Chapter

7

The Challenges and Opportunities for Taiwan and China in the Financial Sector after Entry into the WTO

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INTRODUCTION

In both Taiwan and China, the financial sector is the weakest sector in the economy. Although they have different degrees of commitment to opening their financial markets, both face stringent challenges following accession to the WTO.[1] In China, it is commonly recognized that there are many economic problems in several different areas, i.e., finance, state-owned enterprises, and agriculture, as well as inequalities and imbalances between urban and rural areas, and so on. Among them, however, the most serious challenge facing the new leadership is in the financial sector, where the problems are interwoven. Because the Chinese leadership lacks experience in dealing with financial complications, any single problem may lead

[1] China and Taiwan entered the WTO in December 2001 and January 2002, respectively.

to crises, causing instability in the economy. Most experts believe that, if an economic collapse were to occur in China, the most likely cause would be a crisis in the financial sector. Therefore, there has been some doubt as to whether China will commit to opening its financial markets in stages.

Despite the challenges, the Chinese government has made some progress in recent years, such as aggressively reducing the NPLs (non-performing loans) of the banking system; improving the financial supervisory mechanism; modifying financial laws; encouraging local Chinese financial institutions to collaborate with foreign banks and inviting foreign financial institutions to acquire shares of local financial institutions; and so forth.[2] The signing of the Closer Economic Partnership Arrangement (CEPA) between China and Hong Kong gives Hong Kong's financial institutions access to the Chinese market on more favorable terms, as compared to other countries. This not only provides a boost for the Hong Kong economy, but it also gives Hong Kong banks an edge over their foreign competitors. The Chinese government believes these will help lower the impact of a further opening of Renminbi (RMB) business to other foreign banks.

In Taiwan, in general, foreign financial institutions have been granted national treatment since Taiwan's entry into the WTO. This means Taiwan's financial institutions have to face competition from foreign counterparts on an equal footing. Due to long-term government protection, excessive political involvement, and an inadequately-planned liberalization policy, the financial industry is not competitive, and has a record of poor performance. Indeed, some influential international magazines have suggested that a potential financial crisis is looming. Thus, Taiwan's entry into the WTO is a serious challenge for financial institutions, given that there are too many small-sized and non-competitive banks in Taiwan's over-banked market.

[2] Lee Jih-chu, "Financial Reform in China as well as the Challenges and Opportunities for Taiwanese Banks in China," *Project Report of Council for Economic Planning and Development*, Executive Yuan, Taipei, 2003.

However, coincidentally, China's entry into the WTO provides a timely opportunity for the market expansion of Taiwan's financial institutions. Since the two sides have a common language and culture, when mainland China committed to opening its financial market to foreign banks as a condition to entering the WTO, Taiwan was presented with several advantages. In particular, due to the lag in China's financial development and the inherent advantage of Taiwan's financial institutions, Taiwan's banks could transplant their mature products, which might not be competitive in the markets of the developed countries, to the China market. At the same time, due to their common language and culture, Chinese financial institutions will be able to learn quickly from their Taiwan counterparts and achieve rapid growth. Only when Taiwan's financial institutions could enter China's financial markets did both Taiwan's and China's financial industries stand to gain.

However, because of the sensitive political situation between the two sides, the Taiwan government has many concerns, thus leading it to establish some restrictions on interactions with China. Therefore, Taiwan's financial institutions are establishing themselves in China at a slower pace, and cross-strait financial exchanges and cooperation are sluggish. The recent signing of the CEPA between China and Hong Kong provides a lower threshold and preferential treatment to Hong Kong to access the China market and places serious pressures on Taiwan's financial institutions. But the CEPA also allows foreign corporations that have owned a Hong Kong company for more than one year to apply for CEPA preferential treatment. This encourages Taiwan's financial institutions to buy Hong Kong financial institutions in order to timely enter the China market. Such an arrangement also attracts more Taiwan companies to list on the Hong Kong stock market, rather than on the Taiwan stock market.

After Taiwan's and mainland China's accession to the WTO, there is more room for cooperation in the financial industry. In addition, collaborations between the governments on both sides of the strait may even expand to areas such as stabilizing exchange rates, controlling financial crises, combating financial fraud, and so on.

Unfortunately, due to political considerations, not much progress has been made in these areas over the past several years.

TAIWAN'S ENTRY INTO THE WTO

In general, foreign financial institutions have been granted national treatment since Taiwan's entry into the WTO. This means the Taiwan government can no longer set special restrictions on foreign financial institutions to protect the domestic financial institutions. In other words, Taiwan's financial institutions have to compete with their foreign counterparts on a level playing field. Because Taiwan's financial industry is relatively uncompetitive, as compared with those in the developed countries, the first challenge for Taiwan is to improve the competitiveness of its financial industry and financial structure. At the same time, since with accession, mainland China committed to opening its domestic financial market to foreign countries, the second challenge for Taiwan will be to overcome cross-strait political difficulties to take advantage of the China market, so that Taiwan's financial institutions can be strengthened and provide financial services to Taiwan companies operating on the mainland.

Taiwan's financial system is rather weak, as evidenced by the following characteristics:[3]

1. Over-banking and lack of economies of scale among financial institutions.

As Table 7.1 shows, the five largest banks in Taiwan collectively only account for 38 percent of the total banking assets — a much lower ratio than that of their counterparts in other Asian countries. Furthermore, the average asset scale of the top five banks in Taiwan, compared with their regional and global counterparts, is much smaller (see Table 7.2). There are 5,842 bank branches in Taiwan for a population of only 23 million.

[3] Lee Jih-chu, *Taiwan Financial System and Financial Reform* (Taipei: National Policy Forum, National Policy Foundation, 2002).

Table 7.1 Asset Market Share of the Top Five Banks in Taiwan Compared with Counterparts in Other Asian Countries

	(Unit: %)
Singapore top five banks	93% market share
Hong Kong top five banks	87% market share
Korea top five banks	76% market share
Taiwan top five banks	38% market share

Source: *Morgan Stanley Quarterly Report* (2003).

Table 7.2 Average Asset Scale of the Top Five Banks in Taiwan Compared with Regional and Global Counterparts

World's top five banks	US$ 800 billion to US$ 1 trillion
Regional top five banks	US$ 100 billion to US$ 200 billion
Taiwan's top five banks	US$ 30 billion to US$ 60 billion

Source: *Morgan Stanley Quarterly Report* (2003).

2. Poor profitability and sharply deteriorating asset quality of financial institutions in recent years.

As Table 7.3 shows, the NPL ratio.[4] in Taiwan's banking sector rose from 3.0 percent in 1995 to 8.3 percent in June 2002. Even worse, the NPL ratio for thrifts and rural cooperatives surged from 4.02 percent to 18.2 percent over the same period, against a mere 2.68 percent in June 2002 for foreign banks operating in Taiwan. As Table 7.4 shows, the ROE (returns on equity) and ROA (returns on assets) of Taiwan banks plummeted from 11.5 and 1.0 percent in 1994 to –1.5 and –0.49 percent in 2002, respectively. By contrast, the ROE and ROA of foreign banks in Taiwan increased from 22.2 and 0.93 percent to 30.78 and 1.18 percent, respectively. These statistics reflect, on average, a huge profitability gap between Taiwan banks and foreign banks in Taiwan.

[4] In Taiwan, an NPL is defined as failure to pay interest over six months, in contrast to the international definition of an NPL, which is failure to pay interest over three months.

Table 7.3 The NPL Ratio of Taiwan's Banking Sector (Unit: %)

	Average ratio of all financial institutions	Taiwan banks (including investment and trust companies)	Local branches of foreign banks	Thrifts and rural cooperatives
1995	3.0	2.88	0.82	4.02
1996	4.15	3.74	1	7.1
1997	4.18	3.74	1.07	8.53
1998	4.93	4.41	1.64	10.57
1999	5.67	4.96	3.2	13.7
2000	6.2	5.47	3.22	15.68
2001	8.16	7.70	3.53	16.39
2002-Jun.	8.3	7.75	2.68	18.2

Source: Bureau of Monetary Affairs, Ministry of Finance, ROC (2003).

Table 7.4 Profit Comparison between Domestic and Foreign Banks in Taiwan (Unit: %)

	Domestic banks		Foreign banks in Taiwan	
Time	ROE	ROA	ROE	ROA
1994	11.5	1.0	22.2	0.93
1995	9	0.7	29.6	1.32
1996	9.7	0.7	27.4	1.3
1997	11.4	0.9	33.3	1.52
1998	8	0.6	22	1.01
1999	5.9	0.5	16.72	0.77
2000	4.9	0.39	33.16	1.29
2001	5.5	0.4	32.02	1.19
2002	−1.5	−0.49	30.78	1.18

Source: Central Bank of China, Taiwan (2003).

3. Most Taiwan banks are lacking in innovation, with revenue sources predominantly dependent upon traditional business.

For example, in 2003,Taiwan banks derived 77.7 percent of their revenues from interest rate-related proceeds and only 9.6 percent

Table 7.5 A Comparison of Revenue Sources of Domestic and Foreign Banks in Taiwan (Unit: %)

	Domestic banks	Foreign banks
Interest income	77.7	56.0
Charged fees and commission income	9.64	26.4
Gains on sales of securities	7.19	2.1
Portfolio investment income	1.04	−0.03
Other income	4.4	15.5

Source: Central Bank of China, Taiwan (2003).

from fee income, compared to 56 percent and 26.4 percent, respectively, for foreign banks in Taiwan (Table 7.5).

It is thus not surprising that the international media have repeatedly noted concerns over Taiwan's vulnerability to financial shocks. These weaknesses of Taiwan's financial system have much to do with government policies. The fact that the government does not recognize financial services as an industry has led to excessive intervention on the grounds of maintaining financial stability. At the same time, the government has been reluctant to open up the financial sector to foreign competition.

Efforts to promote competition by allowing domestic institutions to set up new banks since 1990 have been undermined by inadequate exit mechanisms for unsound financial institutions.[5] However the government's preoccupation with preventing bank failures results in "over-banking" and a lack of innovation in Taiwan's banking industry.

Both the government and financial institutions have to confront the harsh reality of unavoidable foreign competition in the post-WTO era.[6] It is encouraging that some financial reforms have been made by the government and some competitiveness enhancements have

[5] Lee Jih-chu, "The Implication of the New Set Up of Taiwanese Private Banks and Its Impact on China's Banking Industry," Conference of China's Bank Privatization, Peking University, 2003.

[6] Lee Jih-chu, "The Challenges of Taiwan Financial System under Global Financial Integration," International Conference on Taiwan's Challenges under Global Economic Integration, National Chengchi University, Taipei, 2002.

been taken by financial institutions. The reform initiatives can be summarized as follows:[7]

1. To improve the competitiveness of domestic financial institutions.

The authority in Taiwan has recently passed three new acts. They are the Financial Institutions' Merger Act, the Financial Holding Corporation Act, and the Financial Asset Securitization Act. The first is aimed at consolidating Taiwan's financial sector so as to take advantage of economies of scale, in turn facilitating the closure of unviable institutions. The second is expected to further increase the economies of scope of the financial sector. Finally, the Financial Asset Securitization Act is intended to benefit the liquidity of Taiwan's financial assets.

2. To dispose of unsound financial assets.

The government now permits the establishment of asset management companies (AMC) to manage asset disposal, in turn improving the financial quality of financial institutions. In addition, the government has reduced the gross receiving business tax in the financial industry and set up a financial restructuring fund with NT$ 350 billion of public money, thus enabling banks to write off bad debts and to exit the market.[8]

3. To establish exit and compensation mechanisms for financial institutions.

The government has passed the Financial Institutions' Merger Act and the Financial Restructuring Fund Act to increase the feasibility of closing unviable institutions.

4 To unify financial supervisory and management systems.

The government set up a new Financial Supervisory Commission in 2004 to integrate regulators of the banking, securities, and

[7] Lee Jih-chu, *Taiwan Financial Reform* (Taipei: National Policy Foundation, 2004).

[8] Lee Jih-chu, "The Design of the Taiwan Restructuring Financial Fund: Based on the Korean Experience," National Policy Forum, National Policy Foundation, 2003.

insurance industries. This arrangement will strengthen supervision of businesses in these three industries.[9]

5 To relax financial restrictions and encourage financial innovation.

Due to these improvements, there are conspicuous advancements in the competitiveness of Taiwan's financial institutions and the soundness of its financial system. For instance, 14 financial holding companies can simultaneously provide banking, security, and insurance services through their subsidiary companies. The sizes of these financial holding companies are much larger than that of their previous counterparts. This helps them to achieve both economies of scale and scope, thus strengthening the competitiveness of Taiwan's financial institutions, both domestically and internationally. At the same time, the Financial Supervisory Commission is useful in supervising the financial holding companies.

In addition, the NPLs of the banks declined drastically from a high of 8.16 percent down to 3.12 percent (see Table 7.6). At least 50 poor-performing banks, thrifts, and rural cooperatives were acquired, and exited the financial market, during the past three years. Many new financial instruments have been created, and some non-traditional businesses have grown significantly, such as credit card and asset management businesses.

With respect to cross-strait financial interactions, since both sides have become members of the WTO, the Taiwan government feels that it is now safer for Taiwan's financial institutions to contact their mainland counterparts directly, or to expand business to mainland China. Therefore, it has further liberalized cross-strait financial exchanges, such as allowing financial agencies to be set up across the strait.

The increasing migration of manufacturers from Taiwan to mainland China has highlighted the constraints on financing such

[9] Lee Jih-chu, "The Design of Taiwan Unified Financial Regulators," in *Taiwan Financial Reform*, ed. National Policy Foundation (Taipei, Taiwan: National Policy Foundation, 2003).

Table 7.6 The NPL Ratio of Taiwan's Banks

	Taiwan banks		All banks in Taiwan	Taiwan banks	Local branches of foreign banks	Thrifts and rural cooperatives
	Profit before tax	Net worth				
2000	967.8	15 991	6.20	5.34	3.22	15.68
2001	575.9	15 964	8.16	7.48	3.53	16.39
2002	21 045.9	14 228	6.84	6.12	2.36	15.37
2003	2267.5	14 420	5.00	4.33	1.51	13.29
2004	155.4	12 256	3.12	2.78	1.03	10.05

Source: Financial Supervisory Commission.

outward investments because of the absence of Taiwan banks within China. Meanwhile, some businessmen in Taiwan have deliberately increased their financial leverage, resulting in defaults on debts in Taiwan — another factor contributing to the rise of NPLs in the banking sector.[10] By allowing banks to set up offices on the mainland, banks can closely monitor how firms from Taiwan utilize their funding on the mainland and can explore the under-developed mainland markets. Furthermore, by liberalizing the trade finance operations of domestic banking units (DBU) and off-shore banking units (OBU), and by establishing correspondence banking between banks in Taiwan and their mainland counterparts, Taiwan banks will have a larger business scope.

All in all, these positive measures have contributed to the overall competitiveness of Taiwan's financial institutions and the long-term development of Taiwan's financial system, and have provided a basis for future cooperation in cross-strait activities.

[10] Chow Tien-chen, Jih-chu Lee, and Wen-chiey Wang, "A Study of the Financing Sources of Taiwan Businessmen and Establishing Financial Institutions in China," *Project Report of Mainland Affairs Council*, Executive Yuan, Taipei, 1997; Chen Ming-chang, "A Study of the Changes of Attitude of Financing Sources of Taiwan Businessmen in China," Taipei Enterprise Management Society, 2002.

THE COMMITMENTS, IMPACTS, AND REACTIONS OF CHINA'S ENTRY INTO THE WTO

China has made a number of commitments regarding financial services in its WTO agreements. With respect to banking deregulation, foreign banks will be allowed to conduct RMB business with Chinese firms three years following accession. By the end of 2006, foreign banks will be free to conduct RMB business with Chinese citizens. In the insurance sector, casualty and property insurance will be open to foreign competition in major cities within two to three years of accession. Other insurance products, such as group, life, and health insurance, will be open to foreign competition within five years. Within the first two years, foreign insurers may control up to 49 percent of the stakes in joint ventures and, in the following two years, they can set up foreign-owned entities in China. As for securities liberalization, the pace will be more gradual. Foreign securities companies can immediately form joint ventures with Chinese asset management companies to manage domestic pension funds. Such joint ventures, with foreign ownership of up to 49 percent, will be permitted to participate in initial public offerings (IPO) and other investment business, as long as the underlying transactions do not breach capital account restrictions. Foreign companies have been allowed to participate in the domestic A-share markets through so-called QFII (qualified foreign institutional investors) since the end of 2002.

As is the case with Taiwan, China's financial system will be exposed to shocks from foreign competition as a result of these concessions. These shocks will interact with the existing problems in the mainland's financial sector:[11]

[11] Justin Lin, "The Prospective of China's Financial System Reform," China Center for Economic Research, Peking University, Beijing, 2001; Lee Jih-chu, "Financial Reform in China as well as the Challenges and Opportunities for Taiwanese Banks in China," *Project Report of Council for Economic Planning and Development*, Executive Yuan, Taipei, 2003.

1. Serious non-performing loans.

China's big-four state-owned banks are among the 30 largest banks in the world in terms of assets. But their large size does not obscure the fact that they are plagued by high NPL ratios. According to the People's Bank of China, China's central bank, NPLs represent roughly 25 percent of the total assets in the banking sector, or RMB 1.2 trillion. However, estimates by foreign banks and rating agencies are even much higher. For example, Goldman Sachs puts the ratio at 40 percent, and *Business Week* reports that the official NPLs are only one-third of the true bad loans. Standard & Poor's maintains that it would cost as much as 43 percent of China's GDP to re-capitalize the banking system. In comparison, the U.S. government spent only 3 percent of its GDP to clean up the S&L crisis in the early 1990s. It is easy to see how severe the NPL-related problems are in China. These NPLs are caused by government instructions to provide credits to unprofitable state-owned enterprises. As a result, the asset quality of the banks will likely not improve, until the soft-budget constraints of the state-owned enterprises are eliminated.

2. Serious distortion of financial loans.

By almost any conventional measure, such as assets, deposits, and loans, the big-four state-owned banks dominated the market, with a market share of 60–86 percent in 2000 (see Table 7.7). Obviously, this oligopoly market structure lacks competitiveness. As a result, non-state sectors have difficulty securing bank loans. For example, bank lending to non-state sectors (not necessarily to the private sector) only accounts for 15 percent of total lending, whereas these sectors contributed to over 50 percent of industrial production in 2001.

3. Underdeveloped money and bond markets.

Both the money market and the bond market are extremely under-developed. The secondary market for government bonds is illiquid, despite the continued issuance of government bonds. The transaction value of the money market over the GDP has been consistently below 30 percent. The lack of liquidity, as well as the lack of institutional investors, are two of the major challenges in the development of the money market.

Table 7.7 The Market Share of the Big-Four State-owned Banks

	Market Share by Assets		Market Share by Profits		Market Share by Deposit		Market Share by Loan	
	1999	2000	1999	2000	1999	2000	1999	2000
Industrial and Commercial Bank of China	25.71%	26.03%	40.64%	34.83%	33.14%	31.15%	25.77%	26.64%
Agricultural Bank of China	16.53%	14.31%	−0.85%	0.59%	17.76%	17.35%	16.88%	16.37%
Bank of China	19.02%	18.96%	10.44%	11.92%	18.84%	18.61%	14.48%	13.64%
China Construction Bank	15.99%	16.59%	17.72%	17.02%	19.61%	19.28%	12.75%	15.29%
Total	77.25%	75.89%	67.95%	64.36%	89.35%	86.39%	69.08%	71.94%

Source: China Financial Association, *Finance & Banking* (2001).

4. An undisciplined stock market.

Over the past eight years, China's stock markets became the third largest in Asia in terms of market capitalization, trailing behind only Japan and Hong Kong. But China's stock markets are unique, even when compared with other newly-emerging stock markets. The firms' listings are totally determined by the China Securities Regulatory Commission (CSRC), instead of by the Stock Exchanges of Shenzhen and Shanghai. Given this listing mechanism, government intervention is not surprising. Not all shares of listed companies are publicly-traded. With non-traded shares accounting for about two-thirds of the total market capitalization, the government remains the major shareholder of the firms, even after they are listed on the stock exchanges. As a result, in many ways, listed companies continue to behave like state-owned enterprises. The existence of large non-tradable shares facilitates price manipulation. Indeed, the Chinese government's heavy-handed intervention is detrimental to the stock markets.

Finally, China's stock markets have been hit by a series of scandals in recent years. Professor Wu Jinglian, an influential Chinese economist, has billed China's stock market as a giant "casino." Accounting fraud of listed companies is widespread. Such events as the bank run of the Hainan Development Bank, the failure of China Venturetech, and the default of GITIC's external debt, suggest that China's stock market is extremely undisciplined.

5. Immature financial supervisory system.

Over the past ten years, the People's Bank of China has made some progress in setting up financial regulators, streamlining organizations and structures, implementing a legal framework, and improving supervision. However, the inherent weakness of the state-owned banks has resulted in systemic corruption, that often makes supervision politically unfeasible. Financial fraud is rampant.

6. Poor financial activities.

The combination of the big-four state-owned banks having monopolistic positions and the various restrictions imposed on foreign banks has prevented bank competition and innovation. Most banks derive less than 10 percent of their total earnings from fee-related incomes.

Against this backdrop, China's financial system will endure some negative impacts in the post-WTO era:[12]

1. Outflows of deposits and defection of qualified clients from Chinese banks to foreign banks.

In the context of weak competitiveness and extraordinarily high NPLs, the reason Chinese banks can still survive is mainly because foreign banks (158 branches and 214 representative offices in China by the end of 2001) are severely-restricted in their business operations in China. Indeed, only a very few foreign banks in a very few cities can conduct RMB business with multinational corporations today. Chinese depositors cannot deposit savings in foreign banks, and Chinese businesses cannot borrow RMB from foreign banks.

However, the deposit and client bases of the state-owned banks are expected to erode, once the geographic and service restrictions are gradually lifted, as the Chinese government delivers on its WTO commitment. Furthermore, there is no deposit insurance mechanism in China's financial system. Therefore, there is a high possibility of financial instability as China gradually removes the restrictions on foreign financial institutions. This is the reason why Ericsson's decision to shift its accounts from state-owned banks to foreign banks has caused concern among Chinese policymakers.

2. State banks' difficulties in retaining well-qualified personnel.

Foreign banks are undertaking concerted strategies to cherry-pick good employees from the Chinese banks. It is impossible for the state banks to get into bidding wars in the light of the government constraints on the state-owned enterprises. Therefore, state banks will lose even more competitiveness as qualified employees flee. State-owned securities and insurance companies are facing similar challenges.

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[12] Jing Huande and Xu Jinlian, *China Financial Development Report* (Shanghai: Financial University Press, 2001).

3. China's financial supervisory system will face serious challenges from the deregulation and the liberalization of financial institutions after accession to the WTO.

Due to the current loopholes, such as the poor regulating skills and supervisory system, regulators were constantly challenged by the financial institutions before WTO entry. In the future, the lifting of financial restrictions will complicate financial services and the more diversified foreign financial institutions will do business in the Chinese market. Both of these changes will make supervision even more difficult.

However, in addition to complicating the challenges facing the Chinese financial system, China's WTO accession also brings some benefits.[13] They are:

1. The acceleration of financial reforms.

Taking advantage of the requirements of WTO entry, China can ignore domestic resistance to reform and accelerate financial restructuring. In addition to opening and liberalizing its financial markets to foreign financial institutions in stages, according to its WTO commitments, the Chinese government also initiated various reforms and restructuring to improve the soundness of the financial system and financial institutions. These included: 1. actively reducing the NPLs of the major banks, 2. inviting foreign banks to buy into domestic banks, 3. planning to introduce IPOs of major domestic banks on the international stock markets, and 4. allowing foreign institutional investors to participate in the domestic A-share markets through QFII from the end of 2002.

Anticipating the challenges in the aftermath of WTO entry, in 1999, the Chinese government transferred RMB 1.3 trillion of NPLs from the big-four state-owned banks to four asset management companies effectively backed up by the Ministry of Finance.

[13] Jiao Jin-pu, *The International Competitiveness of China's Banking Industry* (China: Contemporary Economy Publisher, 2002); Lee Ruo-koo, "The Reform of the Chinese Banking System and the Liberalization of Financial Policy," 35th Annual Conference of the Asian Development Bank, 2002.

Recently the government provided US$ 45 billion of foreign reserves to relieve the NPLs of the two major banks (the Bank of China and the China Construction Bank), and US$ 15 billion to the Industrial and Commercial Bank of China. Since then, the NPLs of the four major banks have declined drastically. In addition, the Bank of China and the China Construction Bank plan to issue IPOs overseas; the other two major banks also plan to list on the domestic stock market.

Furthermore, the Chinese government is encouraging foreign investors to take minority stakes in share-holding banks and asset management companies (see Table 7.8). For example, Citibank has formed an alliance with the Shanghai Pudong Development Bank, and HSBC has acquired a 9 percent stake in the Shanghai Bank. In a recent development, Newbridge Capital, a U.S. hedge fund, has acquired about 17.89 percent of the Shenzhen Development Bank. A significant stake in Shenzhen Development Bank will allow Newbridge to drastically change the bank's existing managerial structure. Aggressive moves by foreign investors in a changing banking landscape have forced policymakers to contemplate banking deregulation in such a way that private banks will be allowed in

Table 7.8 Acquisition of Chinese Banks by Foreign Banks in Recent Years

Foreign Banks	Acquisition	%
Commonwealth Bank	Hangzhou City Commercial Bank	19.9
	Jinan City Commercial Bank	11
ING Group	Bank of Beijing	19.9
International Finance Corporation	Bank of Beijing	5
Newbridge Capital Inc	Shenzhen Development Bank	17.89
Standard Chartered	Bo Hai Bank	19.9
International Finance Corporation and Scotiabank Group	Xi'an City Commercial Bank	5
HSBC Group	Bank of Communications	20
Hang Seng Bank	Bank of Shanghai	15.98
International Finance Corporation	China Minsheng Banking Corp. Ltd.	1.08
Citigroup	Shanghai Pudong Development Bank	5

Source: Reuters (June 2005).

certain areas (Zhejiang province, for example), where the private sector is particularly robust.

2. Improving the misallocation of financial assets.

With 70 percent of bank lending diverted into sectors accounting for less than 30 percent of GDP, the result has been an inefficient utilization of capital. Foreign banks participating in RMB business will break down the oligopoly market structure which, in turn, will improve the efficiency of capital utilization.

3. Upgrading the quality of the domestic work force, services, and operating abilities in the financial sector.

The Chinese government has made efforts to bring those who have had international experience into the regulatory agencies. For example, Hong Kong's former Security Exchange Commission (SEC) Chief was hired as Vice Chairperson of the CSRC. It is now common for those who have studied and worked overseas to be recruited into domestic financial institutions or regulatory agencies.

4. Increasing the inflow of foreign capital and improving the effectiveness of the use of capital.

Foreign enterprises in China formerly maintained their financial management organizations in areas outside of China. As more and more foreign financial institutions are allowed to conduct RMB business, local Chinese financial institutions will become healthier due to the competition. This will encourage more foreign capital to be willing to link up with financial institutions in China, thus increasing the inflow of foreign capital and the efficiency of capital utilization.

THE EFFECT OF THE CEPA ON CROSS-STRAIT FINANCIAL INTERACTIONS

In order to revive the economy of Hong Kong, China and Hong Kong signed the CEPA on June 29, 2003, giving Hong Kong financial institutions preferential status over other foreign institutions in access to the Chinese market (see Table 7.9). Furthermore, if a foreigner

Table 7.9 Mainland China's Specific Commitments on Liberalization of the Financial Sectors for the Hong Kong CEPA

Sectors	Specific Commitments
All insurance and insurance-related services	1. To allow groups formed by Hong Kong insurance companies through re-grouping and strategic mergers to enter the mainland insurance market subject to established market access conditions (total assets held by the group over US$ 5 billion; more than 30 years of establishment experience attributable to one of the Hong Kong insurance companies in the group; and a representative office established in the mainland for over two years by one of the Hong Kong insurance companies in the group). 2. The maximum limit of capital participation by a Hong Kong insurance company in a mainland insurance company is 24.9 percent. 3. To allow Hong Kong residents with Chinese citizenship, after obtaining the mainland's professional qualifications in actuarial science, to practice in the mainland without prior approval. 4. To allow Hong Kong residents, after obtaining the mainland's insurance qualifications, and being employed or appointed by a mainland insurance institution, to engage in the relevant insurance business.
Banking and other financial services (excluding insurance and securities)	1. For Hong Kong banks to set up branches or a corporate body in the mainland, the total asset requirement at the end of the year preceding application is to be not less than US$ 6 billion; for finance companies to set up a corporate body, the total asset requirement at the end of the year preceding application is to be not less than US$ 6 billion. 2. There will be no requirement for setting up a representative office in the mainland before a Hong Kong bank establishes a joint venture bank or joint venture finance company in the mainland, or before a Hong Kong finance company establishes a joint venture finance company in the mainland.

(*Continued*)

Table 7.9 (*Continued*)

Sectors	Specific Commitments
	3. For mainland branches of Hong Kong banks to apply to conduct RMB business: a. they should have been operating in the mainland for more than two years. b. in conducting their profitability assessment, the relevant authorities will base their assessment on the overall profitability position of all branches of the bank in the mainland instead of on the profitability position of the individual branches. 4. To allow mainland branches of Hong Kong banks to conduct insurance agents' business after obtaining approval taking effect from November 1, 2004.
Securities	1. To allow the Hong Kong Exchanges and Clearing Limited to set up a representative office in Beijing. 2. To simplify the relevant procedures for Hong Kong professionals applying in the mainland for securities and futures industry qualifications. Hong Kong professionals applying to obtain securities and futures industry qualifications on the mainland need only to undertake training and pass an examination on mainland laws and regulations; an examination on professional knowledge is not required. 3. To allow intermediaries that are licensed with the Securities and Futures Commission of Hong Kong, and which satisfy the requirements of the China Securities Regulatory Commission, to set up joint venture futures brokerage companies in the mainland. The percentage of shareholding owned by Hong Kong licensed intermediaries should not exceed 49 percent (including shareholding of related parties). Requirements with respect to the scope of business and amount of capital, and so forth, of the joint venture futures brokerage companies shall be the same as those for the mainland enterprises.

Source: Trade and Industry Department, Hong Kong (www.tid.gov.hk/english/cepa), Cross-Strait Exchanges and Cooperation in Financial Services in the post-WTO Era.

has held a company in Hong Kong for over one year, that company will be qualified for CEPA treatment. Since Hong Kong's financial institutions are more advanced than their counterparts in Taiwan, and share the same advantages in terms of common language and cultural background, there were tremendous competitive pressures placed on Taiwan's late-starting financial institutions in the China market. These financial institutions are actively lobbying for the Taiwan government to speed up the process of opening up the mainland market to Taiwan financial institutions, as well as seeking a path to China via Hong Kong. It is the CEPA that makes it less attractive for Taiwan businesses in China to issue IPOs in the Taiwan stock market and that makes the achievement of a regional financing center in Taiwan less likely. Given the present situation, the Taiwan government cannot but eventually modify its domestic listing policies for Taiwan companies in China.

In light of the delicate relationship between Beijing and Taipei, if there had been direct financial exchanges between the two sides, the Taiwan authorities would have been worried about accelerating capital outflows to mainland China, as well as about the use of financial means by the Chinese government to destabilize Taiwan's already-vulnerable financial system and to hurt Taiwan's economic development. Therefore, the Taiwan government did not allow direct financial links or reciprocal agencies to be set up until June 2002. But there is some sentiment that a fast-growing Chinese economy and an under-developed banking sector could alleviate the over-banked problem in Taiwan. Furthermore, Taiwan's reluctance to ease cross-strait financial service exchanges makes it difficult for Taiwan banks to closely monitor their customers' financial status in China. Some Taiwan businessmen have taken advantage of this to deliberately default on their domestic debt, thus increasing the NPLs in Taiwan banks.

After accession, both sides of the strait became members of the WTO. The Taiwan government believes that, under the WTO mechanism, it is relatively secure for Taiwan to undergo cross-strait financial interactions; therefore, some further open policies have been adopted.

The Provisions on Financial Transactions between Taiwan and Mainland China, passed in June 2001, enable banks in Taiwan to set up agencies in China, and allow direct financial exchanges of OBUs and DBUs between the two sides. But these steps still lag behind those of other countries. By June 2003, only eight Taiwan banks had set up offices in China. Due to the lack of agreement over the one-China policy, the two sides have not signed a MOU on mutual financial supervision. Therefore, Taiwan banks are limited to opening agencies, not branches, in the Chinese market, in accordance with Chinese laws. However, many Taiwan agencies, trying to catch up with other multinationals, have agreed to become strategic alliance partners with Chinese banks for future cooperation. And some other Taiwan banks have purchased Hong Kong banks to take advantage of the CEPA to access the Chinese market and to circumvent the restrictions of the Taiwan government. Due to similar political considerations, even OBUs were authorized to make loans to Taiwan businesses in China; however, no OBU had actually lent money to Taiwan businesses in China before the end of 2003.

There are also a number of insurance companies and security firms, that have set up offices in China. Some insurance companies have even set up subsidiary companies, because mainland China does not require the signing of an MOU for mutual financial supervision in the insurance industry. Moreover, it is important to note that, although the Taiwan government has not yet authorized its citizens to purchase Chinese stocks, investors from Taiwan have actively poured much money into the Chinese stock market via numerous indirect conduits.

Even after both sides have entered the WTO, based on the most-favored-nation principle, Taiwan must allow Chinese banks to set up operating offices in Taiwan. There are a few Chinese financial institutions that have shown interest in doing so, but, as of this writing, no Chinese firm has been approved by both governments to set up a branch office in Taiwan.

As stated above, Taiwan's financial sector faces difficult challenges due to the slow response of the Taiwan government. This has been especially true since the mainland and Hong Kong implemented the

CEPA. Therefore, in order to raise the competitiveness of Taiwan's financial institutions, the Taiwan government should quickly further liberalize cross-strait financial exchanges, including:

1. Allowing Taiwan's OBUs to conduct RMB business and to extend loans to Taiwan businesses in China.
2. Reducing restrictions on Taiwan banks that apply to invest in China and basing the approval of such applications on bank performance, instead of the size of bank capital.
3. Permitting Taiwan's financial institutions to M&As with financial institutions located in China.
4. Signing MOUs on mutual financial supervision with the Chinese government as soon as possible.
5. Allowing Taiwan companies in China to easily list on the Taiwan Stock Exchange market.
6. Permitting cross-strait financial cooperation and exchanges among businesses and personnel.
7. Permitting Chinese financial institutions to set up branches or agencies in Taiwan.
8. Setting up a "financial alarm system" that will prevent Taiwan's financial system from damage due to instabilities in the Chinese financial system.

THE OUTLOOK FOR CROSS-STRAIT FINANCIAL EXCHANGES AND COOPERATION

Both Taiwan and China are facing increasing foreign competition and pressures following WTO accession. However, the financial systems in both Taiwan and China are robust enough to cope with the shocks unleashed by such foreign competition, if the risks are not managed prudently. With the rapid increases in bilateral trade, investments and swift economic integration between the two sides, cooperation in the financial sectors will be beneficial to both. In addition to the cooperation and exchanges at the financial industry level, actions in other areas such as the following could enhance the stability of each side's financial system. These include:

1. Sharing experiences of financial reform and financial development.

Taiwan's financial system has experienced various phases of deregulation, liberalization, and internationalization. Many of its lessons and experiences in these areas can be helpful to China, particularly considering their common language and culture.

2. Cooperating on a defense mechanism against international financial speculation and attacks.

Both Taiwan and China have amassed large amounts of foreign reserves. It makes sense for Taiwan and China to sign a bilateral swap agreement so that additional liquidity will be readily available if either side is hit by a financial crisis. Indeed, China has signed similar agreements with many regional economies including Thailand — the country that triggered the Asian currency crisis in 1997. Such multilateral swap agreements have proven to be effective in deterring speculative attacks.

3. Extending business strengths by establishing joint strategic alliances.

Financial institutions in Taiwan should be allowed to form strategic alliances with, and to acquire stakes in, their Chinese counterparts. As financial institutions in Taiwan are familiar with Western financial practices, and Taiwan shares a common language and culture with mainland China, if they can make inroads into the Chinese market, their competitiveness in China will be increased. This will help Taiwan to overcome its current problems in the financial industry. At the same time, Taiwan's financial institutions will be the best conduits for China's financial institutions to master modern financial skills and to become more competitive. In addition, in the areas of trade finance, loan syndication, asset management, and consumer banking, Taiwan's experience is also relevant.

4. Cooperating on work force training and exchanges.

Because there are no language and cultural barriers, it is easy for China and Taiwan to learn from each other's experiences. China will require a large pool of financial professionals, and Taiwan will be able to provide necessary training courses.

5. Signing a reciprocal MOU for a financial supervisory agreement.

The signing of a reciprocal MOU for a financial supervisory agreement would make it possible for government regulators on each side to implement supervisory measures over the home country's financial institutions operating on the other side of the strait.

6. Building communication channels and negotiation mechanisms to solve conflicts in the financial sector.

Establishing normal and legitimate communication channels is beneficial to both Taiwan and China. With increasing trade flows across the strait, both sides will be confronted with an increasing number of disputes and misunderstandings. As a result, it is necessary that objective dispute-solving mechanisms be established.

7. Eliminating financial crime through cross-strait cooperation.

In the context of closer contacts and interactions between Taiwan and China, financial crime, for instance, laundering and counterfeiting, has grown rapidly recently. The two sides of the strait should collaborate with each other to punish those who engage in criminal financial activities to ensure normal financial operations.

CONCLUSION

Since the financial sectors on both sides of the Taiwan Strait are the weak links in terms of their international competitiveness, they face serious challenges due to their commitments to open their financial markets after entry into the WTO. On the one hand, China, in particular, which has an unhealthy financial system and lacks experience in dealing with major financial crises, could face severe economic turmoil, if the process of opening up its financial sector is not well-planned. Therefore, the main challenges facing China are to maintain the stability of the entire financial system and to strengthen financial competitiveness, while opening up its isolated domestic financial market.

On the other hand, after joining the WTO, Taiwan has to compete on a level playing field with international financial institutions. Therefore, Taiwan urgently needs to improve the competitiveness of its financial industry. In addition, Taiwan is already showing signs of an over-banked domestic market. Taiwan's financial institutions need to expand outwards. Since they cannot compete in mature North American and West European financial markets, the mainland China market would be a good target for their expansion. Therefore, the second challenge for Taiwan is to initiate an effective way to take advantage of the China market.

In comparison with foreign competitors, Taiwan's financial institutions enjoy certain advantages in China, since the areas share common linguistic, cultural, and historical backgrounds. Furthermore, the financial system in Taiwan is superior to that in China at the present time. Accordingly, China's opening of its relatively-isolated and conservative domestic financial market could provide a valuable opportunity for Taiwan's financial institutions. This also may help Taiwan's financial sector to catch up with the leading Western counterparts. Meanwhile, from China's perspective, financial institutions on the mainland could readily absorb Taiwan's experiences accumulated over the past decades without encountering obstacles in terms of culture or language. Therefore, cooperation would significantly benefit both sides.

Facing the challenges posed by accession to the WTO, governments on both sides of the strait have instituted an array of measures to strengthen their respective financial industries and to upgrade their financial systems. Some substantial achievements have been made. However, due to political considerations, the pace of cross-strait financial exchange is too slow, which is not beneficial to either side. Taiwan might even miss out on the opportunity to explore the China market, and then the opportunity to become a regional financial center.

Moreover, with the rapid increases in bilateral trade and investment, as well as the swift economic integration between the two sides of the strait, financial cooperation could be extended to more important areas, such as the stabilization of the financial systems, or even to currency exchange mechanisms. As a result, a further boosting and enhancing of cross-strait financial cooperation will promote the ability of each side to overcome the challenges of accession to the WTO.