly competitive in world markets and powered an impressive increase in economic growth and living standards.

During this period, public demands increased for the government to modernize the financial sector and expand access to credit for households and small- and medium-sized businesses. Beginning in 1975, the Taiwanese government started implementing policies to gradually liberalize interest and exchange rates (*Table 1*). By 1987, most controls on interest rates and the exchange rate had been removed.

Despite the removal of most of these controls, the banking sector remained largely unchanged. It was not until the amendment of Taiwan's *Banking Law* in 1989 that the banking sector would fundamentally transform. Importantly, the amendment eliminated the remaining restrictions on bank lending and deposit rates, marking the completion of Taiwan's interest rate liberalization reform which officially started in 1975.

Table 1 - Key Developments in Taiwan's Financial Liberalization, 1975-1992

1975	Taiwanese government began relaxing its controls on bank lending rates.
February 1979	Taiwan's foreign exchange system was converted from a fixed-rate system to a managed float regime.
November 1980	The central bank promulgated and implemented the *Guideline on the Adjustment of Bank Interest Rates,* which deregulated interest rates on negotiable certificates of deposit and money market rates. Bank lending rates were allowed to float within a wider band.
1984	Qualified banks were allowed to establish three full-service branches and three limited-services branches each year, compared with two each earlier.
March 1985	The Interest Regulation Act was abolished. The range of lending rates was expanded. Interest rates on foreign currency deposits were liberalized. Banks were allowed to price their own interest rates.
January 1986	The central bank simplified deposit rate structures and gave banks more freedom to price deposit rates. Prior to the change, there were 13 types of deposit rates; this number declined to four after the change.
July 1987	All foreign exchange controls on trade-related account transactions were abolished.
July 1989	The *Banking Law* was amended. All remaining restrictions on bank lending and deposit rates were eliminated.
1991-1992	Sixteen new private banks were established.

Source: Wu, Chung-Shu, and Sheng-Cheng Hu. Deregulation and Interdependence in the Asia-Pacific Region. Edited by Takatoshi Ito and Anne O. Krueger. Vol. 8. Chicago and London: University of Chicago Press, 2000.

Opening up the Banking Sector in the Early 1990s

Beginning in the early 1990s, Taiwan's banking sector was transformed from a market dominated by a few state-owned banks to one featuring a wide variety of private, semi-private, and state-owned banks. While foreign banks were allowed to enter the Taiwan market as early as the 1950s, banking licenses were generally not granted to domestic private entities.[2]

This situation changed in 1989 with the amendment of the *Banking Law*, which permitted private banks to apply for licenses for the first time. Entry requirements for *de novo* banks as set by the 1989 amendment were fairly stringent. The minimum paid-in capital requirement for a *de novo* bank was NTD 10 billion (USD 304 million).[3] Only four existing banks at that time had a capital base that exceeded this requirement. Among other restrictions for opening up new banks were strict requirements on the qualifications of senior management and restrictions on branching. The purpose of these requirements was to reduce potential operational risks associated with the overcrowding of the banking sector and overly rapid expansion of newly established banks.

Despite these stringent requirements, the private sector welcomed the deregulation of the banking industry with enthusiasm. In 1990 alone, banking authorities received a total of 19 applications for *de* *novo* banks. In 1991, 15 new banking licenses were granted, bringing the total number of domestic banks to 40. In 1992, a 16th new bank received a banking permit.[4] Due to the stringent entry requirements, newly established banks were typically sponsored and controlled by conglomerates and wealthy families.

During this period, several of the largest state-owned banks also underwent partial privatization. The government aimed to improve the operational efficiency of these banks as well as reduce allegations that state-owned banks were being used as tools for political patronage. In 1989, the Executive Yuan established a privatization task force which identified nineteen state-owned enterprises, including four banks, for privatization.[5] In 1991, two additional banks were added to the list of privatization targets.[6] That same year, the Legislative Yuan revised the *Statute for Transfer Public Enterprises to Private Ownership*. The new rules specified that state-owned enterprises, including state-owned financial institutions, could be privatized via sale of assets or offering of shares on the stock market.[7]

Although plans for privatization of the state-owned banks began in earnest in the 1990s, they did not come to fruition until the end of the decade. Privatization was slowed by challenges from bank labor unions, poor market conditions for the sale of shares, and opposition from provincial and city governments to the sale of banks that they owned and supervised.

Among the 14 banks originally targeted for privatization, several state-owned banks were not privatized. The Bank of Taiwan, the Land Bank of Taiwan, and the Export-Import Bank have remained fully state-owned due to a mixture of political opposition and a desire to preserve their special policy mandates. The Bank of Taiwan acquired and merged the Central Trust of China into its operations, preventing that financial institution from being privatized. It took concerted effort by subsequent political leaders to overcome the obstacles to privatization of the remaining state-owned banks. *Table 2* shows the nine state-owned financial institutions that eventually underwent privatization.

Table 2 – Bank Privatization Efforts

Bank	Administrative Authority	Privatization Date
Chang Hwa Commercial Bank	Taiwan Provincial Government	January 1998
First Commercial Bank	Taiwan Provincial Government	January 1998
Hua Nan Commercial Bank	Taiwan Provincial Government	January 1998
Taiwan Business Bank	Taiwan Provincial Government	January 1998
Farmers Bank of China[8]	Ministry of Finance	September 1999
Chiao Tung Bank[9]	Ministry of Finance	September 1999
Bank of Kaohsiung	Kaohsiung City Government	September 1999
Taipei Bank	Taipei City Government	November 1999
Taiwan Cooperative Bank	Taiwan Provincial Government	April 2005

Sources: Sue, Shih-hsien. "The Political Economy of Bank Privatization in Taiwan." Taiwan International Studies Quarterly, 2008. http://www.tisanet.org/quarterly/4-2-5.pdf. Bank annual reports.

Even after privatization, most of these banks retained some level of state-ownership. The government continued to hold shares either directly through the Ministry of Finance, a local government, or via holdings by other state-owned banks, state-owned enterprises, and government-controlled investment funds. As a result, many of the privatization efforts can only be described as partial privatizations. Although most state-owned banks became considerably more market-oriented after their privatization, the Taiwanese government still possesses the ability to influence their operations via its ownership holdings. *Table 3* lists the fully and partially state-owned banks and the most recent information available on the level of state ownership as of this writing.

Table 3 - Fully and Partially State-Owned Banks

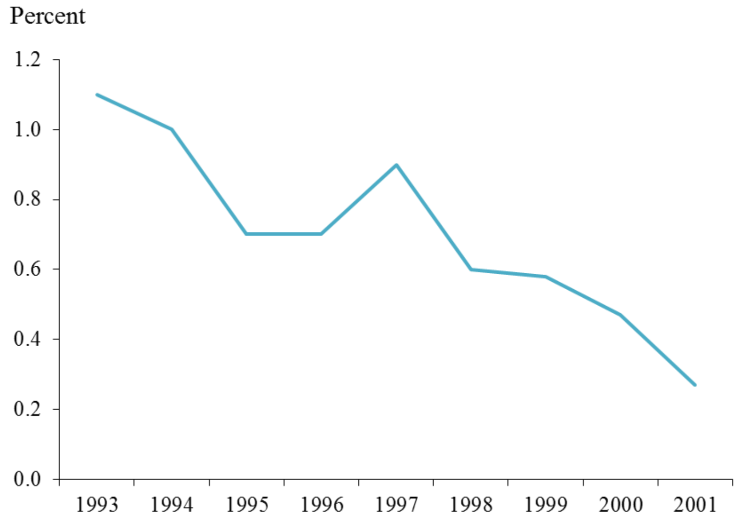
Bank	**Government Share**[10]
Bank of Taiwan	100%
Land Bank of Taiwan	100%
Export-Import Bank	100%
Bank of Kaohsiung[11]	44.94%
Taiwan Cooperative Bank	33.14%
Hua Nan Commercial Bank	25.39%
First Commercial Bank	21.95%
Taiwan Business Bank	21.86%
Mega International Commercial Bank	20.14%
Chang Hwa Commercial Bank	16.33%

Source: SNL

New Reforms in the 2000s

The addition of the new private banks in the early 1990s, together with the deregulation of lending and deposit rates, significantly increased competitive pressure within the Taiwanese banking system. Many new private banks' business models were similar to those of existing large state-owned financial institutions, leading to fierce competition for deposits and customers. Excessive competition often veered in unhealthy directions. To attract new deposits, banks raced to offer higher deposit rates to their customers and the earnings and liquidity conditions of weaker institutions deteriorated rapidly. As shown in *Figure 1*, the return on assets for the banking industry declined precipitously during this period.

Figure 1 – Taiwan Banking Sector Return on Assets (%)



Source: Central Bank of the Republic of China (Taiwan)

In view of the overcrowded banking market and worsening banking sector conditions throughout the 1990s, especially in light of the Asian financial crisis, the Taiwanese government announced a basket of measures to reform the financial system (known as "The First Financial Reform") in the early 2000s. As a significant part of this package, the Legislative Yuan passed the *Financial Institution Merger Law* in 2000. The *Merger Law* encouraged domestic banks and other financial institutions to improve their competitiveness through consolidation and allowed foreign banks to take 100 percent ownership of a domestic bank. The *Financial Holding Company Law* that was passed in 2001 created a legal framework for domestic financial institutions to form financial holding companies, in the hope that the establishment of financial conglomerates would help reduce costs and improve operational efficiencies in the industry.[12]

The goal of The First Financial Reform is often summarized as "2-5-8," which refers to bringing the banking sector NPL ratio to less than 5 percent and increasing the capital adequacy ratio above 8 percent within two years. As part of the package, the government offered temporary tax relief to the banking industry. Overall bank credit quality improved markedly in the following two years. However, the First Financial Reform did not result in immediate improvements in the banking sector's competitive landscape as relatively few mergers occurred during this period.

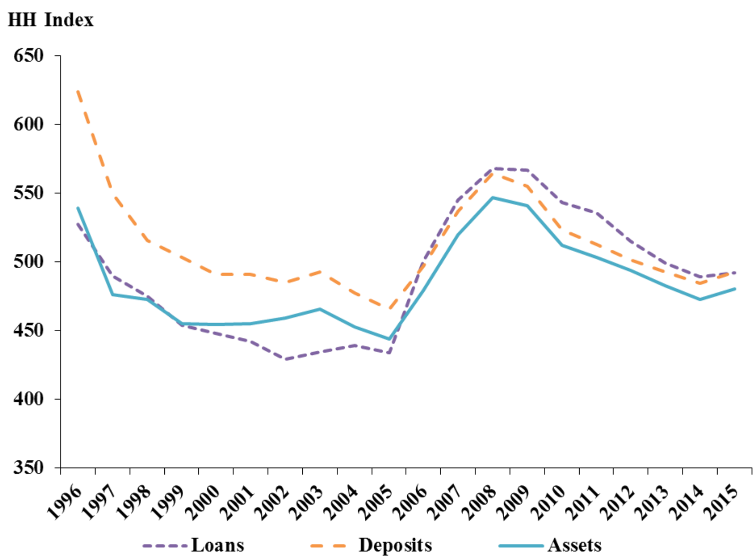
The government initiated a second round of financial reform ("The Second Financial Reform") in 2004, focused on improving the international competitiveness of Taiwanese banks. One goal of the Second Financial Reform is to increase the market share of the top three domestic banks to above 10 percent by end-2005. The plan also called for reducing the number of government-owned banks to six, cutting the number of financial holding companies by half by the end of 2006, and facilitating at least one financial holding company to list on an overseas exchange market or bringing in foreign investors. The Second Financial Reform was generally viewed as unsuccessful as none of these intended goals was achieved due to strong resistance from bank labor unions, political opposition, and public sentiment that the government unfairly favored family-owned conglomerates. Local analysts also saw few synergies resulting from the proposed consolidations.[13] Additionally, the rapid increase of defaults on credit card debt during this period weakened bank profitability, making mergers more difficult.

Ongoing Problems after Liberalization

More than 25 years after the start of banking reform, and despite the efforts of the First and Second Financial Reforms, Taiwan's banking sector remains highly fragmented and profitability levels remain extremely low. While overconcentration is often cited as a problem in banking sectors across the world, lack of concentration can also lead to significant problems. When too many banks are competing for the same pool of customers, banks face strong incentives to engage in unhealthy competition, such as offering services below cost, in order to capture market share. Additionally, the cost structure of the entire banking sector is inflated by the inability of banks to achieve economies of scale. These issues prevent banks from achieving long-term sustainable financial positions, a critical component of overall financial stability.

Figure 2 illustrates the Herfindahl-Hirschman Indices (HHI), a measure of industry consolidation, for Taiwan's domestic banks based on assets, loans, and deposits.[14] The indices show changes in the level of concentration from the start of bank privatizations up until recent times.

Figure 2 - Taiwan Banking Sector HHI Indices

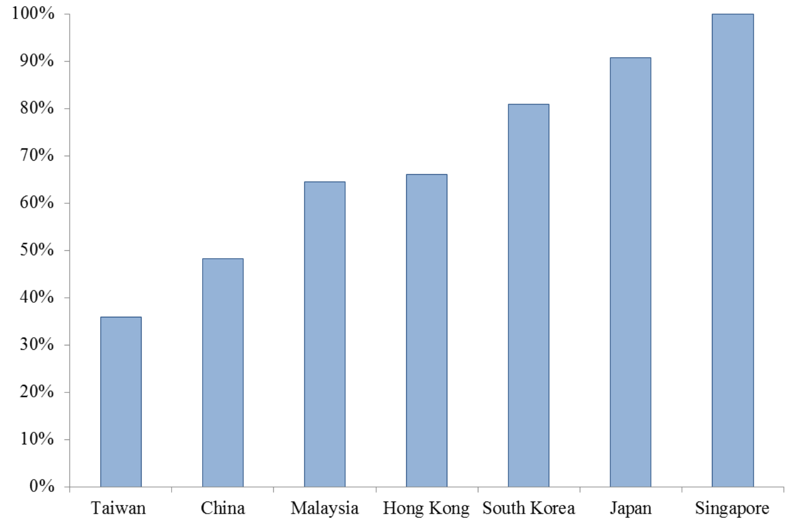


Source: Central Bank of the Republic of China (Taiwan), authors' calculations

As shown in the figure, Taiwan's banking market became much less concentrated between 1996 and 2005. Between 2005 and 2008, there was a brief uptick in concentration due to several mergers among small banks. However, after 2008, concentration levels in the banking sector once again began to decline, indicating that the degree of overcrowding in the banking system has been worsening.

The Taiwanese banking sector also compares unfavorably to other peer economies in the region with respect to concentration. *Figure 3* shows banking concentration ratios, measured by the top five banks as a share of total banking assets, for several of Asia's largest financial systems. As the chart shows, Taiwan has the lowest concentration ratio in the group. As a result of overcrowding, Taiwanese banks have among the lowest returns on assets and net interest margins in the region.

Figure 3 – Bank Concentration Ratios in Major Asian Economies (2015)



Source: SNL, Central Bank of the Republic of China (Taiwan)

Recent Efforts to Encourage Consolidation and International Expansion of Taiwanese Banks

To address the problem of overcrowding in the banking sector and improve overall profitability, Taiwanese authorities have focused on two major policy initiatives, a renewed push for bank mergers and the international expansion of Taiwanese banks.

Bank Mergers

Promoting bank consolidation is a long-standing goal of the Taiwanese regulators and has recently received renewed emphasis. Between September 2004 and October 2015, the Taiwanese banking industry saw 52 bank mergers and the number of domestic banks shrank from 49 to 39. However, many of these mergers were relatively small in size and have done little to reduce fragmentation in the banking industry.

To facilitate greater consolidation in the banking sector and the growth of domestic banks, Taiwanese authorities have adopted several new measures in recent years. In 2013, domestic banks received approval to carry out mergers and acquisitions of foreign banks via tender offers if the offer is able to garner more than 50 percent of the target bank's shares. In 2014, the *Banking Act* was amended to increase the total amount a bank can invest in financial institutions to 40 percent of equity, up from 40 percent of paid-in capital. Most recently, in 2015, the *Financial Institutions Merger Act* was amended to streamline the merger and acquisition process. The amendment also provides a series of tax incentives to financial institutions to reduce the costs of mergers.

Although these measures will undoubtedly make mergers more attractive, significant barriers remain to large-scale consolidation of the banking sector. As mentioned previously, forcing consolidation among the government-controlled banks is difficult due to political opposition and resistance from labor unions. An alternative to mergers between state-controlled banks is the merging of private banks and partially privatized banks. Many analysts believe it would be beneficial for strong private banks to take over struggling partially privatized banks. However, one recent case offers a window into the difficulties of this approach.

In 2005, Taishin Bank made an investment in Chang Hwa Bank, a partially privatized bank. The investment was made as part of a Ministry of Finance initiative to attract strategic investors into Chang Hwa, which was financially weak at the time. The investment of 22.5 percent granted Taishin a majority of Chang Hwa's board seats, giving Taishin effective control over the bank. The investment immediately attracted scrutiny from labor unions, which accused the government of giving away state assets. Over the next several years, the Ministry of Finance soured on the idea of a merger between Taishin and Chang Hwa for a variety of reasons, including political opposition.

Taishin decided to proceed with the merger despite Ministry of Finance opposition. In 2013, Chang Hwa Bank's Executive Directors approved a merger plan, which the Ministry of Finance publicly opposed. In 2014, the dispute reached a critical point during a board of directors meeting. The Ministry of Finance secured six seats, stripping Taishin of three of its seats and forcing it to lose control of Chang Hwa. In response, Taishin initiated a lawsuit against the Ministry of Finance for damages. As of this writing, the lawsuit appears to still be unresolved. The events have reduced the interest of private banks in acquiring a partially privatized bank. As a result, the most probable course for future rounds of bank consolidation is likely to be between private banks.

International Expansion

A second strategy to combat the overbanking problem is to encourage banks to expand their overseas operations. The logic of international expansion is that, given the overcrowded nature and limited profitability of the domestic market, expanding overseas will allow Taiwanese banks to enter new and more lucrative markets. Overseas markets offer access to new customers, reducing the need for Taiwanese banks to engage in unhealthy competition over the relatively small pool of domestic customers. Also, overseas markets often have high net interest margins, allowing banks to earn more on their lending activities.

As with bank mergers, promoting the international expansion of banks is a long-standing government policy. Beginning in the 1980s, the Ministry of Finance started advocating for Taiwan to develop itself into a regional financial center. The Taiwan Financial Supervisory Commission (FSC) maintains an explicit goal of one to two Taiwanese banks emerging as large regional players.

The first steps towards promoting international expansion were taken in 1984 when Taiwanese authorities allowed banks to establish offshore banking units (OBUs). OBUs are independent legal entities affiliated with domestic and foreign banks operating within Taiwan. They provide banking services in foreign currencies and for non-residents and are exempt from reserve requirements, business income tax and stamp duties. The scope of activities permitted for OBUs has expanded greatly over time, providing Taiwanese banks with a mechanism for servicing overseas customers, particularly the foreign subsidiaries of Taiwanese companies.

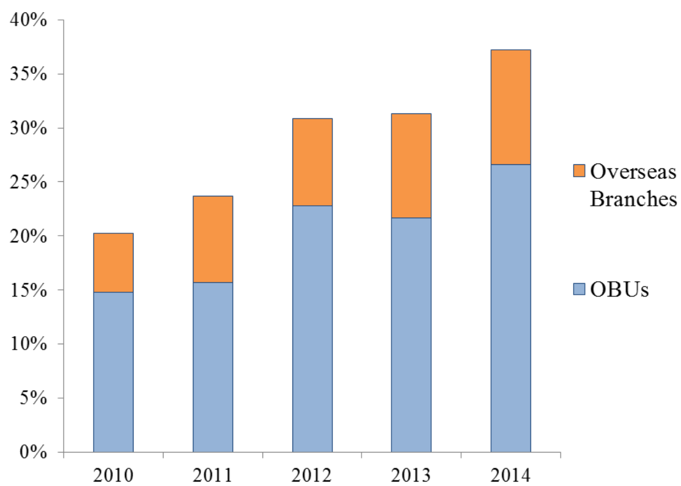
Another important driver of Taiwan's international banking expansion is the growing financial links with mainland China. In the early 1990s, Taiwanese regulators began to permit Taiwanese banks to apply for representative offices in mainland China. Taiwanese banks, however, were not permitted by mainland authorities to establish a presence beyond representative offices. The activity of Taiwanese banks in mainland China accelerated dramatically after Taiwan and mainland China signed the *Cross-Strait*

Financial Supervision Memorandum of Understanding in 2009, which laid the foundation for upgrading representative offices to branches. In 2010, the two sides signed the *Economic Cooperation Framework Agreement* (ECFA). As part of the "early harvest" provisions in ECFA, the time requirement for representative offices of Taiwanese banks to upgrade to branches was significantly reduced.

Another policy breakthrough occurred in 2011 when the Central Bank of the Republic of China (Taiwan) and the FSC allowed OBUs and overseas branches of Taiwanese banks to conduct renminbi business. A total of 13 Taiwanese banks now have branches in mainland China. At the end of 2015, Taiwanese banks had USD 47.35 billion in claims on mainland China on a direct risk basis, representing Taiwan's single largest overseas exposure. Given the rapid growth of exposure, the FSC has taken steps to manage risks, such as limiting total exposure to mainland China to 100 percent of a bank's equity, and encouraging expansion to other Asian economies to reduce high mainland concentration.

The results of Taiwan's push for banks to expand overseas are notable. Overseas banking assets have grown rapidly in recent years. As of the end of 2015, Taiwanese banks had 131 branches and 38 representative offices overseas, with the largest concentration in mainland China. Foreign operations now also account for a sizable portion of the income of Taiwanese banks. In 2014, the profits of OBUs and overseas branches expanded by 53 percent and 36 percent, respectively. *Figure 4* shows that together these entities accounted for 37 percent of total domestic bank profits.

Figure 4 - Profit Contribution of OBUs and Overseas Branches



Source: Central Bank of the Republic of China (Taiwan)

While the international expansion of Taiwanese banks has been impressive, no bank has yet achieved the government's goal of becoming a major regional player. As of year-end 2015, there were no Taiwanese banks among the top 25 Asian banks in terms of assets.

Conclusion and Outlook

The Taiwanese banking sector has undergone a significant transformation over the last 25 years. A system that was previously dominated by large state-owned banks has transformed into a mix of private, public, and hybrid private-public financial institutions. Despite this progress, significant challenges remain to establishing a more robust and diversified banking system.

The principal barrier to achieving a healthier financial system in Taiwan is an overcrowded domestic banking sector. The lack of consolidation within the banking industry has prevented banks from achieving economies of scale, leaving banks with thin operating margins and low retained earnings.

Taiwanese authorities have undertaken proactive reforms to help address this problem. First, regulatory authorities have taken steps to remove the legal and regulatory barriers to consolidation. While a number of the political obstacles to bank consolidation in Taiwan remain, the FSC has reduced many of the other hindrances to mergers, such as limitations on investment by banks into other banks, high costs for merger applications, and an overly complex process for the approval of mergers. Many of the policies are too recent to show definitive results, but in the long-term these reforms are likely to be beneficial.

Second, Taiwanese authorities have encouraged banks' overseas expansion, which offers banks new customers and access to more favorable interest rate environments. Earnings from overseas activities have already emerged as important source of profits for Taiwanese banks, a trend that is likely to continue into the future. Going forward, banking sector consolidation and international expansion are two major trends that will continue to shape Taiwan's banking sector.

Endnotes

1. Lawrence L.C. Lee: "The Development of Banking in Taiwan: The Historical Impact on Future Challenges," Occasional Papers/Reprints in Contemporary Asia Studies, No. 6(149), 1998, University of Maryland.

2. There are several exceptions to this general principle, such as banks established by overseas Chinese (an example is Shanghai Commercial and Savings Bank), city banks (Bank of Taipei and Bank of Kaohsiung) and "medium business banks" that specialize in SME lending.

3 The exchange rate was 32.936 TWD/USD as of December 31st, 2015. This exchange rate is used for all comparisons unless otherwise noted.

4 The sixteen banks that were founded during this period include: Grand Commercial Bank, Dah An Commercial Bank, Union Bank of Taiwan, China Development Corp, Far Eastern International Bank, Asia-Pacific Bank, Bank SinoPac, E. Sun Bank, Cosmos Bank, Pan Asia Bank, Chung Shing Bank, Taishin International Bank, Taipei Fubon Commercial Bank, Tachong Bank, Bao Dao Bank (later become: Jih Sun International Bank) and Entie Commercial Bank. For more information, see Lin, Jung-Chu and Sum, Vichet, Bank ownership and performance in Taiwan: Do politics matter? *Journal of Finance and Accountancy*, 10, 12-30. Available at SSRN: http://ssrn.com/abstract=2020684

5 The banks were Chang Hwa Commercial Bank, First Commercial Bank, Hua Nan Commercial Bank, and Taiwan Business Bank.

6 Farmers Bank of China and Chiao Tung Bank were added to the list.

7 Sue, Shih-hsien. "The Political Economy of Bank Privatization in Taiwan." *Taiwan International Studies Quarterly*, 2008. http://www.tisanet.org/quarterly/4-2-5.pdf.

8 Farmers Bank of China was acquired by Taiwan Cooperative Bank in 2006.

9 Chiao Tung Bank was merged with International Commercial Bank of China in 2002 to form Mega International Commercial Bank.

10 Government share reflects direct ownership by government entities as well as indirect ownership via state-owned banks, state-owned enterprises, and government-controlled investment funds.

11 Held by the City of Kaohsiung.

12 There are currently 16 financial holding companies in Taiwan.

13 Hille, Kathrin: "Taiwan's banks feel the heat," *Financial Times*, July 10, 2007.

14 The Herfindahl-Hirschman Index is a measure of the size of firms in relation to the industry and an indicator of the amount of competition among them. It is calculated by squaring the market share of each firm competing in a market, and then summing the resulting numbers. For the purpose of this report, total assets, deposits, and loans for all domestic banks are used as proxies for market sizes.

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