Taiwan

Sector outlook – Banks

Paul Cavey
paul.cavey@clsa.com
(886) 2 2547 9140

Nora Hou
nora.hou@clsa.com
(886) 2 2547 9137

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Taiwan
Banks

The Japan comparison

Separating the men from the boys

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Underweight banks

Buy
Fubon Financial
(see accompanying report)

Sinking Japanese style?

The future of Taiwan's banks

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Sinking Japanese style?

The Japan comparison: facing the real-economy consequences

This report compares the Taiwan banking system with the Japanese banking system. Taiwan's banks exhibit many of the symptoms of Japan's troubled banking sector. Non-performing loans (NPL) are high and rising, under-recorded, and growing because of structural as well as cyclical factors. Banks are not in a strong position to deal with these problems, suffering from thin absolute and weak relative profitability, and a poor capital base. And the weaknesses of the banking sector are already beginning to have real-economy consequences. Several de facto failures of smaller financial institutions have occurred, and Taiwan is clearly suffering from a credit crunch.

Separating the men from the boys: corporate winners and the rest

But while Taiwan's banking sector is at risk of stumbling into Japanese-style stagnation, such a fate is not yet inevitable, and in any case will not drag down all banks. The health of the overall sector has after all clearly weakened over the last five years, but Fubon Commercial Bank and Bank SinoPac have both continued to perform well. The gap between the best and the rest will if anything become more pronounced over the next two to three years. With their good balance sheets, the quality banks will continue to take market share. They will also gain most from the measures introduced to tackle the sector-wide problems, notably the chance to diversify under the financial holding company (FHC) structure.

Structural causes of the problem

That Taiwan's banking sector is ailing this way is perhaps not surprising. The island was a Japanese colony between 1895-1945 and the banking sector has much in common with Japan's. Consequently, as in Japan, the regulatory framework governing the financial sector has been conservative: until recently, for example, the business scope of banks was highly restricted. Both countries have also suffered from official and bank management complacency. With officials providing an implicit guarantee for all banks, risk management has been weak. Standards of supervision and corporate governance in both Taiwan and Japan have been poor.

The job of reform is half done

Taiwan's government has not stood idly by watching the NPL ratio rise. Officials have introduced a package of reforms aimed at: encouraging consolidation; establishing an exit mechanism; allowing bank diversification; dealing with NPLs; and improving the quality of supervision. But the authorities have not yet done enough to prevent the banking sector falling into a Japanese-style slump. Pricing disagreements, and the reluctance of officials to push reforms of state-linked institutions, are holding up the consolidation process and attempts to deal with NPLs. The credibility of the Financial Reconstruction Fund (FRF) is limited by its small capitalisation. In addition, standards of supervision and corporate governance remain deficient.

Underweight banks

We underweight Taiwan banks due to continued deterioration in asset quality, increased provisioning pressure, limited effect from the financial holding company structure in 2002, and unattractive valuation relative to other regional financial service stocks.

The Japan comparison

Facing the real-economy consequences

Introduction

Growing bad loans

Though still at a less-advanced stage, many of the problems is Japan's banking sector are mirrored in Taiwan. Even by the government's conservative figures, the non-performing loan (NPL) ratio reached an all time-high of 7.8% at the end of September 2001, up from a lowly 3% at the end of 1995. The 2001 downturn in Taiwan's economy does not fully explain this rise: the average annual NPL ratio rose continuously between 1995-98 even though the economy grew quite strongly during this period. And in any case, the official figures underestimate – perhaps by half or perhaps more – the true size of bad loans in the banking system.

Weak finances

The ability of the banking sector to deal with this problem is limited. Profitability is weak. The return on assets of Taiwan's 34 listed commercial banks declined from 0.9% in 1996 to below zero in 2000. Even using government statistics, in all but one of the last six years the increase in NPLs at these banks has outstripped annual profitability; the increase in bad loans recorded in the first nine months of 2001 was almost four times the pre-tax profits earned during the same period. Total profits at the 34 banks averaged NT$63.3bn in 1995-2000. At this rate, if they were to rely on profits alone the banks would need 10 years to write-off all their bad loans. At the same time, banks do not have strong capital bases to fall back on. Assuming an NPL ratio of 15% and a 70% write-off rate, remaining equity in the banking sector slips to just NT$115.3bn (US$3.3bn). With the same recovery rate and an NPL ratio of 17.5%, all equity of the 34 banks is exhausted.

Real-economy consequences

The weakness of Taiwan's financial industry has already led to the de facto failure of institutions on the periphery of the sector. But it is also dragging down the economy as a whole. Deteriorating balance sheets make banks less willing to lend, and the lower supply of credit dampens GDP growth. But slower economic growth generates more bad loans, and so a downwards cycle develops. Such a process has clearly been at work in Japan, and the NPL problem is now affecting the ability of Taiwan's banks to perform their essential intermediation function. Bank lending to private enterprises has slowed fairly consistently since late 1998, and has fallen year on year every month since early 2001. Banks have instead been lending to the government: in November 2001, major financial institutions' claims on the government rose to 17.3%, the highest in over 30 years.

Growing bad loans

Japan in 1991 . . .

"Watch out for a banking crisis." If such comments were heard at all in Japan in 1991 - and they were not common – they more often than not elicited laughter at the apparent foolishness of the speaker than worried gasps from listeners. Okay, the last year had been difficult. The stock market had plummeted by almost 50% from its year-earlier peak and the rate of GDP growth had fallen. But the country's previous record of financial and economic management spoke for itself. In the last ten years, GDP had grown by an annual average of 4%. Indeed, the country's economic development path was regarded by many as a model to be studied and copied.

Figure 1

The Japan comparison: growing bad loans, weak bank finances and real-economy consequences	
Growing bad loans	
A high and rising NPL ratio	❑ Japan: the official NPL ratio was 6.4% at the end of March 2001
	❑ Taiwan: the official NPL ratio has more than doubled since 1995 to reach an all-time high of 7.8% at end-September 2001
Official under-recording	❑ Japan: outside observers put the NPL ratio at 22-30%
	❑ Taiwan: the real NPL ratio is probably at least 15-20%
Structural as well as cyclical causes	❑ Taiwan: the NPL ratio rose during the late 1990s even though the economy was growing strongly
Weak finances	
Thin absolute profitability	❑ Taiwan: return on average assets for 34 listed commercial banks fell from 0.9% in 1996 to zero in 2000
Weak relative profitability	❑ Japan: loan losses accumulated by Japanese banks during 1992-99 exceeded by more than 13 times the profits earned by the banking system during the same period
	❑ Taiwan: in all but one of the last six years the increase in NPLs at the 34 banks has outstripped profitability
Write-offs cannot keep pace	❑ Japan: banks wrote off US$620bn in bad loans between 1992 and September 2000
	❑ Taiwan: although the seven largest banks wrote off NT$112bn in bad loans in 1999-2000, their stock of NPLs still increased by NT$90.6bn in the same period. In 2001 they wrote-off a further NT$95.5bn, but their stock of NPLs rose by almost NT$140bn
Poor capital base	❑ Taiwan: with an NPL ratio of 17.5% and a 30% recovery rate, the equity of the 34 banks (as at September 2001) would be exhausted
Real-economy consequences	
Failure of financial institutions	❑ Japan: failure of high profile financial companies, most notably Long Term Credit Bank and Nippon Credit Bank
	❑ Taiwan: officials have recently begun to take control of the weakest institutions
Credit crunch	❑ Japan: outstanding loans have declined YoY every month since January 1996
	❑ Taiwan: bank lending to private enterprise has fallen fairly consistently since late 1998. In November 2001 outstanding bank lending to private enterprises was almost 4% lower than in the year-earlier period

Source: CLSA Emerging Markets

. . . was rather like Taiwan in 2001

These numbers also easily could be a portrayal of Taiwan in 2001. Japan is much further down the road. The world's second-largest economy has been in the doldrums for ten years. At the time of writing the situation appears to be, if anything, getting worse rather than better. Moreover, the financial sector had not only had a crisis, but its problems are widely regarded as a central cause of the long-lasting economic stagnation.

Taiwan is already exhibiting the symptoms of the Japanese malaise

Does the same fate await Taiwan? It is possible to imagine so, and not just because of the shared record of a long period of economic growth being interrupted all-too abruptly. After all, despite having an economy that grew at an average annual rate of 6.4% in the 1990s, Taiwan's financial sector clearly already exhibits some of the symptoms – albeit it as yet at a less-advanced stage – of Japan's banking woes. Furthermore, although these signs have been visible for several years, it is only since 2000 that Taiwan's authorities have treated tackling them as a priority.

Uncertainty clouds the NPL picture in Japan . . .

Take NPLs in the banking sector. Unfortunately, it is difficult to track developments in Japan's NPL ratio in recent years. Astonishingly, Japanese banks did not publish any information regarding the size of their problem loans until 1993. Since then the method used to calculate the bad loan ratio has been changed several times, and even now there is considerable disagreement regarding the true size of Japan's NPL problem.

. . . but the underlying ratio could be as high as 30%

Based on a definition consistent with international best standards (Figure 3), the NPL ratio at all deposit-taking institutions was 6.4% at the end of March 2001, or ¥43tr (US$325.8bn). But based on the assessments' of banks themselves the figure could be as high as 12%. And in April 2001 Japan's largest opposition party, the Democratic Party, published figures suggesting overdue loans totalled ¥151tr, giving an NPL ratio of 22.4%. Some private sector analysts think the real ratio is nearer 30%.

Taiwan's official overdue loan ratio is 7.8% . . .

So how bad is Taiwan? According to Taiwan's central bank, the Central Bank of China (CBC) the non-performing loan (NPL) ratio for the island's domestic banks rose to an all-time high of 7.8% of total loans at the end of September 2001. This was scary stuff. Just six years ago at the end of 1995, the overdue loan ratio had stood at a lowly 3%. Some of this increase in the official NPL ratio is to be expected. Economic performance did after all deteriorate rapidly in 2001, when GDP contracted for the first time since records began. But the NPL ratio had started to rise before this latest downturn, when GDP growth was still rapid. The rate of economic growth accelerated from 4.6% in 1998 to 5.4% in 1999 and 6% in 2000, but during the same period the average annual NPL ratio rose from 4.7% to 6.1%. It is therefore clear that Taiwan's NPL ratio has been dragged up by structural, and not just cyclical factors.

. . . but this excludes items that would be regarded elsewhere as non-performing

Worse still, the government's figures are widely thought to understate the real magnitude of the NPL problem, excluding items such as restructured loans that would be regarded elsewhere as non-performing. These impaired assets could add up to a substantial amount: when the regional downturn of 1998 prompted the government to start worrying about the health of corporate Taiwan, the exclusion of restructured loans from NPL ratios was proffered by the government as an incentive to encourage banks to extend credit to companies experiencing financial difficulties but that otherwise had "normal operations."

A wider government estimate puts impaired assets at 11.5% . . .

Faced with a widespread lack of confidence in the existing figures, the authorities since December 2000 have been supplementing them with additional data on loans under supervision (which are supposed to include restructured loans). The result is supposed to be a definition of bad loans that is more in keeping with internationally-accepted standards (Figure 3). Including these new figures, Taiwan's NPL ratio was 11.5% at the end of September 2001. But there is much scepticism about the accuracy even of this wider definition. For in addition to the official interventions in the formulation of the NPL ratio, when judging the quality of banks' loan portfolios we also have to contend with the less-than-perfect level of transparency in Taiwan's banking and corporate systems.

. . . but based on experiences elsewhere . . .

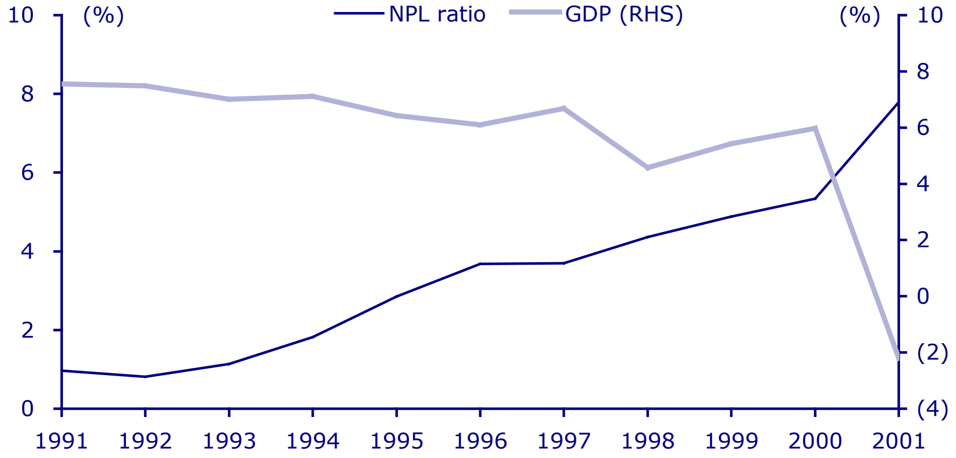
As a result, the true NPL ratio is almost certainly likely to exceed the 11.5% figure. It is obviously impossible to say accurately what the true number is. But we can at least make an educated guess at the likely range. Andrew Sheng in a World Bank report notes that the experience of several countries has been that final loan losses are almost always double the previous estimate.

. . . and recent events in Taiwan, the real NPL figure is probably 15-20%

Applying this rule of thumb to Taiwan would seem to have some validity. In August 2001 a government fund took over 36 ailing grass-roots financial institutions, and handed them over to banks. Before they were taken over these institutions were believed to have a negative worth of around NT$30bn, and officials put aside NT$60-70bn (US$1.7-2bn) for the clean-up operation. In the event the assuming banks were compensated with NT$77.3bn, but were rumoured to have estimated the true cost to be more like NT$100bn. Given the tendency of eventual loan losses to explode in this way, it seems fair to assume that the true NPL number probably lies somewhere between 15% and 20%.

Figure 2

Rising NPLs and weakening GDP growth



Note: NPL data is for year-end except for end-September 2001

Figure 3

The numbers game: defining an NPL

International best standard definition	CBC's definition
Nonaccrual credit Loans on which principal or interest is past due 90 days and any collateral held is insufficient to cover principal and interest	**Past due items** ❑ Loans for which payment of principal is past due three months or more ❑ Loans for which repayment of interest is past due six months or more ❑ Instalment repayment loans past due six months or more
Past due items loans on which principal or interest is past due 90 days but which are well-secured	**Loans under surveillance** Since December 2000 the CBC has been supplementing this narrow NPL figure with information on loans under surveillance, which include:
Restructured items Loans on which the original terms have been modified to provide concessions for the borrower	❑ Loans overdue for 3 months but less than 6 months ❑ Loans where the principal is either not overdue or has been overdue for less than 3 months, but with interest payments past due for between 3 and 6 months, and ❑ loans that reached NPL standards but were exempted from the existing ratio with regulatory approval

Source: CLSA Emerging Markets

Weak finances

Japan's banks wrote off US$620bn in bad loans in 1992-2000

The scale of Japan's banking sector difficulties are in any case not reflected in the NPL ratio in any one year – whatever that figure might be. The NPL ratio in 2001 would have been much higher if Japanese banks had not written off a massive US$620bn in bad loans between 1992 and September 2000. That banks continue in 2001 to have NPLs on their books at all illustrates that new bad loans continue to appear.

Japan's banking sector has weak profitability

And therein lies the problem, because write-offs at the rate achieved during the 1990s are unsustainable – banks eventually run out of money. This would be true anywhere, but is particularly the case in Japan where bank profitability is low relative to the size of the NPL problem. According to Niroshi Nakaso in a report for the Bank for International Settlements (BIS) loan losses accumulated by Japanese banks in the 1992-99 period exceeded by more than 13 times the profits earned by the banking system during the same period. Indeed, during the second half of the 1990s the Japanese government injected around ¥10tr (US$78.5bn) of public funds to boost the capital strength of the major banks, an exercise which in early 2002 looked increasingly likely to be repeated.

Profitability of Taiwan's banking sector is also low . . .

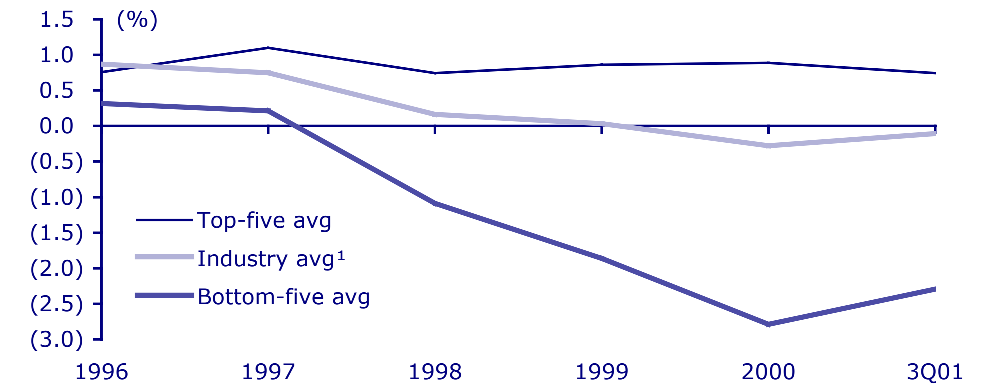
From this point of view, it is perhaps even clearer that Taiwan's banking sector is in trouble. Average returns generated by the banking system have declined steadily in recent years. Based on a simple average, the return on assets of the 34 commercial banks that were listed as of September 2001 – so excluding the two listed investment banks, China Development Industrial Bank (CDIB) and Chiao Tung Bank (CTB) – declined from 0.87% in 1996 to below zero in 2000. This is in sharp contrast to the profitability of the banking system in, say, Australia, which generated an average return on assets of almost 1.5% in 1994-98.

. . . with recent increases in NPLs outstripping annual profits . . .

In all but one of the last six years the increase in NPLs outstanding has outstripped annual profitability; the increase in bad loans recorded in the first nine months of 2001 was almost four times the pre-tax profits earned during the same period. Total profits in our universe of 34 banks averaged NT$63.3bn in 1995-2000. At this rate, if they were to rely on profits alone the banks would need ten years to write-off all the bad loans they had on their books at the end of September 2001. And this is after writing down bad loans by the provisions accumulated by the banks at the end of September 2001, and assuming no dividend payments are made during the next ten years.

Figure 4

Return on assets of Taiwan's listed banks



Note: Based on universe of 34 listed commercial banks; Source: CLSA Emerging Markets, *Taiwan Economic Journal*

. . . and net worth

But it is not just from the standpoint of profitability that the banks look weak. Their equity base also looks thin. At the end of 1995 NPLs at the 34 listed commercial banks totalled NT$166.5bn; not a major problem, considering that the net worth of the banks concerned totalled NT$527bn. But by September 2001 NPLs had more than quadrupled, rising to NT$756.2bn, while net worth had not even doubled, increasing to just NT$947.3bn.

Taiwan's seven largest banks wrote-off NT$155.4bn in 2000-01

And this is even though since July 1999 the banking sector has enjoyed a de facto capital injection of around NT$60bn a year as a result of the government's decision to cut the business tax rate for financial institutions from 5% to 2%. The government instructed banks to use these funds to dispose of bad loans – when announcing the tax cut in February 1999 officials said they wanted NPLs to be reduced to just 2.5% of system assets by September 2003. Banks have certainly been writing off more and more bad loans in recent years. According to our calculations based on monthly financial releases, after writing off NT$51.4bn in 1999, the seven biggest banks in Taiwan wrote off NT$60.9bn of NPLs in 2000 and a further NT$94.5bn in 2001.

. . . while the stock of NPLs increased by NT$90.6bn

But despite the NT$112.3bn written off in 1999 and 2000, the stock of NPLs of these seven banks continued to increase, rising by NT$90.6bn in these two years. The environment for the banking sector was even tougher in 2001, when write-offs did not even keep pace with the value of new NPLs appearing: between January and December 2001 NPLs at the same seven banks increased by NT$139.8bn. And as this analysis is based on the official NPL ratios reported by the banks, the discrepancy between write-offs and the creation of new bad loans is in reality greater still.

Bad loans could already exceed capitalisation

Figure 5 indicates just how bad Taiwan's banking sector problems really are. We have estimated here how much equity our universe of 34 listed banks would retain assuming different scenarios for NPL ratios and write-off rates (using equity, accumulated provisions and bad loan figures for the end of September 2001). Even assuming the official NPL ratio, which for these banks as a whole is 8.9%, and a write-off of just 50%, the simple, unweighted capital-adequacy ratio (CAR) for these banks falls below 8%. But this scenario seems highly unlikely. We have already noted that the NPL ratio for the financial sector as a whole is likely to be 15-20%. At the same time, given the weakness of the property market, we believe that banks are likely to generate a recovery rate on written-off loans of just 30%.

Assuming 70% recovery rate/ 17.5% NPL ratio: equity of 34 banks is exhausted

Assuming an NPL ratio of 15% and a 70% write-off rate, remaining equity in the banking sector slips to just NT$115.3bn (US$3.3bn). With the same recovery rate and an NPL ratio of 17.5% – an entirely plausible scenario – all equity of the 34 banks is exhausted. Admittedly, the state of the banking sector does not look quite so perilous following the surge in equity prices since September 2001: the financial institution sub-sector of the Taiex has risen by just over 30% in the last four months. But with the economy still weak, the NPL ratio is likely to have risen since then as well. And the expansion in the equity base has not boosted the banks' thin profit margins.

Figure 5

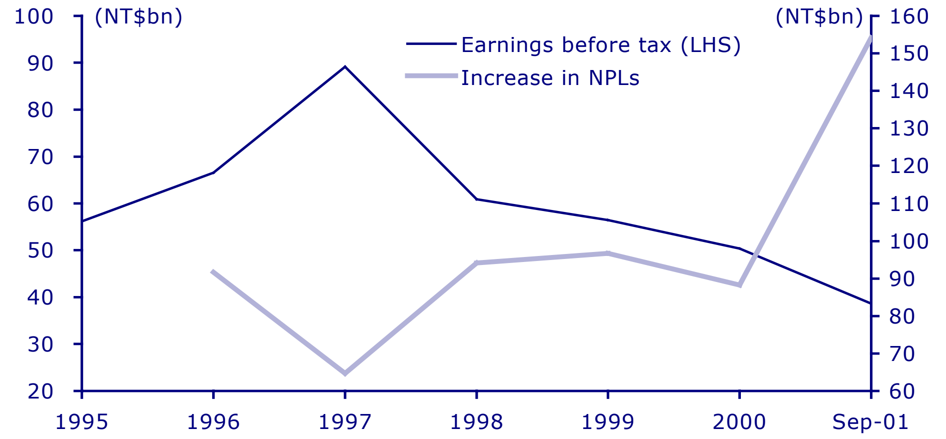
Remaining equity under different NPL and write-off assumptions (NT$bn)

Write-off (%)\ NPL ratio (%)	8.9	12.0	15.0	17.5	20.0
50	668	526	389	275	161
60	587	417	252	115	(22)
70	506	307	115	(44)	(204)
80	425	197	(22)	(204)	(387)

Note: Based on universe of 34 listed commercial banks; Source: CLSA Emerging Markets

Figure 6

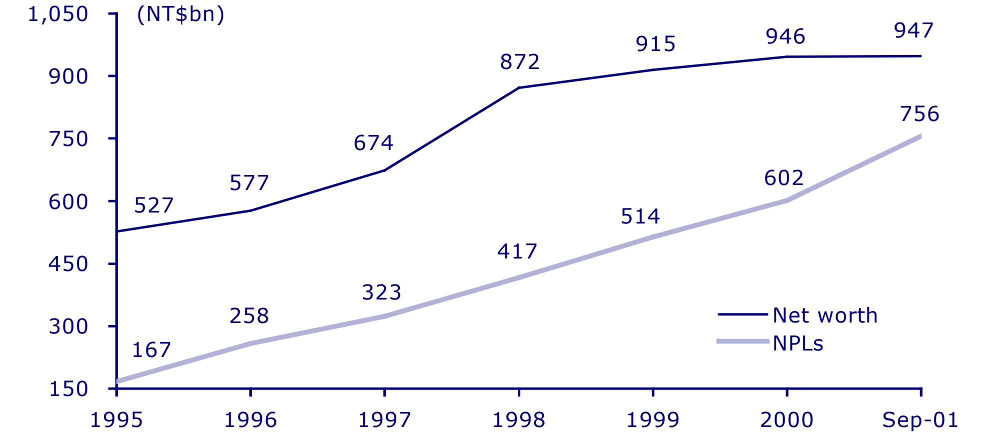
Banking sector annual earnings and yearly increases in stock of NPLs



Note: Based on universe of 34 listed commercial banks

Figure 7

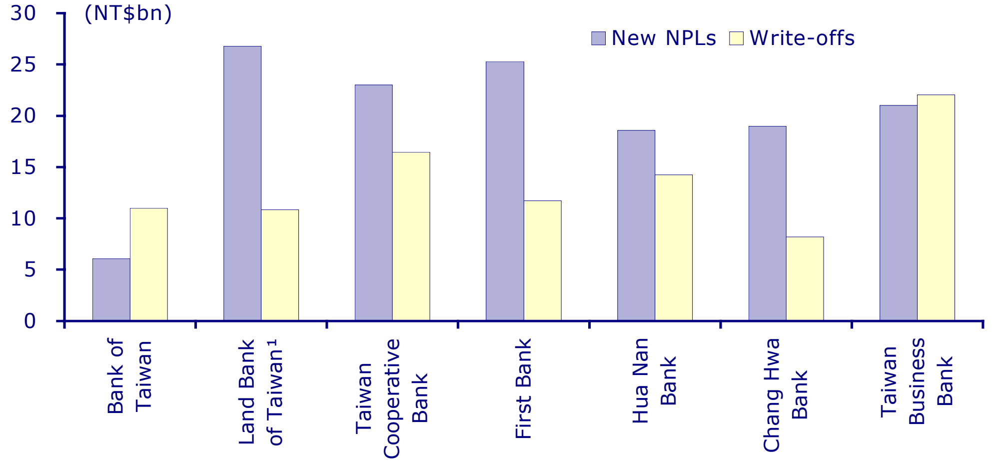
Net worth and total outstanding NPLs



Note: Based on universe of 34 listed commercial banks; Source: CLSA Emerging Markets, *Taiwan Economic Journal*

Figure 8

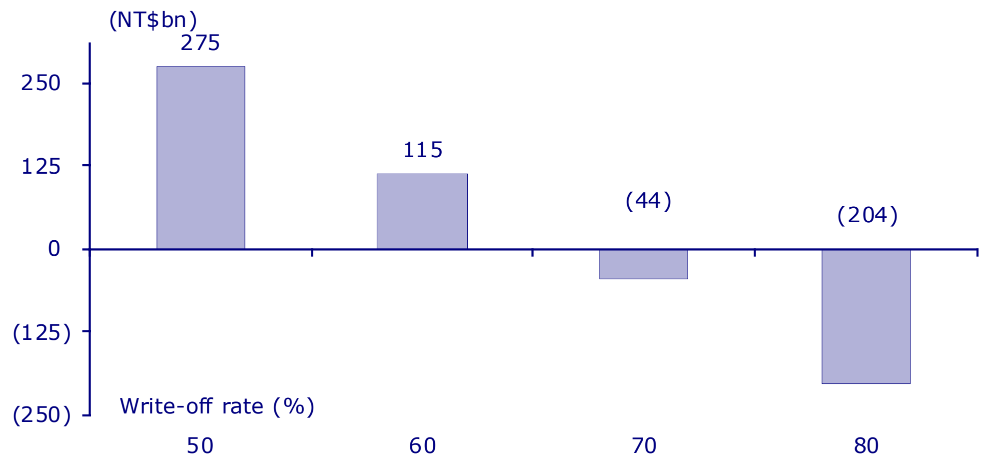
NPLs and write-offs of major banks



Note: Write-off for Land Bank of Taiwan excludes Nov-01 data; source: CLSA Emerging Markets, *Taiwan Economic Journal*

Figure 9

Remaining bank equity assuming a 17.5% NPL ratio



Note: Based on universe of 34 listed commercial banks; Source: CLSA Emerging Markets

Real-economy consequences

Japan has suffered bank failures . . .

The extent of the problems in Japan's financial sector is also not reflected in the overall NPL ratio because this number does not immediately make clear the difficulties faced by individual institutions. And it is the large-scale failure of financial companies – rather than the rise in the NPL ratio per se – that banking sector supervisors most fear. After all, such developments bring home to the general public problems that may otherwise seem esoteric. This in turn can trigger a loss of confidence in the banking system, triggering bank runs and a systemic crisis. In Japan during the second half of the 1990s some high profile financial companies did fail, most notably Long Term Credit Bank and Nippon Credit Bank, together racking up net losses of almost ¥7tr (US$53bn). Other big firms Sanyo Securities, Hokkaido Takushoku Bank and Yamaichi Securities also all went under. Other institutions would have failed without the help of the government's ¥10tr lifeline.

. . . and peripheral institutions in Taiwan have gone bust

Since 1998 a number of peripheral financial institutions in Taiwan have run into difficulties. Such cases have largely involved local credit co-operatives and the credit departments of farmers' and fishermans' associations (such as the 36 the authorities took over in August 2001), but small banks have also needed government support. After news of mismanagement surfaced in November 1998, Taichung Business Bank, a middle-ranking regional institution, suffered a bank run, prompting the intervention of the government's Central Deposit Insurance Company (CDIC). From 2000 the government was rumoured to be working behind-the-scenes to keep a handful of institutions afloat. In late 2001, using newly granted powers, the CDIC took over administration of the ailing Chung Shin Bank and in January 2002 assumed control of the Kaohsiung Medium Business Bank. It is clear that Taiwan's financial sector is showing signs of stress.

Both supply of and demand for credit falls . . .

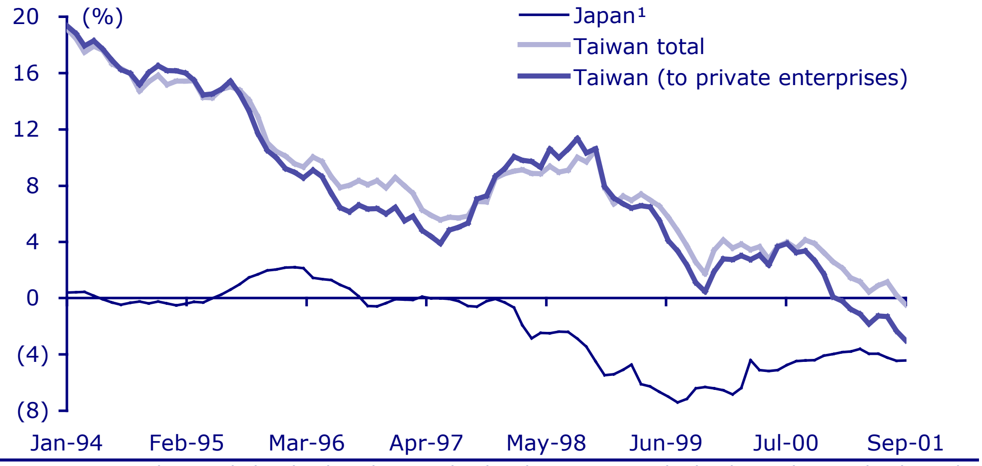
We need hardly mention that the reason new NPLs keep emerging in Japan is that the economy has yet to escape the slump that was triggered by the collapse of the asset price bubble economy in the early 1990s. But there is a self-perpetuating cycle at work here. Banks with large stocks of accumulated bad loans become reluctant to issue new credit for fear of generating new losses. Cutting outstanding loans is also a way to maintain capital adequacy ratios as banks write down capital to dispose of existing NPLs. But such behaviour, while perhaps rational for one bank, is clearly dangerous for the economy as a whole: a decline in credit pushes even more borrowers into financial difficulties, further increasing the banks' NPL ratios and depressing the economy. Of course, demand-side factors are also at work here. Banks may be less willing to lend, but with Japan's economy being in slump for much of the last ten years, there are also few companies looking for new investment funds.

. . . and both Taiwan and Japan suffer from a credit crunch

Still, whatever the balance between contracting supply and stagnating demand, it is clear that the supply of credit in Japan has fallen. Outstanding loans in Japan have declined YoY every month since January 1996. And Taiwan, with its weak banks and, more recently, contracting economy, seems to be following a similar path. Bank lending to private enterprises has slowed fairly consistently since late 1998, and has fallen year on year every month since early 2001. In November 2001 outstanding bank lending to private enterprises was almost 4% lower than in the year-earlier period.

Figure 10

YoY change in loans outstanding for Japan and Taiwan



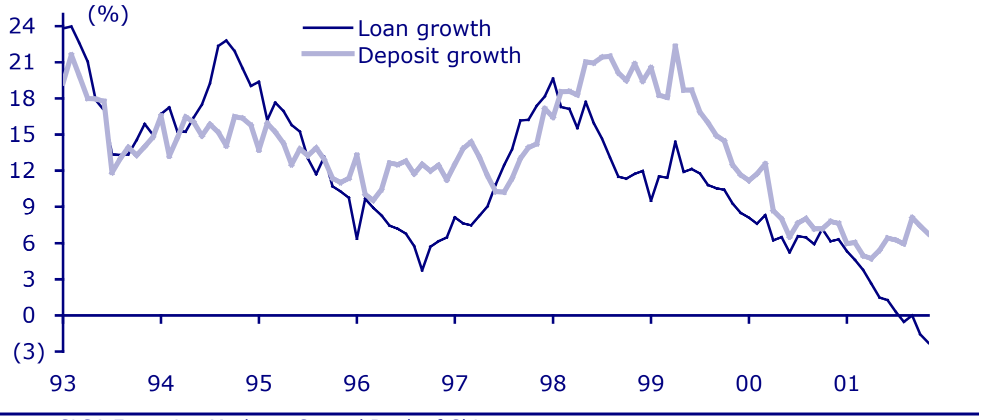
Note: [1]Japanese data includes lending by city banks, long-term credit banks and trust banks only; Source: CLSA Emerging Markets; Central Bank of China

In the absence of alternatives, banks increase lending to the government

But although loan growth has slumped, deposits in both Japan and Taiwan have held up. Faced with holding excess liquidity, banks in both countries have increased lending to the government. Banks in Japan, for example, have resorted to buying Japanese Government Bonds (JGB). According to Robert Ward of the Economist Intelligence Unit, this has resulted in the strange situation where yields on JGBs are falling, even though Japan's fiscal situation, credit ratings and economic outlook are all poor. In Taiwan major financial institutions' claims on the government have increased steadily as a proportion of their total loans and investments, from a low of 12.8% in August 1998 to 17.3% in November 2001, the highest in over thirty years.

Figure 11

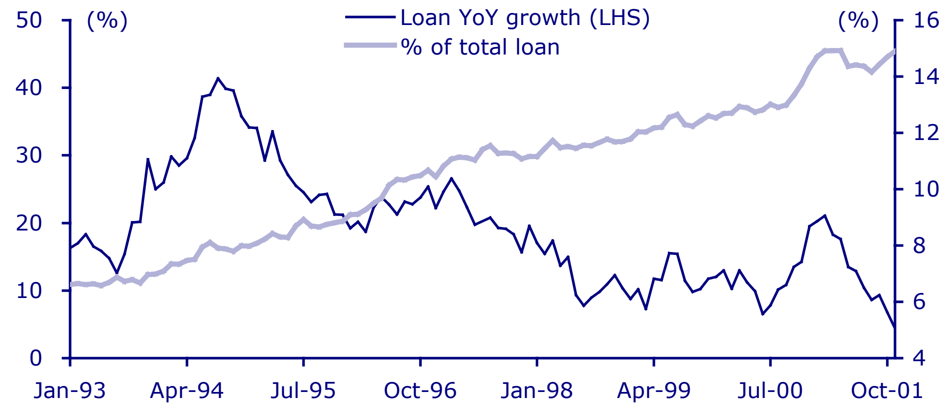
Deposit and loan growth in Taiwan



Source: CLSA Emerging Markets, Central Bank of China

Figure 12

Lending by major financial institutions to the government



Source: CLSA Emerging Markets, Central Bank of China

Summary

Taiwan is showing some of the symptoms of the Japanese malaise

It is clear that Taiwan is already showing some of the symptoms of the Japanese malaise. The stock of NPLs, under-recorded by the authorities, is high and rising. Both profitability and the capital base appear weak compared with the size of the problem. And with the quality of their loan portfolios deteriorating, the banks have become cautious in issuing new credit. But although worrying, that the performance of Taiwan's banking system is showing signs of deteriorating along the same path already trodden by its Japanese counterpart is not surprising. After all, the underlying structures of the two systems are very similar.

Separating the men from the boys

Corporate winners and the rest

Taiwan's banking sector can still avoid the route taken by Japan

But while Taiwan's banking sector is in danger of following the route that Japan has taken, such a fate is not yet inevitable, and in any case will not drag down all banks. The health of the sector overall has clearly weakened over the last five years, but Fubon Commercial Bank and Bank SinoPac have both continued to perform well. The gap between the best and the rest will if anything become more pronounced over the next two to three years. With their quality balance sheets, these two institutions will continue to take market share. They will also gain most from the measures introduced to tackle the sector-wide problems, notably the chance to diversify under the Financial Holding Company (FHC) structure.

Good names stand

Some firms have done well over the last five years when the banking sector has weakened consistently . . .

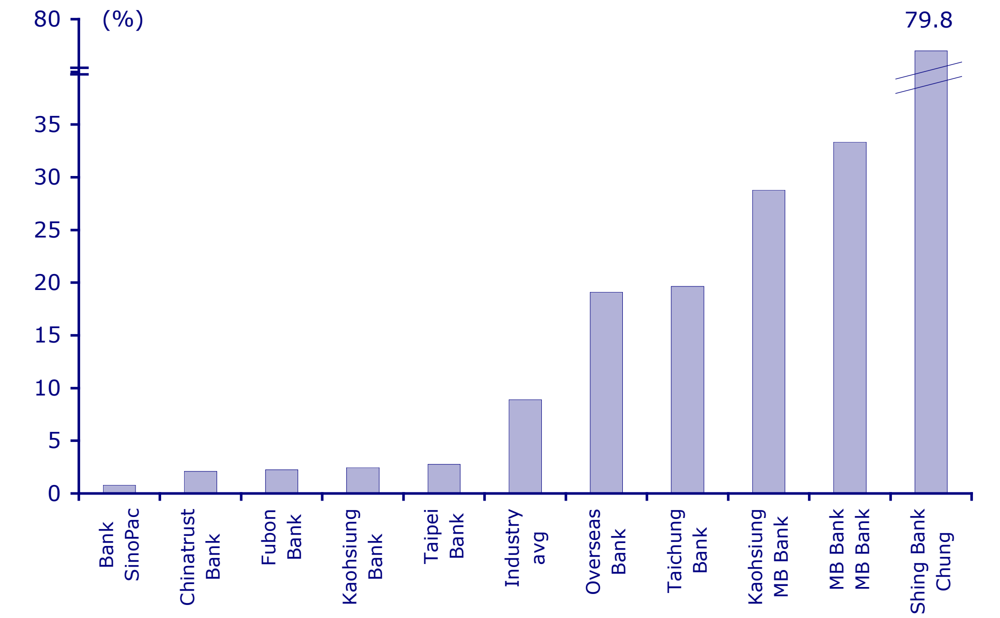
Taiwan's banking sector clearly exhibits many of the same symptoms as the damaged Japanese financial sector. Still, even if the sector as a whole does deteriorate further, some banks will continue to generate decent earnings. For evidence that this scenario is possible we need simply to review the last five years. During this time earnings of the banking sector as a whole have weakened consistently, but despite the poor state of the industry as a whole some individual institutions have continued to do rather well, namely Fubon Bank — now subsumed into Fubon Financial (2881.TW - BUY) — Chinatrust Bank (2815.TW - U-PF) and Bank SinoPac (2839.TW - BUY). The asset quality and profitability of these banks remains above the industry average.

. . . they will continue to take market share with their competent management and good balance sheets

This is not surprising. The problems faced by weaker institutions – a description that fits the majority of Taiwan's banks – present those with strong, focused and competent management, coupled with good balance sheets, with an enormous opportunity to take market share.

Figure 13

NPL ratio comparison



Note: Data as of September 2001; industry average is calculated based on data from 34 listed banks
Source: CLSA Emerging Markets

Figure 14

ROA comparison (%)

	1996	1997	1998	1999	2000	3Q01
Fubon Bank	0.60	1.18	0.55	0.80	0.91	0.90
Chinatrust	0.74	1.02	0.74	0.80	1.07	0.73
E.Sun Bank	0.69	0.96	0.74	0.72	0.62	0.73
UWCCB	0.99	1.49	1.15	1.08	1.07	0.70
Bank SinoPac	0.77	0.84	0.55	0.90	0.77	0.65
Industry average	**0.87**	**0.75**	**0.16**	**0.03**	**(0.28)**	**(0.11)**
Hsinchu Bank	0.74	0.73	0.54	0.00	0.00	0.00
Overseas Bank	0.03	0.56	0.04	(0.62)	(0.95)	(0.59)
Taitung MB Bank	0.14	(0.72)	(4.59)	(5.45)	(4.21)	(2.30)
Chung Shing Bank	0.89	1.09	0.56	(0.79)	(5.98)	(3.97)
Kaohsiung MB Bank	(0.22)	(0.60)	(1.98)	(2.45)	(2.80)	(4.61)

Note: Industry average is calculated based on data from 34 listed banks

Reforms help the strong get stronger

The better banks will continue to get better from the reforms the government has recently introduced . . .

The polarisation of institutions within the banking sector will, if anything, increase over the next two to three years. This will not be only due to the continuing weakness of the industry as a whole. It will also be because the better institutions in the market will be the ones that benefit most from the reforms the government has introduced to tackle the general malaise.

. . . such as the financial holding company structure

These measures have included, for example, changes to allow banks to diversify into other areas of the financial industry, most notably through the introduction of the FHC structure. These reforms will allow the more forward-thinking institutions to develop cross-industry synergies, thus raising their cost-efficiency and further bolstering their already-strong balance sheets.

Poorer ones are likely to face marginalisation, even in the FHC structure

The government has already approved the establishment of 13 FHCs, and at least two more will be formed during the remainder of 2002. In the long run, those banks not in an FHC structure are likely to face marginalisation. This is because they will have higher costs and a less efficient capital structure. Not even all the banks in the 13 FHCs already announced will survive. As we explain later, Taiwan's market can probably support no more than seven or eight efficiently-operating FHCs.

Figure 15

Approved financial holding companies

FHC	Registered cap (NT$bn)	Paid-in cap (NT$bn)	Total assets (NT$bn)	Listing date	Major participants
Hua Nan	100	41.4	1,230.6	19-Dec-01	Hua Nan Commercial Bank, Entrust Securities
Cathay	120	54.0	1,090.2	31-Dec-01	Cathay Life Insurance, Tong Tai Insurance
Chinatrust	100	46.1	810.4	1Q02	Chinatrust Bank (2815.TW), Chinatrust Securities (unlisted)
Fubon	120	54.7	450.9	19-Dec-01	Fubon Insurance, Fubon Bank, Fubon Securities, Fubon Life
SinoPac	100	35.3	347.5	1Q02	Bank SinoPac (2839.TW), National Securities (6001.TWO), SinoPac Securities (unlisted)
CDIB	200	84.6	190.1	28-Dec-01	CDIB, First Taiwan Securities
First	100	38.2	1,228.0	1Q02	First Commercial Bank (2802.TW), Taisec Securities, Mintai Insurance (unlisted)
E.Sun	50	22.9	259.8	28-Jan-02	E.Sun Bank, E.Sun Bills Finance, E.Sun Securities
Taishin	100	45.0	554.0	18-Feb-02	Taishin Bank, Dah An Bank
Shinkong	50	24.2	506.6	19-Feb-02	Shinkong Life, Power World Securities
Chiaotung	50	28.9	565.3	4-Feb-02	Chiaotung Bank, International Securities
Jih Sun	50	21.9	205.9	5-Feb-02	Jih Sun Securities, Jih Sun Bank
Fuh Hwa	50	20.9	67.5	4-Feb-02	Fuh Hwa Securities Finance, Fuh Hwa Securities, Shin Fu Life, Asia Pacific Bank

Source: CLSA Emerging Markets

Corporate winners and the rest

Fubon Holdings is the market leader

We believe Fubon Financial will continue to outperform the other financial holding companies. The Fubon Group, with comprehensive product coverage and a highly integrated marketing arm, looked a lot like an integrated financial conglomerate even before the implementation of the government's recent reforms. We expect the FHC structure to help Fubon Group deploy its capital more efficiently. With cash transferred from its overcapitalised subsidiaries, and fewer legal restrictions on investment activities, Fubon Financial will be able to optimise its returns on equity through re-investments and mergers and acquisitions. The FHC structure will also help cross-selling of a wider range of products within Fubon Group entities. The product categorisation underway will help the group strengthen its cross-selling platform. The alliance with Citigroup will further facilitate the cross-selling activities overseas, given Citigroup's well-recognised brand equity and franchise value. We also believe the FHC structure will generate significant cost efficiency starting in 03CL.

SinoPac Holdings needs time to become an integrated entity

We are also positive on SinoPac Holdings. Resulting from the merger between Bank SinoPac and National Securities (6001.TW - No rec), the soon-to-be listed FHC will create synergy far faster than most other combinations, as Bank SinoPac will be able to quickly leverage National Securities' stock transaction accounts and local brokerage distribution channels. This will improve Bank SinoPac's loan and deposit growth, brokerage, online trading and underwriting businesses, as well as its fee income revenues. But SinoPac Holdings will not be off the blocks as quickly as Fubon Holdings: it will take some time for SinoPac Group to fully integrate National Securities, which has a distinct corporate culture, management style and IT system.

Chinatrust has potential due to its strong customer base . . .

We are neutral towards **Chinatrust Holdings** (due to be listed in 1Q02). Based on the pre-existing Koos Group of companies, Chinatrust Holdings can already offer a wide range of financial products. In Chinatrust Bank's nearly 4m credit card holders the group also already has a strong customer base on which to develop cross-selling activities. These strengths will, however, be partly offset by the small size of the group's equities arm, Chinatrust Securities (unlisted). According to Chinatrust Bank, subsequent to the FHC formation most of the securities related businesses will be transferred to Chinatrust Securities from Chinatrust Bank. We however view this decision as ineffective.

. . . but is currently held back by the small size of its securities arm

Chinatrust Securities has a net worth of under NT$3.4bn, limiting the scale of the synergies the Koos Group as a whole will be able to achieve. For instance, government rules currently restrict securities companies from underwriting deals that exceed 15 times their net worth. The size of Chinatrust Securities' net worth means it can only underwrite deals worth NT$51bn or less, indicating limited room for growth.

Negative on Cathay due to its lack of strong banking and securities exposure

We are negative on the prospects for **Cathay Holdings** (2882.TW - SELL), even though it is centred on Cathay Life insurance, which is renowned for its strong sales force. The absence within the Cathay Group of a large bank means it will be unable to fulfil its full potential in the near future – banks are clearly the best cross-selling platform. In addition, given its leading industry position and immense scale of operation, Cathay Holdings also needs a compatible securities house that can efficiently cross sell the group's products. Cathay Life currently has **Yuanta Securities** (6004.TW - BUY) as a strategic partner. However, the two are unlikely to be gather under the same holding umbrella as Yuanta Group strongly aims to lead the merger. Cathay

Holdings had intended to merge **Capital Securities** (6005.TW - No rec) but eventually failed, missing the opportunity to broaden its distribution network. We are somewhat worried about Cathay Holdings' future. As local brokers are increasingly taken over, few good candidates will be left.

E.Sun and Chiaotung have some strength, but are small

The major constituent companies of **E.Sun FHC** (2884.TW - No rec) are good quality — a well-regarded bank and a profitable bills finance company. But the group as a whole is small, with paid-in capital of NT$23bn. The securities company in particular is a marginal player, having just one branch and a market share below 1%. **Chiaotung Bank FHC** (2886.TW - No rec) is little bigger, with paid-in capital of just NT$28.9bn. And while the core of the group, Chiaotung Bank, has a strong investment record, managers will have to develop commercial banking and securities businesses if they are to produce a successful FHC.

Hua Nan lacks diversification

Hua Nan FHC (2880.TW - No rec) is dominated by Hua Nan Bank and includes Entrust Securities as its securities arm. Entrust Securities is by comparison a small company, and will make little headway in working with Hua Nan's vast client base and distribution network. The performance of the group on the whole will continue to be dragged down in the foreseeable future by Hua Nan Bank's large stock of problem assets.

First Holdings' equities arm is small

Compared with Hua Nan FHC, another group based on a former state-owned bank, First Holdings (due to be listed in 1Q02), is more diversified. **First Commercial Bank** (2802.TW - No rec) has already teamed up with Taiwan's second largest non-life insurer, Mintai Insurance (unlisted). The group's equities arm is currently small: Taisec Securities' (unlisted) had a market share of just 0.7% as at the end of October 2001. This deficiency would be rectified if **Polaris Securities** (6011.TW - No rec) is brought on board. Still, as with Hua Nan FHC, the upside for the group as a whole will continue to be limited by First Commercial Bank's poor asset quality, which will pull down group consolidated earnings.

CDIBH needs to acquire a bigger securities house

CDIB Holdings (2883.TW - No rec) is based on the strong industrial banking business of China Development Industrial Bank. The FHC also includes First Taiwan Securities, but the presence of this firm has done little to alter the business focus of the group: First Taiwan Securities is small, with just six branches and a market share of 0.4% as at the end of 2001. CDIBH's acquisition of First Taiwan Securities seems to have been more an attempt to ensure that the group could meet the government's requirement that FHCs have cross-sector operations than a strategic move into the securities business. If it is to leverage its industrial banking activities, CDIBH needs to acquire a bigger securities house with more underwriting expertise. **Grand Cathay Securities** (6003.TW - No rec) and **President Securities** (6019.TW - No rec) are potential takeover targets. However, CDIBH's distinctive management style and strong ties with political parties could make finding compatible partners difficult.

Fun Hwa Holdings: strong political stance and insignificant banking and insurance exposure

We are negative about **Fuh Hwa Holdings** (2885.TW - No rec) due to its strong political stance. Currently, the opposition Kuomintang (KMT) still holds over 50% of Fuh Hwa Securities Finance, the main vehicle of Fuh Hwa Holdings. This is a minus for Fuh Hwa Holdings given the KMT's notorious records in corporate governance. Fuh Hwa Securities has a significant presence, with a 3% brokerage market share. However, it would still be unwise for it to ally with second- or even third-tier banks, such as **Asia**

Pacific Bank (2843.TW - No rec), and life insurance companies, such as unlisted Shin Fu Life, due to their poor financial status.

Shinkong Group set up two financial holdings

Unlike other domestic conglomerates, the Shinkong Group has been divided by the Wu family into two subgroups – Shinkong subgroup and Taishin subgroup – with each setting up its own financial holding company. The split-up can be attributed to three reasons. Firstly, the two subgroups have fairly different shareholder structures, making rapid consolidation difficult. Second, the two subgroups differ from each other in nature, as Taishin subgroup is focused on consumer banking while Shinkong subgroup originally focused on the insurance segment. Lastly, and most importantly, for long time there have been rumours about family feud, with the front line drawn between the two subgroups.

Concerns over Taishin FHC's asset quality . . .

We are neutral towards **Taishin FHC** (2887.TW - U-PF) due to its comprehensive product coverage, including banking, securities, bills finance, and insurance agency. Together, these form a complete cross-selling platform which helps Taishin subgroup continue to focus on consumer-oriented financial services. However, we are still concerned about the possibility of deterioration in asset quality resulting from its take-over of Dah An Bank. For the time being, the most important task for Taishin FHC is to clean up the bad assets at the bank subsidiary level.

. . . and Shinkong FHC's weak cross-selling platform

We think **Shinkong Holdings** (2888.TW - No rec) is unlikely to succeed as it lacks a bank subsidiary. The subgroup is known for its position as the second-largest life insurer in Taiwan, but this alone will not allow it to become a good FHC. A compatible bank is still needed, as banks are the most effective cross-selling platform. Except for the insurance business, all the other segments under Shinkong subgroup are weak. Shinkong subgroup has included Power World Securities under its holding umbrella, but as the brokerage has only branch, this gives the subgroup few opportunities for cross-selling.

Negative on Jih Sun FHC due to its weak banking exposure

We are negative about **Jih Sun FHC** (5820.TW - No rec) due to its weak banking exposure – Jih Sun Bank's poor asset quality and insignificant market position. As of September 2001, Jih Sun Bank's NPL ratio was 4.93% and its market share of outstanding loans was less than 1%. This would offset Jih Sun Securities' competitive advantage – strong proprietary trading capability and a brokerage market share of nearly 4%.

Figure 16

Winners and losers

FHC	Strength	Weakness	CLSA comment
Fubon	❑ Comprehensive product coverage, good quality management, integrated marketing	❑ Already doing a reasonable amount of cross-selling. Will take some time to make further progress	Positive
SinoPac	❑ Clean balance sheet relative to local peers, strong consumer banking expertise	❑ Inter-group consolidation will be time consuming ❑ The group is small, and will need to grow through further mergers and acquisitions	Positive
Chinatrust	❑ Immense exposure to a wide range of financial products ❑ Strong credit card business	❑ Decentralised and complicated ownership structure ❑ Weak securities arm	Neutral
Cathay	❑ Strong life insurance sales force	❑ Weak in banking and securities	Negative
Hua Nan	❑ Good distribution channels	❑ Hidden bad assets ❑ Weak securities business	Negative
CDIB	❑ Strong investment team	❑ Lacks commercial banking exposure ❑ Weak securities business ❑ Political cronyism	Negative
First	❑ Comprehensive product coverage ❑ Vast distribution channels	❑ Huge hidden bad assets ❑ Old-fashioned management	Negative
E.Sun	❑ Clean balance sheet relative to local peers ❑ Lack of business focus	❑ Small scale of operation, need for further mergers and acquisitions ❑ Conservative management team	Neutral
Taishin	❑ Immense exposure to a wide range of financial products ❑ Strong credit card business	❑ Decentralised and complicated cross-ownership ❑ Poor corporate governance	Neutral
Shinkong	❑ Strong life insurance sales force	❑ Merged with bank that has poor asset quality	Negative
Chiaotung	❑ Strong investment arm	❑ Lack of commercial banking or strong securities exposure	Neutral
Jih Sun	❑ Good distribution channels	❑ Hidden bad assets at the banking subsidiary	Negative
Fuh Hwa	❑ Lack of strong exposure to any mainstream financial businesses	❑ Strong ties with political parties	Negative

Source: CLSA Emerging Markets

Figure 17

Financial Holding Companies – Confirmed combinations

	Participants	Assets (NT$m)	Net worth (NT$m)	Share swap ratio	Comments
Fubon	Fubon Insurance	75,665	38,400	1.0000	❑ Comprehensive coverage and good quality management in banking, insurance, brokerage and investment banking
	Fubon Securities	62,453	34,268	1.5078	
	Fubon Bank	261,397	28,447	1.7053	❑ Will include Fubon Investment Trust in the second stage
	Fubon Life	3,142	6,516	0.7556	
	Fubon Investment Trust	–	–	–	
Cathay	Cathay Life Insurance	1,015,925	81,223	1.0	❑ Strong in insurance but relatively weak in other financial sectors
	Cathay United Bank	147,863	11,546	6.0	❑ Likely to include Cathay Investment Trust and UWCCB into the holding umbrella in the second stage
	Tong Tai Insurance	8,510	2,520	4.5	
	Cathay Investment Trust	280	250	–	
SinoPac	Bank SinoPac (2839.TW)	269,306	23,327	1.0267	❑ Successful in banking. The money management account (MMA) business has just started to show progress, although the scale is as yet too small to generate significant profit
	National Securities (6001.TWO)	35,336	16,370	1.0099	
	SinoPac Securities	–	–	0.7969	
					❑ Working with National Securities will improve brokerage, internet trading and underwriting businesses
Hua Nan	Hua Nan Commercial Bank	1,222,986	78,660	1.0000	❑ Hidden problematic assets
	Entrust Securities	16,712	5,755	1.2821	❑ Weak brokerage
First	First Commercial Bank (2802.TW)	1,263,853	83,722	1.00	❑ Hidden problematic assets
					❑ Strong exposure to the property insurance market through Mintai Insurance
	Taisec Securities	–	–	1.11	
	Mintai Insurance	–	–	–	❑ Very likely to include Polaris Securities in the second stage
Jih Sun	Jih Sun Bank	176,280	12,636	1.7301	❑ Good securities business but weak in banking
	Jih Sun Securities	34,055	17,804	0.6928	❑ Poor asset quality and corporate image
Chinatrust	Chinatrust Bank (2815.TW)	795,834	73,202	–	❑ Banking business outperforms all others in the group
	Chinatrust Securities	–	–	–	
	Chinatrust Insurance Agt	–	–	–	❑ Needs to leverage its strength in commercial banking to acquire more investment banking business
Fuh Hwa	Fuh Hwa Sec. Finance	51,577	21,434	1.00	❑ Controlled by Kuomintang party. Lack of banking exposure
	Fuh Hwa Securities	–	–	1.06	
	Singfor Life Insurance	–	–	–	❑ Chung Hsing Bills Finance and Grand Cathay Securities are likely to be included into the FHC in the second stage
	Fuh Hwa Investment Trust	–	–	–	
	Asia Pacific Bank (2843.TW)	157,513	12,937	–	

Source: CLSA Emerging Markets

Figure 17

Financial Holding Companies – Confirmed combinations (cont'd)

	Participants	Assets (NT$m)	Net worth (NT$m)	Share swap ratio	Comments
CDIB	CDIB	196,662	125,163	1.00	❑ Strong investment arms
	First Taiwan Securities	29,697	16,097	2.50	❑ No significant synergy created via take-over of First Taiwan Securities
					❑ Need further M&A to strengthen brokerage and commercial banking exposure
Shinkong	Shinkong Life Insurance	509,641	28,321	1.00	❑ Strong life insurance business but lack of banking and brokerage exposure
	Power World Securities	–	–	2.05	
	Shinkong Insurance	10,095	2,559	–	
Taishin	Taishin Bank	283,592	28,055	1.0	❑ Well above the industry average in banking and securities
	Dah An Bank	207,386	16,741	2.0	
	Taishin Bills	–	–	–	❑ Insurance agency is very profitable
	Taiwan Securities	41,392	12,851	–	❑ Will not include Taiwan Securities into the FHC in early stage
	Taishin Insurance Agent	–	–	–	
Chiao Tung	Chiao Tung Bank	558,285	53,469	1.00	❑ Led by a state-owned industrial bank
	International Securities	–	–	2.05	❑ Strong direct investment business
	Barits Securities	47,578	34,334	–	❑ Intent to add consumer banking into holding umbrella, and to develop investment banking business
	Chung Hsing Bills Finance (2814.TW)	–	–	–	
	Chung Hsing Securities	–	–	–	
	Chi Ho Securities	–	–	–	
	Jih Sheng Securities	–	–	–	
E.Sun	E.Sun Bank	263,473	22,895	1.00	❑ Good quality management
	E.Sun Bill	9,941	5,290	1.10	❑ Too small to achieve economies of scale efficiently
	E.Sun Securities	–	–	1.25	
	E.Sun Investment Trust	–	–	–	❑ A likely take-over target for other domestic conglomerates
Taiwan	Bank of Taiwan	2,241,533	187,999	1.00	❑ Will take time to convert government-owned stakes into the FHC shares
	Land Bank of Taiwan	1,513,345	83,556	1.00	❑ Need to add non-bank subsidiaries to meet regulatory requirements
	Central Trust of China	275,612	5,877	1.00	❑ Too big to operate efficiently
					❑ Employee-resistance to lay-offs
Int'l Bills	International Bills Finance	26,702	21,068	–	❑ Small scale
	Int'l Bills Securities	–	–	–	❑ Lack of banking and insurance exposure

Source: CLSA Emerging Markets

Structural causes of the problem

Colonialism, complacency and corruption

Colonialism

It is perhaps to be expected that the banking systems of Taiwan and Japan share strong structural similarities. Taiwan was a Japanese colony during 1895-1945, a period when many of the foundations of the island's current legal and financial systems were laid.

Conservatism

Consequently, as in Japan, the regulatory framework governing the financial sector in both countries has been conservative. Shortly after the Second World War, for example, the Japanese and Taiwanese authorities both adopted US-style Glass-Steagal restrictions that sough to prevent banks from easily expanding into other areas of the financial services industry. And unlike in the US, where even before its repeal in November 1999 regulators had interpreted Glass-Steagal rules increasingly liberally, until recently these and other restrictions on the scope of the banking sector continued to be enforced fairly strictly in both Japan and Taiwan. As a result, banks in both countries have been overly dependent for income on loan and deposit activities. But with low concentration ratios, and government interference, interest margins have been kept low. The FHC law reverses that policy direction 180 degrees.

Complacency and corruption

In addition to these problems, the health of the banking sectors in both Taiwan and Japan has been affected by complacency. With governments providing an implicit guarantee for all banks, for example, risk management has been weak. This has been particularly damaging because banks' better customers – large companies – have been substituting expensive bank loans with cheaper financing from the capital markets, thus forcing the banks to take on riskier customers. Bankers may have thought the risk was not that great: they did, after all, routinely demand collateral for any loans made. But with hindsight this too looks like smugness: property prices in both Japan and Taiwan have slumped during the 1990s. Finally, standards of supervision and corporate governance in both Taiwan and Japan have been poor. This has led to mismanagement and outright corruption. These problems have been exacerbated in Taiwan by the island's indecisive links with China.

Colonial roots

Legacy of Japan's 1895-1945 colonisation

That Taiwan's banking sector exhibits some of the symptoms – albeit it at a less-advanced stage – of the Japanese malaise should not come as a great surprise. Taiwan was after all a colony of Japan for fifty years from 1895, during which time many of the foundations of the current legal and financial systems were laid. Although the US has become an important role model for Taiwan, many local officials admire Japan's achievements and still look first to it when trying to find examples of how things should be done (as unfortunately reflected in the drafting of Taiwan' securitisation law). It should therefore be of no surprise that Taiwan's banking system is wracked by some of the same structural weaknesses that were responsible for tripping up Japan's banks.

Figure 18

Structural causes: colonialism, conservatism, complacency and corruption

Colonialism		
Colonial roots	❑	Both: the foundations of Taiwan's financial system was laid during Japan's colonial rule (1895 to 1945)
Conservatism		
Glass-Steagal restrictions	❑	Both: strict enforcement of rules preventing banks from easily diversifying
Dependence on loans and deposit income	❑	Japan: during the 1980s, interest income on average accounted for 90% of the current income of city banks
	❑	Taiwan: in 2000 interest income accounted for 89% of the gross earnings of Taiwan's domestic banking sector
Low concentration ratio	❑	Japan: the top five largest banks had a combined market share of 32% in 1990
	❑	Taiwan: in 2000 the five banks controlled 33.5% of the market
Low margins	❑	Japan: rules to keep lending rates low, ensuring industry could benefit from cheap supply of capital
	❑	Taiwan: cut-throat competition resulting from the entry into the market of 16 new banks in 1991
	❑	Taiwan: large number of state-owned banks resulting in the provision with no charge of many services
Complacency		
Poor risk management	❑	Both: authorities did not like to see the failure of financial institutions
Disintermediation	❑	Both: development of capital markets gives companies access to non-bank sources of finance
	❑	Japan: bank debt of listed manufacturing companies fell from 35% of assets in the mid-1970s to under 15% in 1990
	❑	Taiwan: non-bank company financing rose from 20% of all funds in 1986-1994 to 35% by 2000
Dependence on property prices	❑	Both: lending generally based on collateral, rather than cash-flow
	❑	Japan: loans to the real estate and construction industries has accounted for around 18% of bank lending
	❑	Taiwan: in the mid-1990s lending to the real estate industry accounted for 40% of bank credit
	❑	Japan: land prices have dropped continuously since March 1992, and are now 40% below their peak
	❑	Taiwan: real estate prices have fallen continuously for the last five years, and are now 10% below the March 1996 level
Corruption		
Weak supervision and corporate governance	❑	Taiwan: bank supervision has been split between different government agencies
	❑	Both: banks have been pressured to lend to support the government's wider aims; direct political interference and corruption have also been big problems
China exposure	❑	Taiwan: almost 5% of lending by financial institutions could have ended up in China

Source: CLSA Emerging Markets

Conservative attitudes

Spectre of Glass-Steagal

For one thing, the regulatory framework governing the financial sector in both countries has been conservative. In March 1947 during the US occupation of Japan, a version of the now well-known Glass-Steagal Act was introduced, preventing banks from easily expanding into other areas of the financial services industry. This restriction was duly adopted in Taiwan. And unlike in the US, where even before its repeal in November 1999 regulators had interpreted Glass-Steagal rules increasingly liberally, until recently these and other restrictions on the scope of the banking sector continued to be enforced fairly strictly in both Japan and Taiwan.

US banks have diversified . . .

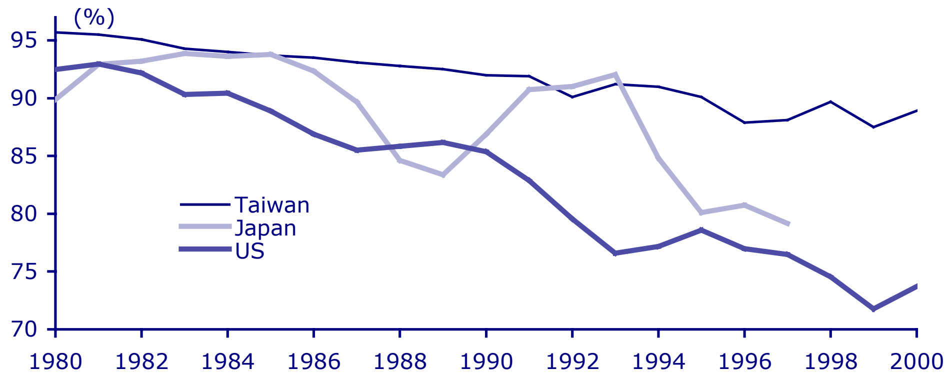
The relaxation of Glass-Steagal restrictions has allowed US banks to diversify away from their traditional dependence on deposit and loan activities: the proportion of gross interest income to total income of US banks fell from over 90% in the early 1980s to nearer 70% in the late 1990s. The US Federal Financial Institutions Examination Council (FFIEC) definition of the transactions that contribute to US banks' non-fee income gives an indication of just how diversified some institutions now are. According to the FFIEC, US banks' non-interest income includes: investment banking, advisory, brokerage and underwriting fees and commissions, venture capital revenue, net servicing fees, net securitisation income, insurance commissions and fees, and net gains (losses) on sales of loans. And this process of diversification has not just been confined to the US. Originally a rather traditional bank, the UK-based HSBC Holdings has diversified in recent years to become a financial services group, and in recent years has derived almost 30% of its earnings from fees and commissions.

. . . but banks in Taiwan and Japan remain dependent on interest income

Until recently, because of legal restrictions, most banks in Taiwan and Japan have only been able to dream of starting to make money from activities such as investment banking. Partly as a result, they have continued to rely heavily on income from traditional lending and deposit activities. In 2000 interest income accounted for 89% of the gross earnings of Taiwan's domestic banking sector – a ratio almost unchanged from 1995. In Japan during the 1980s, interest income on average accounted for 90% of the current income of city banks. Fee income in both countries remains correspondingly small. In 1997 fee income accounted for just over 4% of the total income of Japanese city banks. Between 1995 and 2000 fee income earned by Taiwan banks increased, but only from 2.5% of the total to 3.7%. In the first eight months of 2001 only Chinatrust Bank out of Taiwan's largest ten banks recorded fee income exceeding 10% of total income.

Figure 19

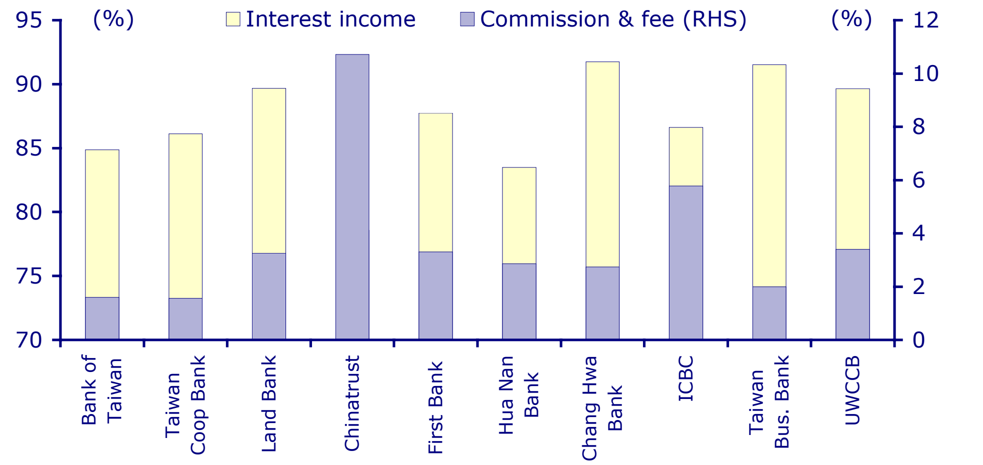
Interest income as a percentage of total income



Source: CLSA Emerging Markets

Figure 20

Interest and fee income for Taiwan's ten largest banks



Source: Central Bank of China; Federal Deposit Insurance Corporation (FDIC); Takeo Hoshi and Ani Kashyap, The Japanese banking crisis: Where did it come from and how will it end

Concentration ratios are low in Taiwan and Japan

In addition to Glass-Steagal rules, the undiversified income stream – and resultant vulnerability of banking systems to any cyclical downturn in lending activities – was also due to competition. As of October 2001 the biggest player in Taiwan, Bank of Taiwan, controlled 8.7% of the total local credit market; the combined market share of it and the next four largest players was just 33.1%. In the same year 30 of Taiwan's 53 commercial banks had shares of the domestic bank market of less than 1%. Before Japan's banking crisis began the market structure there was similar: Japan's largest bank controlled just 7.1% of the local market in 1990, with the five largest banks together having a combined market share of only 32%. This is stark contrast to both Australia and the Netherlands, which both have populations similar in size to that of Taiwan, and where the five largest players on average controlled more than 70% of the market throughout the 1990s.

Margins are kept low by government policy, overbanking . . .

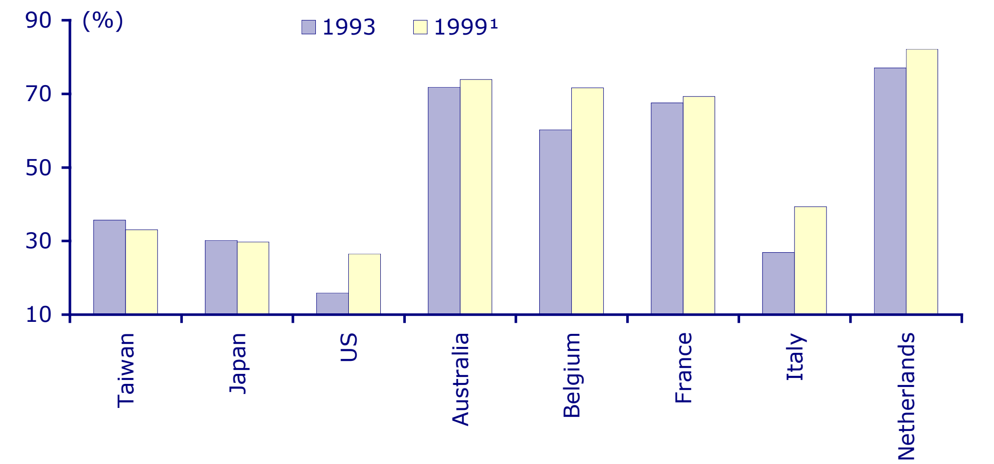
In Japan the market was not actually as competitive as these figures might suggest: government rules prevented many banks from establishing more than city or regional operations (the Glass-Seagal limitations on expansion across states is one reason why the US still has quite a low concentration ratio, but a relatively stable banking system). Still, this did not help the bottom line of the banking industry. Other rules forced banks to keep lending rates low, thereby allowing Japanese industry easy access to funds. In Taiwan competition has been more intense, especially since 1991 when the government granted licences allowing the formation of 15 new banks, and the conversion of an existing Investment and Trust Company into a bank.

. . . and the existence of large state-owned banks

Previous to this policy change, state-owned players that did not have profit maximisation as their main aim dominated Taiwan's banking sector. As a result, they provided many services for free, a status quo the new banks, eager to gain market share, were hardly in a position to challenge. This situation has largely persisted to this day. This is clear from anecdotal evidence: while complaints of "rip-off banks" are common in the US, UK and Australia, such charges are rarely heard in Taiwan.

Figure 21

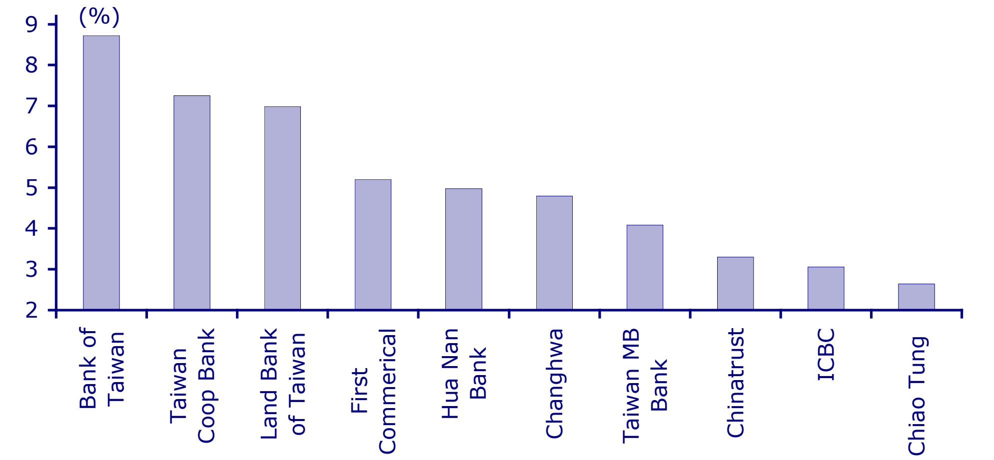
Combined market share of five largest institutions



Note: ¹Taiwan's 1999 data is Oct-01 data

Figure 22

Individual market share of Taiwan's ten biggest banks (2000)



Note: Oct-01 data. Source: CLSA Emerging Markets

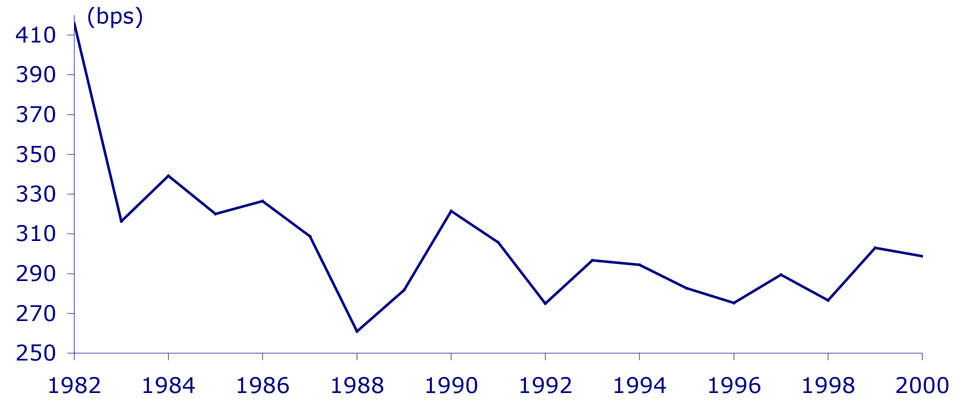
Complacency

Taiwan has suffered from the provision of credit on too-easy terms

At first glance, the increase in competition that followed the opening up of the market in 1991 seemed to put only marginal downwards pressure on spreads in Taiwan: headline figures suggest that average spreads in Taiwan fell from 320 basis points in the 1980s to 290 in the 1990s. Anecdotally though, competition in the banking sector has been cut-throat. One central bank official we spoke to complained that some of the new banks issued loans at below cost-price in an attempt to establish a foothold in the market. And credit certainly became much more easily available in the early 1990s. Between 1990 and 1995 domestic credit outstanding in Taiwan as a proportion of GDP soared from around 100% to 160%.

Figure 23

Interest rate spreads in Taiwan



Source: CLSA Emerging Markets, Central Bank of China

Risk management has been poor . . .

In fact, the numerical and anecdotal evidence are not so contradictory. After all it was not the spread per se but rather the risk-weighted spread which was either low – or often even negative. In Taiwan intense competition was certainly a reason for this phenomenon; in Japan loan pricing was often not related to risk because of government regulations that gave banks little or no say over the interest rates they could charge borrowers. And the poor pricing of loans was aided and abetted in both countries by the fact that if not owned by the government (Taiwan), than the banking system did at least suffer from a high degree of government interference (Japan).

. . . partly because banks could not fail

As a result, individual institutions could not really fail – however bad their loan portfolios might be. As a result, banks did not feel the need to invest in risk management systems, or train their staff in such techniques. (In Japan, weak risk management was also a result of the "delegated monitoring" that was an important part of the "main bank system": the bank that provided most loans to a group of companies would evaluate risk, and other banks would issue loans based on the main bank's view). The establishment of Taiwan's 16 new banks in 1991 did not change this situation: below the most senior management these banks were after all largely – at least initially – managed and staffed largely by former employees of the state-owned banks.

Financial sectors were initially strictly controlled . . .

The banks' lack of interest in risk management systems and techniques would have been foolish at any time. This negligence though was particularly dangerous in the 1980s in Japan and in the 1990s in Taiwan when the customer portfolio of the banking system was undergoing fundamental changes. Before these respective periods capital markets in both countries were small and undeveloped. As a result, the vast majority of companies wishing to borrow funds had no choice but to go to a bank.

. . . but deregulation in Japan led to disintermediation, . . .

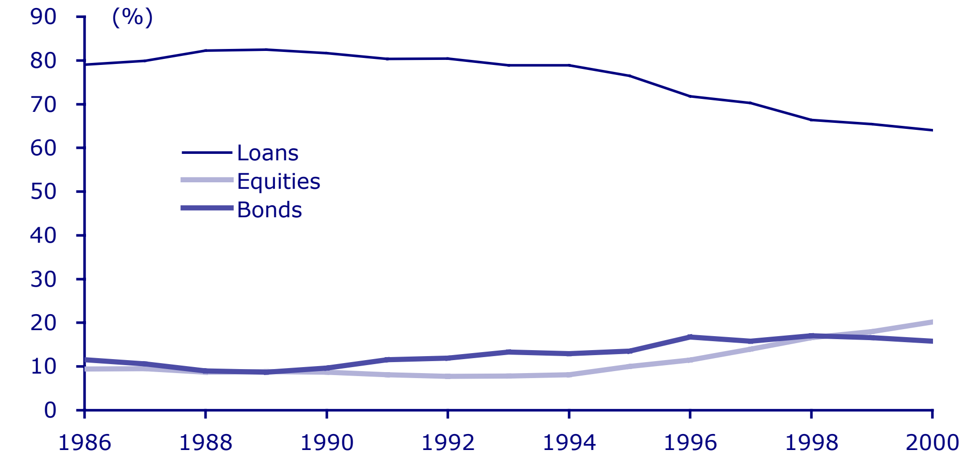
But in 1975 the Japanese government started a gradual liberalisation of the country's bond and stock markets. With capital market financing being cheap, larger firms – the traditional customers of the banking sector – began to issue bonds and shares instead of borrowing from banks: according to Takeo Hoshi and Anil Kashyap, the ratio of bank debt to assets for listed Japanese manufacturing companies plummeted from around 35% in the mid-1970s to under 15% in 1990. As a result, Japanese banks began to seek customers among smaller firms. Lending to smaller firms is generally riskier than lending to large ones; this was particularly the case for Japanese banks that had little previous experience of dealing with small businesses.

. . . a process copied in Taiwan

A similar process of disintermediation from the banking sector happened in Taiwan during the second half of the 1990s. The proportion of company financing originating from sources other than banks averaged around 20% between 1986 and 1994, but had risen to 35% ten years later (these figures exclude direct investments by financial institutions). Corporate bond and equity issuance rocketed: between 1995 and 2000 the proportion of financing provided by equity issuance doubled from 10% to 20%. Partly as a result, growth in outstanding bank credit to the private sector slowed, and then began to fall, from 147% of GDP in 1995 to 137% in 2000. So a large number of banks have been competing for a pie that has been shrinking in a relative sense. This context seems of almost textbook-quality as a breeding ground for NPLs.

Figure 24

Disintermediation in Taiwan



Note: excluding direct investments by financial institutions
Source: CLSA Emerging Markets, Central Bank of China

Banks used collateral-based lending policies . . .

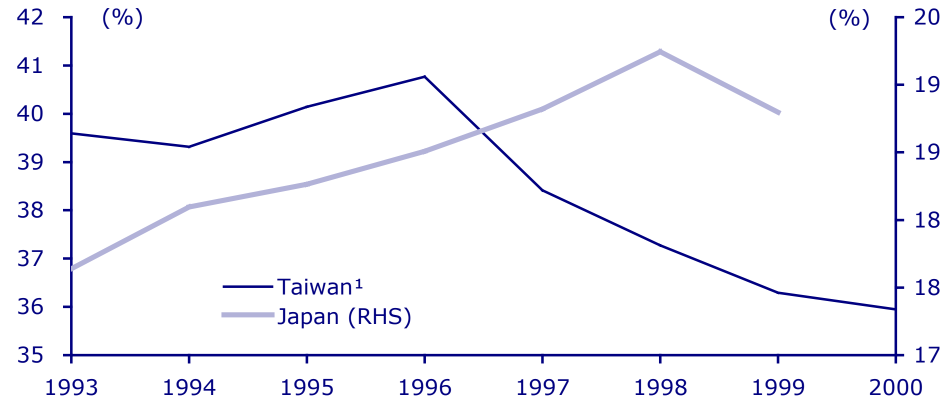
Banks perhaps thought that they could deal with any bad loans that arose. After all, when issuing credit, banks in Taiwan and Japan routinely requested collateral in return, usually in the form of land, but sometimes as shares. Indeed, maintaining collateral for outstanding loans was a legal requirement in Taiwan: in 1993 secured loans accounted for almost two-thirds of bank lending on the island. But such collateral-based lending, as opposed to the cash-flow based lending that has become increasingly prevalent in the west, is perversely likely to encourage lending to risky projects: why worry too much about the ability of a borrower to repay when you have a piece of land that is worth 150% of the value of the loan?

. . . and lent directly to property firms

But banks in both Japan and Taiwan were not just dependent on the property market through their collection of collateral. Lending directly to the real estate industry also became big business. Loans to the real estate and construction industries in Japan in recent years has accounted for around 18% of bank lending. In the mid-1990s lending to the real estate industry accounted for 40% of outstanding bank credit in Taiwan.

Figure 25

Collateral and real estate lending



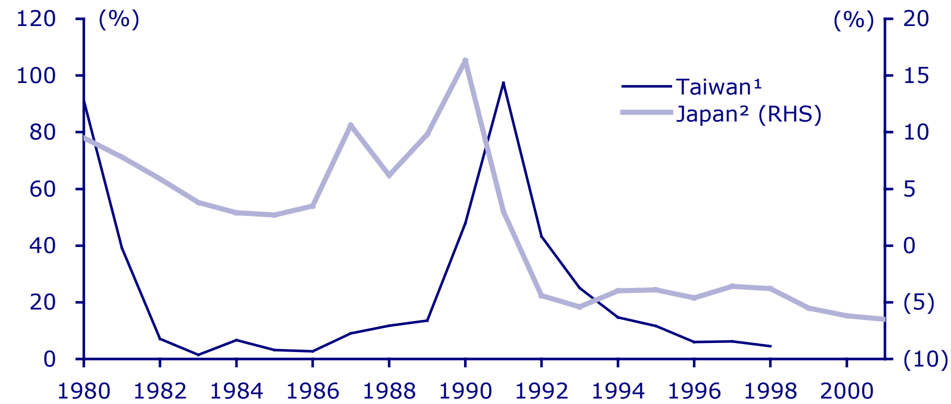
Note: Taiwan's definition of loans to real estate is wider than that in Japan, so the data are of illustrative use only. Source: CLSA Emerging Markets

Banks have consequently been vulnerable to falling property prices

Such dependence is fine when property prices rise; but it becomes positively dangerous when they fall. And fall is exactly what they have done in both Japan and Taiwan. Land prices in Japan have dropped continuously since March 1992, and are now almost 40% below their peak. According to government statistics, real estate prices in Taiwan have fallen continuously for the last five years, and are now 10% below the March 1996 level. And these statistics clearly understate the real weakness of Taiwan's property market. According to Taiwan's population and housing census, a massive 17.6% of all residential property units were vacant in 2000.

Figure 26

Property prices in Japan and Taiwan



[1]Index only published from September 1994; [2]Average of indices for commercial, residential and industrial property. Source: Ministry of Interior, (Taiwan), Real Estate Institute (Japan), CLSA Emerging Markets

Poor supervision and corruption

Taiwan has had a complex supervisory structure

Of course, that such poor lending practices and subsequent deterioration in the health of the banking sector have been allowed to occur at all reflect wider weaknesses, namely deficient standards of supervision and corporate governance. The organisation of the supervisory system in Taiwan has been part of the problem. In particular while power for supervising the financial sector is vested in the Ministry of Finance (MOF), the ministry shares with two other institutions powers of investigation: the Central Bank of China (CBC), and the Central Deposit Insurance Company (CDIC).

Banks have shouldered broad economic responsibilities

Weak supervision has also been the result of government's in both Japan and Taiwan having traditionally looked upon banks in rather a paternalistic manner. Officials viewed the banking sector not as an industry or a business but rather as a mechanism that can be used to ensure a steady stream of savings was available to finance national industrialisation. Officials in both countries have aimed to maintain the stability of the banking sector, and as mentioned above, to prevent individual institutions from failing. In return banks have been expected to support the government's wider economic policies, and have sometimes been required to maintain credit lines to favoured companies. Thus, as the economy in Taiwan has weakened, the government has pressured banks to rollover loans to some troubled firms. As an incentive to encourage banks to do this, the government has allowed them to exclude move such restructured loans from their NPL ratios – further exacerbating concern over the reliability of these statistics.

Banks have suffered from political interference . . .

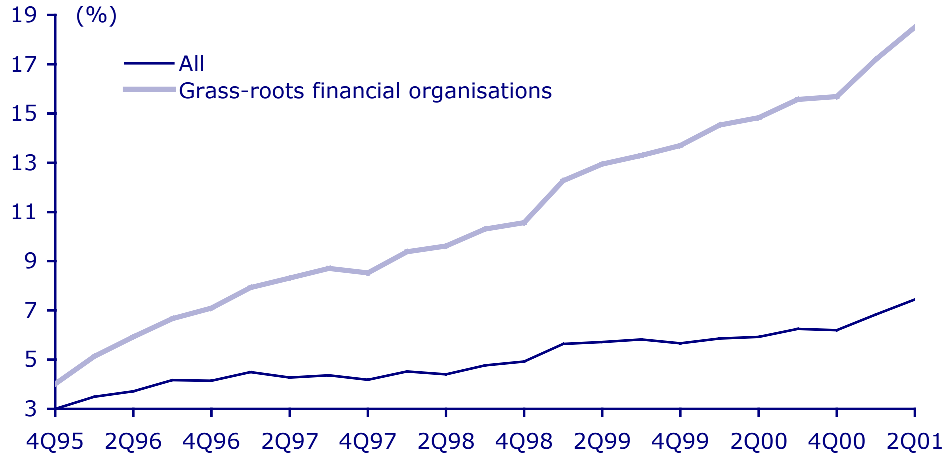
The quality of supervision has been further weakened by plain political interference. Both Taiwan and Japan have had long periods of unbroken one-party rule, through the Kuomintang (KMT, which ruled Taiwan between 1945 and 2000) and the Liberal Democratic Party (LDP, the governing party in Japan between for 38 years up to 1993, and again since 1996). With the political tenure of one political party extending over so many years, it is perhaps hardly surprising that damagingly close links developed between some politicians and financial institutions. Taiwan's farmers' and fishermans' associations and credit co-operatives have, for example, routinely been used by local politicians as sources of electoral funding (in the run-up to Taiwan's 1 December 2001 national election, the government – which is now led by the former opposition Democratic Progressive Party – sent investigators to one-third of Taiwan's grass-roots institutions to look for transfers that might be associated with vote-buying).

. . . and outright corruption and gangsterism

Both countries have also suffered from corruption of a more blatant type. In his book *Tokyo Underworld*, Robert Whiting records that during the 1990s several senior bureaucrats in Japan's Ministry of Finance and Bank of Japan "had accepted bribes and hospitality from the executives they were supposed to be policing." Examples of corruption and abuse of power are not hard to find in Taiwan's financial history. The health of individual institutions in both countries has also been affected by their links with organised crime. Mr Whiting quotes one magazine as calling the Japanese government's 1995-96 bailout of the country's leading failed housing loan corporations as "the first ever taxpayer-financed debt forgiveness of a nation's criminal underworld." The connections between Taiwan's grass-roots financial institutions and organised crime are one reason why the health of this sector is so poor, with an average NPL ratio of 15.7% at the end of September 2001.

Figure 27

NPL ratios of grass-roots institutions and banks



Source: Central Bank of China

Taiwanese investment in China has been huge, . . .

Of course, the government's task of supervising banks has not been made any easier by the poor accountancy and transparency standards in the corporate sector. Such problems are common to most emerging market economies, but have been exacerbated in Taiwan by the island's indecisive links with China. While local firms have been allowed to set up shop in China since 1991, until recently Taiwan's government has both prevented local companies from investing directly in the mainland (funds have had to first pass through a third area, usually Hong Kong), and maintained many restrictions even on indirect investments.

. . . perhaps as much as US$100bn

But many local companies have evaded this second set of restrictions by simply keeping their investments in the mainland secret – from both the government and shareholders. As a result, no one knows for sure just how much Taiwan firms have invested in the mainland. Taiwan's Ministry of Economic Affairs (MOEA) says government-approved investment in China totalled US$19.6bn between 1991 and November 2001. But private estimates put the figure much higher, perhaps as large as US$100bn. Even the MOEA's sister agency, the CBC, admits accumulated China investment probably totals US$70bn. These sums are significant: between 1991 and 2000 private-sector investment in Taiwan only came to US$360bn.

Figures on local banks' exposure to China are difficult to find

Given the huge sums involved, Taiwanese banks now clearly have significant mainland exposure. Of course, given the opaqueness that has characterised most of the island's corporate investment in China, it is difficult to know just how much lending by local banks has ended up on the other side of the Strait. Even the institutions themselves probably do not know for sure. We would hope that local banks at least have some estimate, but perhaps unsurprisingly, none of the ones we spoke to were willing to divulge this information.

One survey found 6% of firms use direct bank financing to fund their China investments

One way of calculating China lending is to use the results of a recent survey by the MOEA's Investment Commission of investments by local companies in China. According to this investigation, 6.3% of local firms rely directly on loans from financial institutions in Taiwan to finance their mainland operations. But this does not reflect the full extent of the China exposure of local banks.

Further 38% rely on funding from parent companies

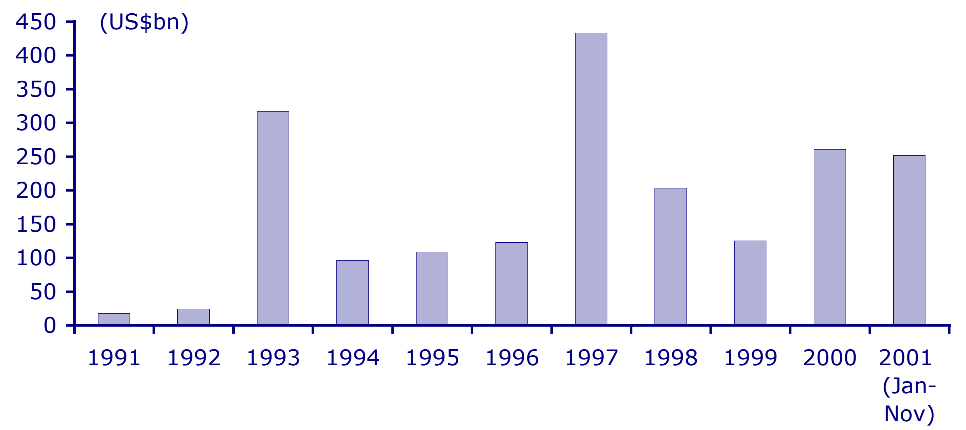
The MOEA investigation showed that almost 38% of the 1,644 projects surveyed were financed by parent companies in Taiwan; the ratio was even higher for electronics companies, where almost 50% of projects were financed directly by the parent firms (the other financing sources specified included banks in China and third countries, corporate bonds, and joint ventures). In 1995-2000 lending by financial institutions accounted for almost 50% of the total financing accessed by firms listed on Taipei's main board. If this same ratio applies to the financing of mainland investments, then it is likely that at least 20% of such projects rely on bank lending sourced by the parent companies. As a result, Taiwan banks have probably financed at least 25% of the US$70-100bn invested in China by local firms since 1991.

China exposure is probably at least 5% of all assets

And a good deal of this will be current exposure: the MOEA figures show that just over 65% of Taiwan's approved mainland investment has been made since the beginning of 1997. Thus, we believe that local banks have current lending worth perhaps between US$11-16bn to projects on the other side of the Strait, at the upper end of the scale representing almost 5% of the US$370bn in credit outstanding to the island's financial institutions in November 2001. If we include a proportion of the 17.7% of firms that responded to the MOEA survey to say funding came from "other" sources, then Taiwan banks' exposure to the mainland is higher still.

Figure 28

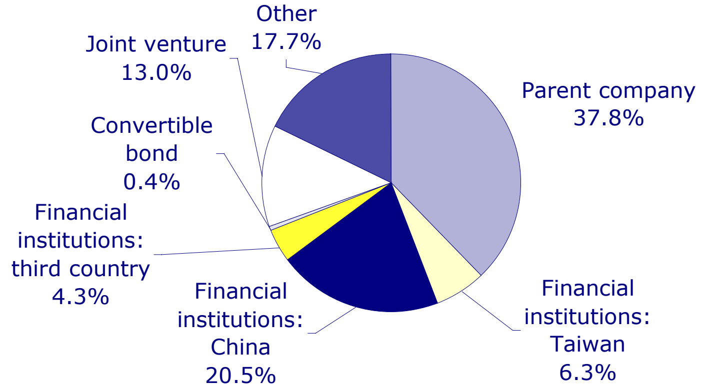
Approved Taiwan investment in China



Source: Ministry of Economic Affairs; CLSA Emerging Markets

Figure 29

Sources of finance for Taiwan investments in China



Source: CLSA Emerging Markets

China exposure is problematic as well as large

Local bank exposure to the mainland is not just large. It is also problematic. The lack of transparency with regard to banks' exposure to China is worrying in itself. Even the contribution made by the supposedly groundbreaking MOEA Investment Commission survey was limited: only 13% of the 13,038 companies questioned responded to the survey. Just over 40% of these firms said that in 1999 they lost money on their mainland investments. Newspapers in Taiwan frequently complain that borrowers from the island are uprooting to the mainland, taking their borrowed funds with them and leaving their debts behind. Regulators we met played down the importance of the problem, but it does seem to be a real issue: market players say that a standard NPL portfolio in Taiwan contains a larger proportion than would be usually be expected of borrowers who have simply ceased to exist.

The similarities with Japan are therefore not surprising

Taiwan's banking system has been structurally similar to Japan's

That Taiwan is showing these symptoms is not surprising. Taiwan's banking system historically has been structurally similar to Japan's, and not just because of its colonial roots. The sectors in both countries have suffered from: undiversified banks; oversupply; low margins; weak systems of risk management; disintermediation; dependence on the property sector; and poor supervision. Taiwan's banking sector has been additionally weakened by the often opaque nature of its customers' China business interests. If the health of the island's banking sector is to be resolved, it is clear that these structural deficiencies must be tackled. And in recent years doing just this appears to have become an increasingly pressing priority for Taiwan's authorities.

The job of reform is half done

A lot of reforms have been passed . . .

To its credit, Taiwan's government has not stood idly by watching the NPL ratio rise. Over the last year or so the authorities have introduced a largely cohesive package of measures aimed at tackling all the major underlying weaknesses of the banking sector. The reforms can be grouped into five broad areas, those aimed at: encouraging consolidation; establishing a mechanism for weak financial institutions to exit the market; allowing banks to diversify away from their traditional dependence on basic lending and deposit activities; dealing with the stock of NPLs; and improving the quality of supervision.

. . . but the economy remains weak and major margers have yet to occur

But while we commend the authorities for introducing this raft of reforms, we do not believe these measures are sufficient to prevent Taiwan's banking sector from stumbling into a Japanese-style stagnation. Apart from anything else, in 2001-02 banks will continue to face a poor economic environment. In addition, the sector has so far appeared reluctant to make use of the framework for reform that officials have put in place. Despite the raft of measures introduced by the government, only one major bank merger has so far been implemented. The much-vaunted FHC structure could actually prove a barrier to consolidation of the banking sector. Even if this does not prove to the case, the merger process will at the very least be slowed by disagreements over price. And in any case, mergers between private banks will have not have the desired effect of improving the health of the whole industry unless officials start to push a real restructuring of the large state-owned and state-linked sector.

Banks have yet to start selling NPLs, the FRF is not credible, and supervision is deficient

Pricing issues are also weakening the affect of government attempts to deal with the NPL problem. Furthermore, while the Financial Reconstruction Fund (FRF) has got to work, its capitalisation is currently small, preventing it from becoming a credible exit mechanism. Finally, despite recent reforms, standards of supervision and corporate governance in Taiwan continue to be deficient. For example, while the government has allowed FHCs to form, many accompanying regulations are not yet in place. The new Financial Supervisory Commission (FSC), which was supposed to complement the FHC structure, has not yet even gained legislative approval. And officials continue to exhort banks to provide credit to embattled companies.

A lot achieved

Financial reform is clearly on the agenda

To its credit, the government has not stood idly by watching the recent increase in the NPL ratio. Indeed, officials in Taiwan appear to realise that the banking sector's problems are serious. This awareness if hardly surprising when, as one banker put it to us, every official visitor meeting the minister of finance comments on the worrying similarities between Japan and Taiwan. The banking sector's problems first emerged onto the government's agenda as early as February 1999 and since late 2000 officials would appear to have made resolution of these issues a priority. Indeed, over the last year or so the government has introduced a largely cohesive package of measures aimed at tackling all the major underlying weaknesses of the banking sector.

The first major legislative changes were passed in late 2000

The first major measures aimed at resolving the problems in the banking sector came in February 1999, when officials announced that the business tax levied on financial institutions would be reduced, and reserve ratios cut. Little more happened until late 2000, when the Legislative Yuan approved government proposals to ease related-party ownership restrictions for banks, and also passed the Financial Institutions Merger Law (FIMA).

Six further measures were passed in June 2001

Six further measures related to reform of the financial sector were passed when the legislature met in special session in June 2001. Passage of the Financial Holding Company Act (FHCA) received most attention, but legislators also passed the Statute for the Establishment and Management of the Financial Reconstruction Fund (FRF), and approved amendments to the Insurance Law, Bills Finance Management Law, Business Tax Law and Statute of Deposit Insurance. Further reforms are likely to be forthcoming: the Legislative Yuan is expected in early 2001 to pass the Financial Supervisory Committee Act, a Securitisation Act, and approve amendments to the Enterprise Law.

Encouraging consolidation

- Allowing the establishment of financial holding companies (FHC), thereby permitting one firm to build or acquire subsidiaries across the financial services spectrum
- Raising the maximum stake in a bank for one institution or individual from 15% of equity to 25%, or to 100% if the investor is an FHC, even a foreign one
- Improving the tax regime for merging financial institutions, including exemption from deed and contract tax and reduced income tax
- amending the Enterprise Law to clear the way for hostile mergers under which stocks and shares can be used as an acquisition currency
- Allowing merging institutions that sell NPLs to write off NPLs over a 15-year period

Establishing an exit mechanism

- Establishment of the FRF, modelled on the Resolution Trust Corporation used by the US government to clean up bad assets in the late 1980s and early 1990s
- Providing NT$140bn (US$4.1bn) in funding for the FRF, from the premiums paid to Taiwan's Central Deposit Insurance Corporation (CDIC)
- Establishing the legal framework for the FRF to be administered by a Financial Reconstruction Board under the auspices of the CDIC
- Amendments to the statute of deposit insurance to allow the CDIC to offer full insurance to depositors in affected institutions

Allowing diversification

- Through the FHCA, allowing banks to sell a wide range of financial service products
- Approval of amendments to the Insurance Law and Bills Finance Management Law, thereby easing restrictions on the business scope, respectively, of insurance companies and bills finance firms
- Allowing banks to move into investment management from November 2001, by permitting them to apply for securities investment trust enterprise (SITE) licences

Dealing with the stock of NPLs

- In February, 1999 reducing reserve ratios and announcing that in July the same year the business tax levied on financial institutions would be cut from 5% to 2% (the tax cut alone is equivalent to an annual capital injection to the banking system of NT$60bn). Banks were told to use the resultant funds saved to cut NPL ratios to 2.5% within four years
- Through a clause of the FIMA, allowing the establishment of Asset Management Companies (AMC)
- Allowing banks selling NPLs to an AMC to write-off losses over a five-year period
- Establishing a legal framework for securitisation

Improving the quality of supervision

- Hiving off existing regulatory bodies from their current parents and grouping them together under a new supervisory commission with ministry rank
- A nine-member supervisory committee will head the structure. Seven members of the committee (including the chairperson) will be appointed for four-year terms, with no more than four members being affiliated to any one political party. A deputy minister of finance and deputy governor of the CBC will also have seats on the committee.
- based on UK, US and Korean systems, the new commission will have investigative powers

The economic background

Taiwan's GDP may start to grow again . . .

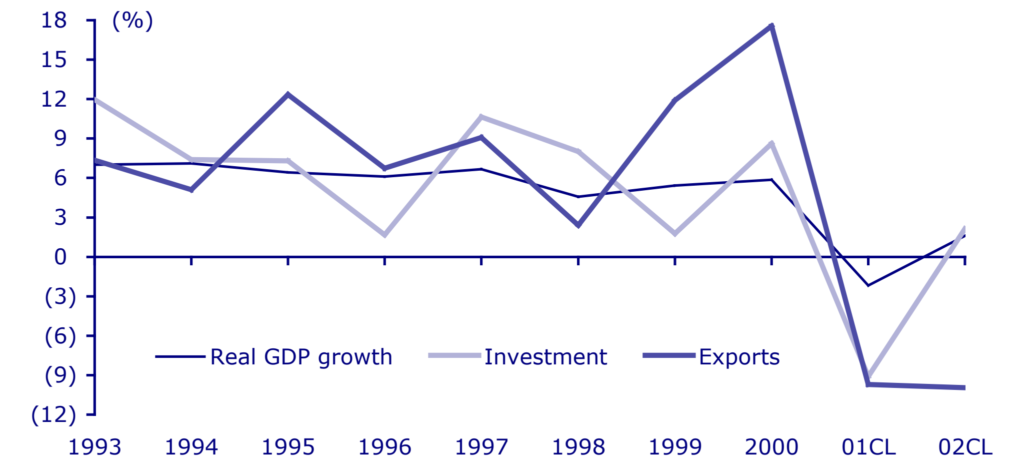
Will Taiwan suffer the same fate that has befallen Japan? This is clearly no pie-in-the-sky proposition. Granted, the structures of the Japanese and Taiwanese economies are different: imports and exports of goods and services account for just one-fifth of Japanese GDP, but for around 95% of Taiwan's. All indications are that no pick-up in the Japanese economy is likely for the foreseeable future. In contrast, with its heavier reliance on external trade Taiwan's real GDP will start to grow again as soon as external demand begins to expand.

. . . but this will not help the banks much

But the difference in export penetration rates will not be enough to ensure that Taiwan's banks do not follow the same road that has been trodden over the last ten years by their Japanese counterparts. After all, as we noted earlier, Taiwan's GDP grew strongly in 1995-2000, but the NPL ratio continued to rise. Real economic growth in this period was led by the island's high-tech sector investing and exporting to supply the US's IT boom. Many of the strongest firms involved in this process accessed cheap capital from financial markets rather than relying on loans from Taiwan's domestic banks. And it is expected to be companies like **Taiwan Semiconductor Manufacturing Company** (TSMC) (2330.TW) and **United Microelectronics Corp** (UMC) (2303.TW) that will again lead growth when an upturn does occur. But the feed through into the banking sector will be even weaker than it was in 1995-2000: even if the economy does start expanding again, the real rate of growth will remain well below the heady 5-6% a year achieved in the mid-1990s.

Figure 30

Taiwan GDP, export and investment growth



Source: CLSA Emerging Markets

Prices will fall . . .

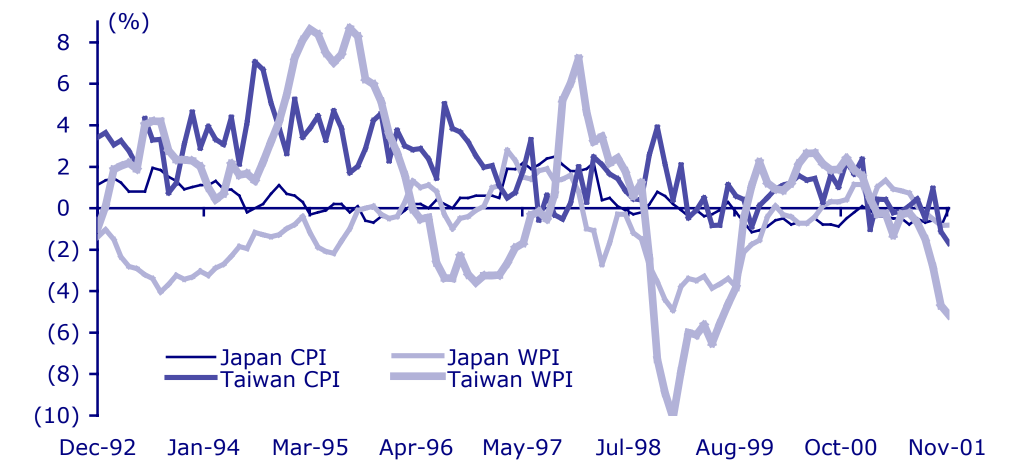
Moreover, while Taiwan's GDP may grow in real terms in the next two years, it is likely to stagnate nominally. Inflationary pressures (as measured by changes in the consumer price index) eased fairly consistently during the second half of the 1990s. As with the NPL ratio, given that the economy grew relatively strongly in real terms throughout this period, this downturn in inflation would appear to be due to structural rather than cyclical factors, namely increasingly competitive markets both at home and abroad. In 2001 this underlying lessening of price pressures was reinforced by the effects of slumping GDP growth, and consumer prices were virtually flat during the year.

. . . partly as a result of WTO entry

Structural downwards pressure on prices will be strengthened over the next two years by the effect of Taiwan's recent entry to the World Trade Organisation (WTO), which will bring a further intensification of competition in the domestic market. And with the economy remaining weak, there will be no growth-induced pick-up in prices either. As a result, we expect consumer prices to fall in 2002-03.

Figure 31

Price growth in Taiwan and Japan



Source: CLSA Emerging Markets

Taiwan could suffer from a Japanese-style downturn

So Taiwan's economy is now on dangerous ground. Deflation has been both a major cause and a significant consequence of Japan's long stagnation in general, and the persistent difficulties in the banking sector in particular. Falling prices drag down corporate earnings, and increase the real value of outstanding debts. This pulls up the NPL ratio, cutting banks' ability and willingness to lend. And this erosion of the efficiency with which banks intermediate savings adds to the downward pressure on domestic demand. And so the cycle continues.

Bank reforms are essential, but the government has not yet done enough

The government's financial sector reforms, by restoring the banking sector to health, are supposed to break this cycle. By raising profitability and reducing the stock of NPLs in the banking sector, the reforms should raise banks' appetite for lending. The authorities also hope that higher profitability, together with imminent changes in the supervisory regime, will prevent a future repeat of the problems that currently afflict the banking sector. But principle and practice are two different things. As things currently stand, we do not believe the government has done enough to prompt a fundamental improvement in the health of the banking sector – and therefore the wider economy.

The consolidation conundrum

No big mergers yet

Take consolidation. In Taiwan, officials view overbanking as the biggest single cause of the banking sector's current difficulties. But despite the raft of laws introduced – and the exerting of behind-the-scenes government pressure – only one real merger among banks has been announced, with Taishin Bank announcing a tie-up with the weaker Dah An Commercial Bank under the auspices of an FHC. The government's many attempts to corral state-owned and state-linked banks into mergers – such as the on-off one between Bank of Taiwan, Land Bank of Taiwan, and Central Trust of China – remain little more than blueprints on the desk of Finance Minister Lee Yung-san.

The FHC structure is proving popular

This is not to say that the government's attempts to spur merger activity have had no impact on the industry. As we have seen, several companies have moved to establish FHCs, announcing cross-industry tie-ups as part of this move. By mid-January the MOF had given the go-ahead for 13 FHCs. Another two applicants – Taiwan FHC (the above-mentioned combination of the three government-owned institutions Bank of Taiwan, Land Bank of Taiwan and Central Trust of China) and International Bills Holdings are expected to submit required material to the Ministry of Finance (MOF) in 2002.

And further applications may follow: some institutions have signalled the intention to establish an FHC, but are monitoring how the first batch of applicants fares before taking the plunge.

This is not an indication of success . . .

Such a large number of applications, however, is not an indication of success. When introducing the new structure the government ruled that any bank, insurance company or securities house with total assets of over NT$300bn (US$8.6bn) had to convert to an FHC, a requirement affecting 14 banks and two insurance companies. And in addition, the minimum capital threshold required to establish an FHC was set at a low level, just NT$20bn (US$580m). The problem is that this makes forming an FHC too easy. A small bank does not have to face the painful process of joining together with another bank – rather, it can meet the minimum capital requirement simply by joining up with an insurance and securities company. So, while at least 15 FHCs will be established in Taiwan by the end of 2002, we believe the island's small market size can support no more than seven to eight efficiently operating financial groups.

. . . but rather is because of low barriers to entry

With less not more FHCs being the aim, why set the barrier so low? One academic told us it was to allow smaller bills finance companies – whose business elsewhere would be controlled by banks – to form FHCs. Another possible explanation is that the government did not believe there was sufficient acquisition capital currently available in the financial sector to allow a sweeping consolidation to occur in one stage. The theory goes that through the establishment of smaller FHCs, together with passage of proposed amendments to the Enterprise Law, acquisition capital will be built up which will allow a second, deeper round of consolidation to occur. A third possible explanation is that the government, worried about the capacity of its supervisory framework, was reluctant to encourage the early emergence of financial services super-groups.

FHC structure could delay bank consolidation

Whatever the ins and outs, there is a danger that the introduction of the FHC structure will delay the consolidation that is undoubtedly necessary within the banking sector by perhaps two or even three years. Managers bringing together a bank with other types of financial services companies will be pre-occupied for some time (or at least we should hope so) in consolidating the new structure, establishing group-wide risk management, marketing, personnel and back office functions, and working out how the much-vaunted cross-selling will work in practice. And even if firms feel they can master these challenges quickly, cross-industry mergers will anyway provide some of the increase in physical presence that would be the main motivation for a link-up between two smaller banks: as one local bank pointed out to us, as part of the same FHC, a bank can gain access to the branch network of a securities firm.

Use of FHC model is still understandable

So why introduce the FHCA at all? In theory at least the new structure gives banks a means by which they can diversify away from traditional deposit and lending activities. And by expanding across the financial services industry banks and other institutions in Taiwan will have the chance to develop synergies and thus raise cost efficiency. But an FHC structure was not necessary to achieve these aims: since November 2001 banks have been allowed to apply for securities investment trust enterprise (SITE) licences, clearing the way for them to provide asset management services. Still, regulators in the countries Taiwan traditionally looks to as role models – Japan and the US – have used FHC frameworks to allow banks to diversify, rather than adopting a European-style universal banking model. In this sense Taiwan's decision to use an FHC structure at this stage is understandable.

Figure 32

Synergies created via different combinations

	Business activities	Distribution forces
Bank and securities house	Deposits and loans Ordinary banking services Investment consulting Asset management Capital market fundraising	Financial specialist Securities broker
Bank and insurance company	Deposits and loans Ordinary banking services Insurance products Integrated financial planning	Financial specialist Credit card marketing Insurance agent

Source: CLSA Emerging Markets

Individual firms will benefit directly from FHC structure . . .

But while this is the case, it also seems likely that the FHC bill was introduced in the first place as a fillip to individual influential institutions as much as for the benefit of the banking sector as a whole. For example, the wealthy China Development Industrial Bank (CDIB) has been eager to escape the legal restrictions that prevent it from being anything other than an investment bank (Chiao Tung Bank is in a similar situation). And while Fubon Group already looks likes a diversified financial services conglomerate, it has been lobbying the government to provide a legal environment that will allow it to rationalise its corporate structure and deepen Cupertino between its different units.

. . . and so may become bank buyers . . .

Still, just because the structure appears in the short term more suitable for some institutions than others does not automatically mean it will not in the end provide benefits for the banking sector as a whole. The fact that the FHCA appears designed for them should mean that players like Fubon can quickly make use of the new legal structure to begin expanding their scope. And managers at Fubon admit that they have been looking at acquisition targets in the banking sector. This is significant, as this would result in a merger between two commercial banks (although Fubon Commercial Bank is hardly a major player, having a market share of just 1.1%).

. . . as might foreign firms

There could be other buyers too. Under the FHCA foreign institutions can buy outright ownership of a local bank. In principle, Taiwan is an attractive market for foreign banks: a wealthy country with a record of strong economic growth, free-ish capital flows and democracy. And with the recent legal changes allowing banks to provide a wider range of financial services, it will be easier for foreign banks to make money in Taiwan. Citigroup already owns 15% of Fubon; and it is common knowledge that other major international banks such as HSBC and ABN-Amro have held acquisition talks with local players.

Currently there are few sellers

The government assumes that an aggressive move by a quality local or foreign player would trigger a broader consolidation of the banking sector. The problem is that by setting the barrier so low, the government has allowed institutions which otherwise might have played an important part in this rationalisation process to use the FHC structure as a way of avoiding a take-over. An obvious example is fairly well-respected E.Sun Bank, which has a market share in the banking sector of just 1% and had a net worth of only around NT$23bn (US$666m) in September 2001, but has still applied to establish *an FHC*. Which is a shame, as it is Taiwan's strong pro-independence attitude – albeit here towards the workplace rather than the island's political status – that could yet prove to be a formidable barrier to the government's attempts to restructure the financial industry. While there are some serious buyers, there seems to be a lack of serious sellers.

Good banks are not for sale – at any price

Even leaving aside the example of E.Sun, it is no exaggeration to say that Taiwan's few good banks are not for sale at any price. And these institutions are likely to work hard to maintain their independence: one banker we spoke to said while he would probably look in the future for acquisition targets, any mergers would be conducted in such a way as to leave the original shareholders in control. Which leaves the morass of mediocre and poor banks.

Mediocre banks fear loss of face and money

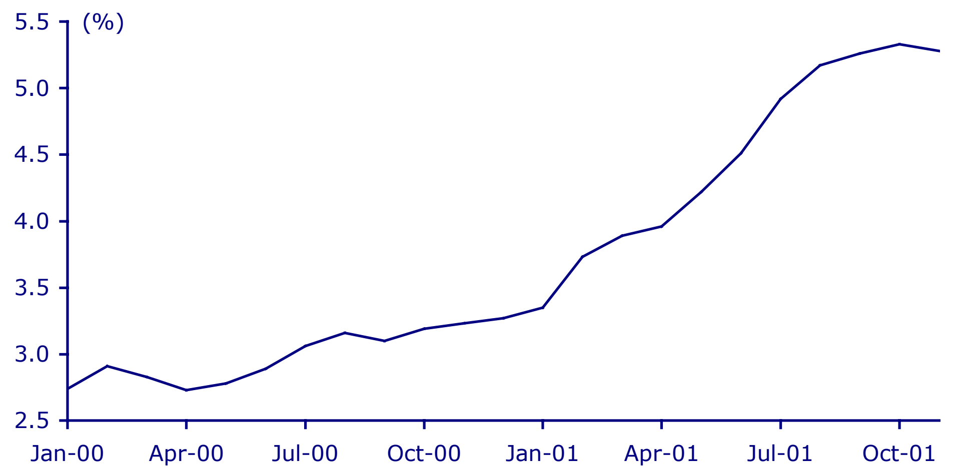
Let's take the privately-owned institutions first. These were previously not for sale either. As a result of government pressure and the economic downturn exacerbating their financial difficulties, the owners of these institutions have recently become more open to offers. But they are keen not to be seen as selling too low (some banks complain that the recent underperformance of the their shares relative to the sector as a whole is an over-reaction on the part of the stockmarket, rather than imposition of a fair market price). This reluctance is partly to do with cultural issues: selling too cheaply would be seen as a loss of face. But businessmen also fear that a decision to sell off assets at a low price would leave them vulnerable to prosecution: such cases are not unheard of in Taiwan.

A lack of mergers during the downturn is understandable . . .

It is particularly worrying that no significant deals have been announced during 2001, by far the worst year for Taiwan's economy in living memory. Of course, economic downturns and general uncertainty are not ideal times for merger and acquisition activity. This is particularly the case in Taiwan where unemployment has risen rapidly over the last year to record levels. Several bankers we met cited rapidly rising joblessness as a barrier to merger. Resistance to the lay-offs that are an inevitable by-product of merger would likely be more vigorous in this environment, doing nothing for a bank's public profile. From our interviews we gained the impression that bankers in Taiwan genuinely worry about laying people off if they think these workers are unlikely to gain employment elsewhere.

Figure 33

Unemployment in Taiwan



Source: CLSA Emerging Markets, Directorate General of Budget, Accounting and Statistics

. . . but they might not happen after economic recovery either

An economic recovery would in some ways create a climate more conducive to mergers: less lay-offs would need to be made if the economy was growing, and those losing their jobs would at least face a greater supply of alternative employment opportunities. But increased enthusiasm on the part of buyers is unlikely to be mirrored on the sell-side. The need to sell is likely to become less urgent as the economy begins to recover next year; reaching agreement on price may then become all but impossible.

The state sector needs to be rationalised as well

Even if there were some merger movement with respect to privately-owned banks, this would not be enough to ensure an improvement in the health of the banking sector as a whole. Fully private banks in Taiwan have a market share of just 42.2%; the remainder is controlled by the 17 state-owned and state-linked institutions (Figure 28). This is something the government seems to forget in its exhortations for consolidation of the banking sector: as we noted earlier, little if any progress has been made on implementing the merger plans that have been announced for the state sector. But without real consolidation of state-owned banks – and their eventual complete privatisation – it will be extremely difficult for the other institutions to implement the price increase which are necessary for the sector to attain a more sustainable level of financial health (as we noted earlier, the free service culture of state banks is one reason why fee income earnings of banks in Taiwan are so low).

Figure 34

Taiwan's state-owned and –linked banks

		Govt share (%)	Market share (%)
Government-owned			
Central Trust of China	unlisted	100.00	1.20
Bank of Taiwan	unlisted	100.00	8.70
Land Bank of Taiwan	unlisted	100.00	7.00
The Export-Import Bank of ROC	unlisted	100.00	0.80
Government-linked			
Taiwan Cooperative Bank	unlisted	60.00	7.30
Taiwan MB Bank	2834	61.23	4.10
Kaohsiung Bank	2836	48.75	1.10
Farmers Bank	2822	44.99	1.20
Taipei Bank	2830	44.13	2.40
ICBC	2806	41.42	3.10
Hua Nan Bank	listed[1]	37.76	5.00
Taiwan Development Bank	2841	36.12	0.20
First Commercial Bank	2802	35.99	5.20
Chang Hwa Bank	2801	23.45	4.80
UWCCB	2826	22.29	2.60
Chiao Tung Bank	unlisted	32.70	2.60
CDIB	unlisted	3.42	0.50

Note: Hua Nan Bank is no longer listed because of the 19-Dec-01 listing of Hua Nan FHC; source: CLSA Emerging Markets

Dealing with NPLs

Little use has yet been made of the AMC facility

Pricing issues are also weakening the effect of government attempts to deal with the NPL problem. We have already seen that under government pressure – and with public funds provided by the 1999 tax break – banks have been moving to write-off bad loans. But little use has yet been made of the AMC facility – in fact by mid-January 2001 only such deal had been concluded. Again, according to market players, the issue is one of price. One lawyer we spoke to said he had heard of a case where a local bank was offering to sell NPLs at a 15% discount, with the purchasing AMC saying it would only pay 15% of the face value of the original loan.

Bankers do not want to sell too cheaply

Different motivations contribute to this stalemate. Both state and private bankers are worried about selling too cheaply. State bankers (who are public servants) need good deals to ensure promotion – or at least avoid demerits. Private bankers on the other hand want to avoid the wrath of shareholders. Still, that sellers were unwilling to part with their NPLs in 2001 is worrying: the economy after all is estimated to have shrunk by 2.6% in 01CL. Economic conditions are unlikely to be as bad in 2002, so sellers are likely to adopt an even harder stance towards price.

AMCs are worried about the value that can be retrieved from NPLs

At the same time buyers have been reluctant to offer higher prices because they are worried just how much they will eventually get back from any NPLs purchased. This, in turn, is related in part to deficiencies in the island's insolvency procedures. Thomas McGowan, a legal consultant and banking specialist, summed up the problems in an August 2001 article in *Topics,* the magazine of the American Chamber of Commerce in Taiwan (Amcham). In this article, Mr McGowan complained that Taiwan's bankruptcy laws "leave major shareholders and their surrogates in control of insolvent companies even though it is the incompetence – and, more often than not, malfeasance – of those same major shareholders that created the problem." This situation in turn prevents "a rational restructuring" of indebted corporations. Mr McGowan, expressing the views of Amcham's Banking Committee, said that given this context, "AMCs are likely to find restructuring a highly frustrating process and Taiwan's banking system is likely to remain vulnerable to repetitions of the current problems."

The one deal that has been announced is not a big step forward . . .

The one deal that has been announced does not suggest these issues have been resolved. In late December the China Development Industrial Bank Holdings (CDIBH) – the newly-formed financial holding company led by CDIB said it was selling NT$4.4bn (US$128m) of bad loans for NT$2bn. At first glance the price seems relatively high, and this is perhaps because the NPLs were sold to the CDIBH's own AMC, rather than an external group, which would presumably be more demanding.

. . . and buyers might disappear

The government cannot afford to be complacent on this issue. It is true that several foreign companies have been working on establishing AMCs in Taiwan – GE Capital, for example, has set up joint ventures on the island. But these firms will only stay on the island if they are making money, and this is obviously dependent on the NPL market here getting up and running. Furthermore, the patience of these foreign players is likely to be limited. After all, while NPLs for sale in Taiwan might be in short supply, this is not a phenomenon repeated in all other countries. Here we are not thinking so much of Japan as of China, which is already a rival to Taiwan in so many areas, and could prove to be so in the sale of bad loans as well. Two major NPL deals were closed in China last year, and more are expected to be signed this year. As one market participant pointed out to us, with China's huge NPL market already beginning to gain momentum, there is a danger that buyers will forget about Taiwan.

Exiting

The FRF sees action . . .

The government's FRF, only established in June 2001, has already seen action. In August it took over 36 grass-roots financial institutions, later handing them over to ten banks with a guarantee that full compensation would be provided for any loan losses incurred. The FRF then moved in October to take control of an ailing commercial bank, Chung Shing Bank (the bank had been under CDIC supervision since 2001), and is now looking to sell the remaining assets of the bank to another institution. After announcing in late 2001 that it was investigating the Kaohsiung Medium Business Bank (KMBB) (2810.TW – No rec), the FRF took control of this ailing institution on 28 January 2002. According to media reports the bank had a negative net worth of NT$2.9bn (US$83m) at the end of 2001.

. . . but its capital base is too small . . .

The establishment of this exit mechanism should signal that the implicit government guarantee that previously applied to all banks no longer exists. This should in turn ease moral hazard issues in the banking sector, feeding through to an improvement in standards of corporate governance. But the FRF is currently far from a credible mechanism. Chung Shing and KMBB are only the first two banks that the FRF has taken over. More seriously, the FRF already faces a severe shortage of capital: with losses at the 36 credit co-operatives alone totalling NT$77.3bn, the FRF has already used up half its NT$140bn of capital. This financial weakness will look even more serious if far-reaching consolidation of the banking sector does begin. This process should after all lead to bad banks – which are hardly likely to be acquisition targets in any market-driven process – becoming marginalised, and so in theory being driven first into the clutches of the FRF and then out of the market.

. . . and this restricts the government's efforts to reform the sector

The government has so far shown little interest in increasing the size of the FRF. This is worrying, as it suggests that the government will continue to use its tried-and-tested methods of dealing with bad banks. This involves forcing the better institutions to take over the bad at a loss, which drives down the health of the whole sector (and as we noted earlier, market rumours suggest that banks were not fully compensated by the FRF for the 36 co-operatives that were restructured in 2001). Alternatively, officials themselves will try to keep bad banks afloat, but this hinders the government's professed aim of reducing overbanking.

Supervision and corporate governance

Standards of supervision and corporate governance continue to be deficient

Finally, despite the improvements that have been made over the last year, standards of supervision and corporate governance in Taiwan will continue to be deficient in the near future. This is important because, as we have sought to stress, although Taiwan could do with fewer banks, it has not been overbanking per se that has been the island's downfall, but rather overbanking in a context of deficient supervisory and corporate governance standards.

The FSC is a step in the right direction . . .

The government has started to make the supervisory regime more rigorous. Officials have proposed the establishment of a new unified structure, the Financial Supervisory Commission (FSC), to oversee the whole financial industry. It is clear that the FSC has the potential to improve the quality of supervision in Taiwan: it is helpful, for example, that the head of the commission, although being of minister-rank, will have tenure for terms of four years at a time. Moreover, at least some financial companies are starting to pay closer attention to corporate governance issues. Taiwan's better banks are, for example, taking the issue of risk management more seriously than they used to, looking more to cash flow than collateral when making lending decisions, and seeking to build risk control systems.

. . . but there is considerable uncertainty about the FHC structure

Even so, there clearly are still problems. Industry players seem unclear about the kind of divisions between different sectors that are supposed to exist under the FHC structure. Bankers we spoke to said the MOF had been contacting them to ask how cross-selling would work in practice: hardly the picture of a regulator fully in control of the situation. Even if Taiwan's new supervisory structure was already in place, regulators would be struggling to keep pace with developments in the financial industry.

Taiwan's authorities have not even made the best of their limited lot

Admittedly, even in the US and Europe regulators are often running to keep up with the rapidly evolving financial industry. And some of Taiwan's problems, such as poor standards of accounting and transparency, are deep-seated issues that we could not expect the government to solve overnight. But the authorities in Taiwan have not even made the best of their admittedly limited lot. For example, although the FHCA has been passed, many accompanying regulations are still under consideration. It would clearly have been sensible for the government to have laid out all the associated rules, and introduced the new supervisory structure, before pushing through the FHCA, rather than vice versa. At the very least, following passage of the FHCA ministers would have been expected to treat passage of the FSC legislation as a priority; but instead establishment of the new watchdog has been held back by turf battles, with the MOF in particular worrying about what responsibilities it will be left with after its regulatory ones are hived off.

Official attitudes still disappoint

In addition, we believe the authorities have yet to adopt the kind of attitude towards the financial industry that is necessary for the health of the banking sector to improve in a fundamental sense. When setting up the FRF, for example, the authorities had a clear opportunity to demonstrate that their traditionally paternalistic attitude towards the banking system had changed. As noted above, the establishment of a credible exit mechanism would have signalled that the implicit government guarantee that previously applied to all banks no longer existed. But because of the inadequate resources made available to FRF, this has not been achieved.

Officials continue to exhort banks to lend to embattled companies

Worst still are the government's exhortations to the banking sector to continue to provide credit to embattled companies. In June 2001 the chairman of Taiwan Ratings, Chen Sung-hsing, criticised the government for calling on banks to extend credit to a construction and chemical fibre maker, Tuntex, when the company already accounted for almost 1% of bad loans in the banking system. Private bankers to an extent seem able to ignore these calls, but the same is not true of the many government-linked and government-owned institutions. That the authorities are concerned to prevent a damaging credit crunch is understandable. But what officials do not seem able to accept is that the problem faced by many of these companies is not the current economic downturn per se. Rather, it is that the provision of credit on too-easy terms in the past led, which these companies to grow unreasonably rapidly. The state this left them in means they are no longer able to cope now that Taiwan's economic situation has changed. The reality is that many of these firms should be allowed to fail.

More remains to be done

The government must do yet more both to perfect the institutional framework and to ensure the new structures are actually used

While we commend the Taiwanese authorities for the financial-sector reforms that have been introduced in recent months, we do not believe that officials have yet done enough to prevent Taiwan's banking sector – and the wider economy – falling into a Japanese-style slump. The government must do yet more both to perfect the institutional framework that has been introduced – for example, by addressing the FRF's lack of credibility – and to ensure the new structures are actually used – for instance, by making sure that banks do start to merge with each other.

The financial policies CLSA recommends for Taiwan

Officials need to do more

We believe the banking sector reforms currently introduced will not be sufficient to prevent Taiwan's banks – and thus the domestic economy as a whole – from falling into a Japanese-style slump. We are not yet saying that such a development is inevitable. But to avoid it, the government must go further to force rapidly both the rationalisation of the sector and disposal of bad loans. To do this the government should consider: consolidating and selling to foreign investors the remaining state-owned and state-linked banks; forcing the banks over which it has influence to sell NPLs to an AMC; considering as a matter of urgency increasing the capital size of the FRF; and halting the calls for banks to extend credit to ailing companies.

Figure 35

Policy recommendations and their results

Recommendations	Results
Consolidation	
Auctioning a state-owned bank to a foreign buyer ❑ price must be right ❑ new owner must have freedom to restructure	❑ Sends clear signal to market players that consolidation is occurring, so risk of marginalisation of small banks becomes a reality, not just a distant threat ❑ With lay-offs as part of the deal, the government demonstrates it is willing to accept the pain of real restructuring ❑ Raises funds for dealing with NPL issue ❑ Introduces foreign expertise
Stock of NPLs	
1. Compelling state-owned banks to sell NPLs to an AMC 2. Enforcing NPL target ❑ government could use existing capital injection as a lever	❑ Establishes a yield curve ❑ Sets a precedent ❑ Sends a message that although corrupt behaviour will be punished, bankers will not face criminal sanction for making bad lending decisions ❑ Creates volumes for AMC and securitisation markets
Exit mechanism	
1. Raise capitalisation of the FRF Capital raised through: ❑ special debt issuance ❑ extending FRF's period of access to funds raised from business tax on financial industy from current four years to ten. ❑ Privatisation of state banks	❑ Strengthens credibility of exit mechanism
2. Announce a limited time-frame for operation of the fund	❑ Lessens moral hazard problems
Supervision	
1. Quick implementation of the new unified supervisory structure	❑ Has the potential to improve the quality of supervision
2. Desist from pressuring banks to lend to ailing companies	❑ Makes the government's efforts to clean-up the sector more credible

Source: CLSA Emerging Markets

The consolidation conundrum

A big deal could trigger a lot of movement

The conclusion of one significant deal – either a bank or NPL sale – would give a great boost to the market. For one thing, it would help to establish a yield curve, giving subsequent sellers a benchmark from which prices could be set.

But the aggressive expansion into the market of a quality local player such as Fubon or one of the leading international banks would also trigger the far-reaching consolidation that is necessary. Marginalisation of the smallest banks will then become a reality, rather than a somewhat distant threat. And it then becomes more profitable to sell earlier rather than later.

The state-linked sector needs to be reformed

The government could wait for a deal to take place. But it could be waiting a long time. A better policy would be for the government itself to trigger the process. As we noted previously, the government still has a considerable presence in the banking industry, owning outright several banks and maintaining significant equity stakes in others. Indeed, the government's reluctance to enforce a rationalisation is one reason why the sector still has too many suppliers.

So the government should auction a bank

We believe the government should consider auctioning ownership of a significant state-owned bank to a foreign player. There is no doubt that, given the right price, foreign players would be interested in such a deal (in the 1990s governments of several Central European countries tapped strategic investments by foreign firms to clean up their ailing banking systems). There are of course many issues to be resolved if such a sale was to be successfully concluded – in addition to price, any buyer would need to be guaranteed the freedom to lay off staff who are currently classed as public servants. But such a deal would fundamentally change the status quo in the banking industry, clearing the way for the consolidation that the government says it wants.

Dealing with NPLs

The government should sell off state-owned NPLs . . .

The government could take a similarly pro-active approach to the issue of the disposal of bad loans. At least two options are available. Officials could force a state-owned bank to make a precedent-setting agreement to sell NPLs to an AMC. To avoid any concern that the banks are simply reshuffling assets in order to benefit from the five-year amortisation period, we would particularly like to see NPLs sold to an outside concern, rather than an in-house AMC. By establishing the basis of a yield curve such a deal would clear the way for further sell-offs. And the momentum that the market thus gained would prevent foreign financial institutions from losing interest in Taiwan.

. . . and be more aggressive about its NPL target

The government could also take a firmer stance towards its target of reducing the NPL ratio to 2.5% by 2003. When announcing this target in February 1999 the government also cut the business tax for the financial industry from 5% to 2% – equivalent to an annual capital injection of NT$60bn (US$1.7bn). But although banks are under moral pressure to use these funds to meet the government's target, they face no penalties if this goal is missed (which given the current rate of progress, it certainly will be). Penalisation of those banks not reducing NPLs rapidly enough would provide a good incentive for banks to start dealing with AMCs. At least one market participant has suggested that the government introduce interim targets to judge the progress individual banks are making towards the eventual 2.5% aim, with the tardy being penalised.

Exiting?

The capital size of the FRF needs to be increased . . .

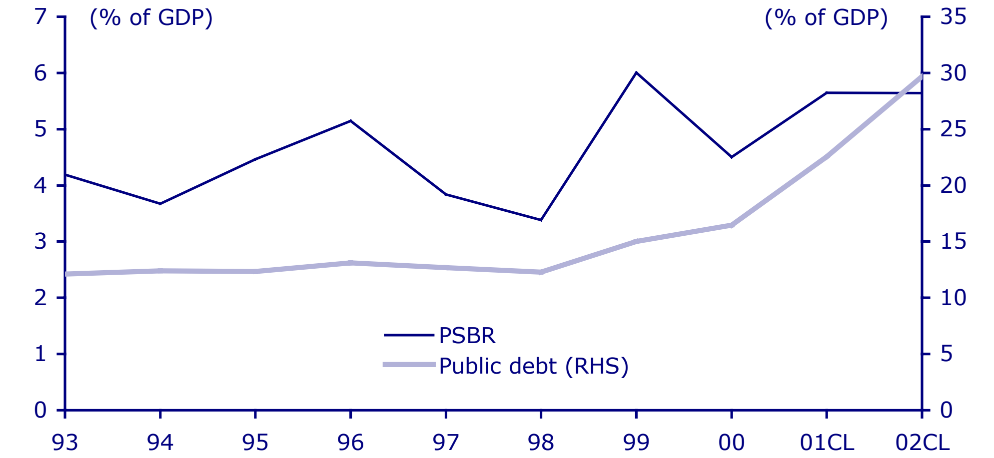
Officials urgently need to enhance the credibility of its nascent exit mechanism by expanding the FRF's capital size. Officials may initially have only intended the fund to be used to restructure grass-roots financial institutions, but it is clear it will now be involved in cleaning up small banks as well. Setting a time frame for operation of the fund – and moving aggressively to restructure the worst-performing institutions during this period – would lessen the moral hazard risks inherent in the funds' 100% depositor guarantee.

. . . and the authorities have the resources to do this

The government does have the ability to set more resources aside to cover losses in the financial sector. At the time of its establishment in June, some legislators proposed guaranteeing the fund access to the proceeds of the existing 2% business tax levied on financial companies for a ten-year period, rather than the four years that was eventually agreed. Privatisation of a state-owned bank, as we outlined earlier, could be an additional source of funds. And although the provision of extra capital to the FRF would tax Taiwan's already-high annual fiscal deficit, it would not lead to a fiscal crisis: outstanding public debt was an internationally-low 16.5% of GDP in 2000.

Figure 36

Fiscal deficit and public debt



Note: PSBR=public sector borrowing requirement; source: CLSA Emerging Markets

Desisting from putting pressure on banks to lend

Supervision and corporate governance

While banks in Taiwan do not have a happy record of risk assessment and management, they are in a better position than the government to perform these tasks. The government claims it wants to put the banking sector on a more healthy footing. Officials must accept that the corollary of this process will be the failure of bad companies, some of which will be large.

Tough measure, difficult to implement

The way forward

Nearly all of these recommendations will be difficult for the authorities to introduce, because in the short-term they would all be unpopular with particular interest groups in Taiwan. But the island's leaders must understand that the measures introduced so far, although commendable, have established only an incomplete framework for reform of the financial sector. Moreover, while activation of the mechanisms included in this framework is undoubtedly essential for the health of the banking sector as a whole, it is not necessarily yet in the best interest of individual bankers and bureaucrats to use the new structures. The government must therefore act to perfect the institutional framework that has been introduced over the last year or so, and to ensure that this structure is used. Otherwise Taiwan's banking sector will become a second setting sun.

Underweight banks

Underweight Taiwan banks

Despite a better macroeconomic outlook, most Taiwan banks will continue to face pressure from rising provisioning expenses, due to continued deterioration in asset quality. While the introduction of the financial holding company (FHC) structure will allow banks to diversify into other areas of the financial industry, we do not see much likelihood that the model is workable in 2002. Compared with other regional banks, Taiwan banks are also unattractive in terms of slower earnings growth and returns on equity. Underweight Taiwan banks.

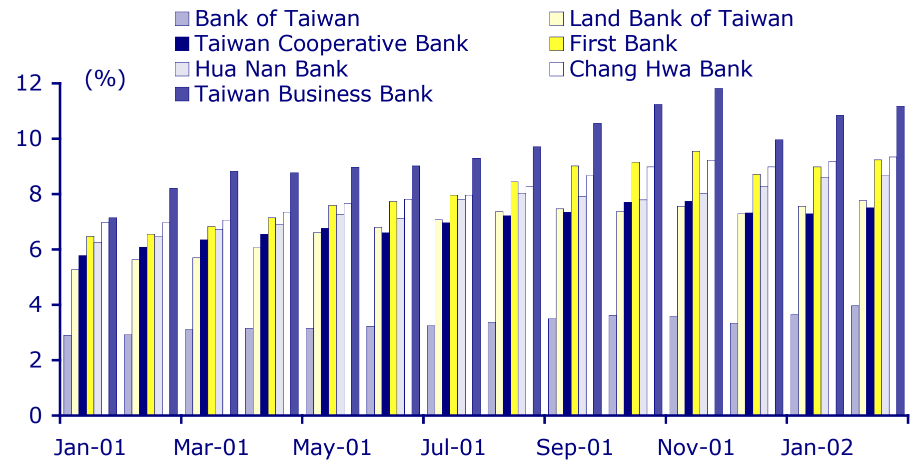
Asset quality remains weak

Non-performing loans continued to climb

Despite aggressive write-offs in 2000-01, most Taiwan banks will see their asset quality continue to deteriorate in 2002. For example, as mentioned earlier, Taiwan's seven largest banks together wrote off NT$94.5bn in 2001, compared with NT$60.9bn in 2000 and NT$51.4bn in 1999. This, however, has not helped much on improvement in asset quality. The average non-performing loan (NPL) ratio of these seven banks continued to climb to 7.8% in February 2002, from 7.6% in January and 7.7% as at the end of 2001.

Figure 37

NPL ratios of Taiwan's seven largest banks



Source: CLSA Emerging Markets

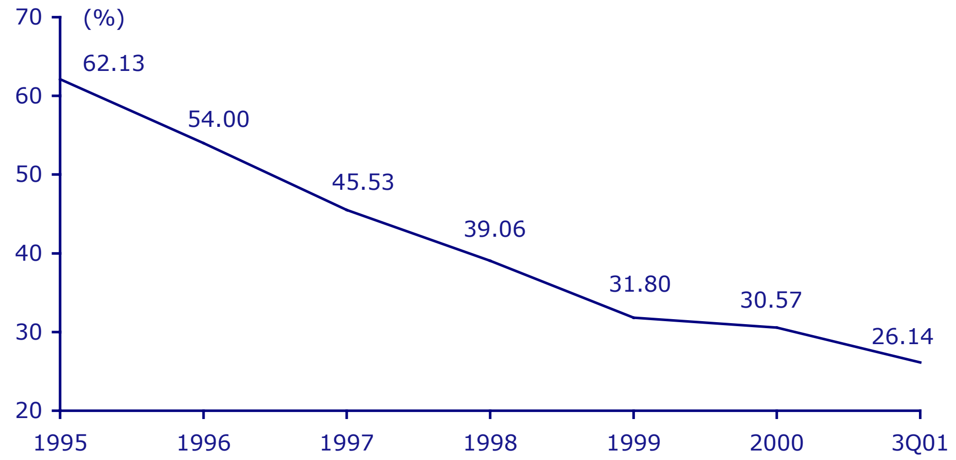
Provisioning expenses to eat up bottom line growth

More provisioning expenses in 02CL for most Taiwan banks

We foresee rising pressure of provisioning for most Taiwan banks. Among the 34 listed commercial banks, NPL coverage ratio continued to fall over the last six years, to 26.1% as of the end of 3Q01, from 62.1% in 1995. And this ratio would be even lower after taking into consideration grass-roots financial institutions. Going forward, the existing loan loss provisions are not sufficient, given continued rises in non-performing loans. The pressure of more provisioning expenses will eat up banks' bottom line growth, if there is any.

Figure 38

NPL coverage of Taiwan's listed banks



Source: CLSA Emerging Markets, Taiwan Economic Journal

The financial holding company structure won't work in 2002

The FHC model won't work in 2002

While the introduction of the financial holding company (FHC) structure will allow banks to diversify into other areas of the financial industry, we do not see much likelihood that the model is workable in 2002, for two reasons. First, management of an FHC is extremely complicated. A financial holding company operates a wide range of business categories that have distinct natures and carry potential risk, and comprehensive knowledge and management skills are necessary. This is especially true for inter-group consolidation, where integration of corporate cultures and management teams is the most critical, but the least achievable, issue.

Time required to create synergy and develop cost efficiency

The second problem with the FHC model is the time required to create synergy and develop cost efficiency. We have yet to see any cases where a bank's problematic assets have been efficiently written off subsequent to the formation of a financial holding company. Simply placing several banks/financial institutions under a holding umbrella does not necessarily bring up cost efficiency. Aside from IT system integration, downsizing is inevitable in most instances of consolidation, in particular inter-group consolidation. However, it is not that easy – either politically or socially – to sack employees in Taiwan. Without prudent preparation up front, aggressive lay-offs may also lead to a loss of clients.

Unattractive valuation

Inferior return on equity

Compared with the other financial services stocks in the region, Taiwan banks are a little cheaper in terms of price to book value. However, this is offset by their below-regional-average core earnings growth, which we forecast to be 23.7% YoY in 02CL and 14.5% YoY in 03CL, compared with the region's average of 28.7% YoY and 25.5% YoY, respectively. More importantly is to look at the return on equity ratio, on which Taiwan's banks together are expected to post at 10.8% in 02CL and improve slightly to 11.0% in 03CL. This is lower than the region's average of 15.4% and 16.7%, respectively, and also far behind Indonesia and Thailand, which suffered most amid the Asian financial crisis of 1997-98.

Figure 39

Regional comparison

	Price to core earnings (x)		Core earnings growth (%)		Price to book value (x)		Return on equity (x)	
	02CL	03CL	02CL	03CL	02CL	03CL	02CL	03CL
Average	**14.4**	**11.4**	**28.7**	**25.5**	**1.7**	**1.5**	**15.4**	**16.7**
Hong Kong	18.4	15.2	0.9	20.8	2.3	2.3	13.8	15.9
Indonesia	3.1	2.6	8.4	20.3	0.9	0.7	32.0	30.5
India	6.1	5.3	21.0	14.7	1.0	0.9	16.2	16.3
Korea	7.8	6.0	82.9	28.8	1.7	1.4	24.0	25.6
Malaysia	18.5	17.1	15.2	7.7	2.3	2.1	12.5	13.1
Philippines	21.6	16.2	6.9	33.8	1.7	1.5	7.8	9.9
Singapore	24.1	17.7	(15.5)	36.4	1.7	1.6	7.1	9.1
Thailand	14.1	9.3	114.8	52.5	1.9	1.6	14.5	18.7
Taiwan	**15.5**	**13.5**	**23.7**	**14.5**	**1.6**	**1.4**	**10.8**	**11.0**

Source: CLSA Emerging Markets

Appendix 1

Taiwan's banking sector exhibits some of the symptoms of the Japanese malaise

Growing bad loans	Weak finances	Real-economy consequences
A high and rising NPL ratio	Thin absolute profitability	Failure of financial institutions
Official under-recording	Weak relative profitability	Credit crunch
Structural as well as cyclical causes	Write-offs cannot keep pace	
	Poor capital base	

This is hardly surprising - Taiwan's banking sector shares strong structural similarities with Japan's

Colonialism	Conservatism	Complacency	Corruption
Colonial roots	Glass-Steagal restrictions	Poor risk management	Weak supervision and corporate governance
	Dependence on loans and deposit income	Disintermediation	Mainland exposure
	Low concentration ratio	Dependence on property prices	
	Low margins		

Faced with these problems, the authorities have introduced reforms aimed at:

Encouraging consolidation	Allowing diversification	Dealing with the stock of NPLs	Improving the quality of supervision

But the authorities have yet done enough to prevent the banking sector falling into a Japanese-style slump

The economic background	The consolidation conundrum	Dealing with NPLs	Exiting	Supervision and corporate governance
Real GDP growth will remain well below the 1990s norm	Only one major bank merger have so far been implemented	Only one deal between a bank and an AMC has been announced	The FPF has taken over 36 credit co-operatives and two commercial banks	Detailed regulations to accompany the FHC structure are not in place
Consumer prices will fall	The FHC structure could delay tie-ups between banks	Sellers appear unwilling to part with NPLs at prices buyers would pay	But in doing so it has used up half its capital, so is hardly a credible exit mechanism	The new FSC has yet to gain legislative approval
New NPLs will continue to be created	There is a mismatch between private-sector buyers and sellers			Officials continue to exhort banks to lend to embattled companies
	State sector merger plans are little more than blueprints			

CLSA believes the government still needs to go further

Consolidation	Stock of NPLs	Exit mechanism	Supervision
Auctioning a state-owned bank to a foreign buyer	Compelling state-owned banks to sell NPLs to an AMC	Raise capitalisation of the FRF	Desist from pressuring banks to lend to ailing companies
	Enforcing NPL target		

Source: CLSA Emerging Markets

Appendix 2

How many banks should Taiwan have?

Taiwan's banking market is competitive . . .

The government's claim that "overbanking" is the most important cause of Taiwan's current banking sector problems is in a sense disingenuous; this explanation at the very least plays down – if not totally ignores – the role that weak standards of corporate governance and supervision have played in the island's current difficulties. And at first glance, the only solution to the problem – fewer banks – would appear a bad one. After all, having lots of banks, and consequently vibrant competition in the financial market, would seem good for the economy, keeping the interest rates and other banking costs faced by companies and consumers low.

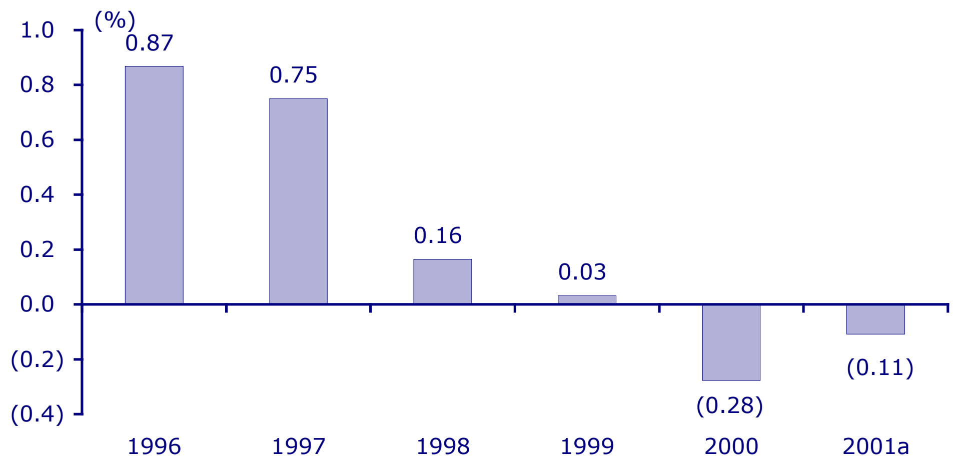
. . . but academic research suggests an oligopolistic one may be better

Academic research does give some support for this argument, suggesting that a less competitive banking sector does lead to a lower rate of credit growth. But researchers also suggest that a concentrated banking system may provide some advantages to specific firms, such as younger companies in industries that are heavily dependent on bank financing (such firms may benefit from lower interest rates when they start up, which the monopoly bank provider will recoup once they become profitable). A less competitive banking sector may also bring advantages for the economy as a whole, as with more banks sharing a market, the incentive to screen loan applicants will fall, dragging down the quality of loan portfolios. As a result, while a monopoly market structure may not maximise economic development, perfect competition might not either. The best market structure would therefore seem to reply somewhere in between, in other words oligopoly.

Concentrated markets are not necessarily more profitable

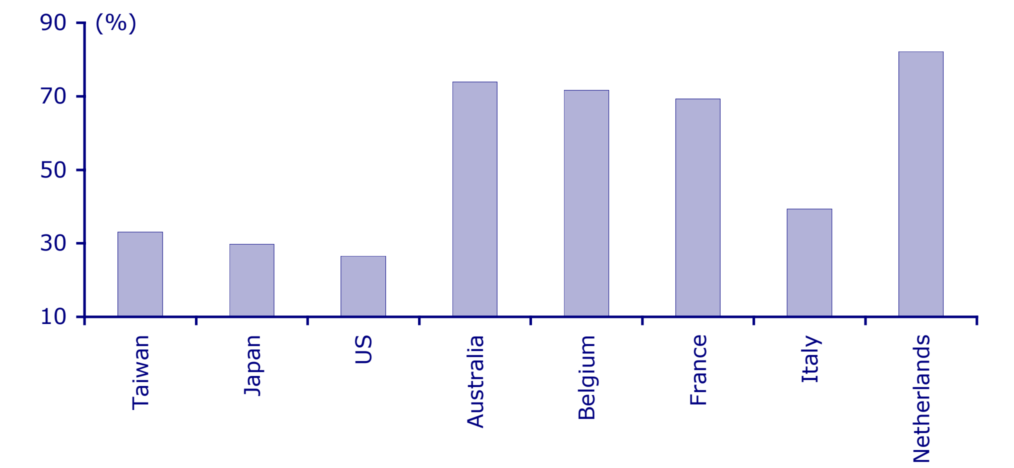
As our illustration of concentration ratios shows (see below), many developed banking sectors already have an oligopoly market structure. And certainly, some of these sectors are much more profitable than Taiwan's: the annual return on average assets (ROAA) in Australia's banking sector, for example, averaged 1.4% a year in 1994-98. But this is not to say that a more concentrated banking sector necessarily leads to better returns. In the same 1994-98 period the ROAA for France's highly concentrated banking system averaged just 0.2% a year.

ROA trend of Taiwan banks



Source: CLSA Emerging Markets

Combined market share of five largest banks (1999)



Source: CLSA Emerging Markets

Concentrated markets could tend towards monopoly

Nor does this imply that the banking markets in these countries exhibit an optimal balance of competition and monopoly. For example, the UK's top ten financial institutions, which between them control more than 85% of current accounts and more than 70% of savings accounts and personal lending, achieved a post-tax return on equity of a whopping 18.5% in 1995-99. In a report commissioned for the UK government, "Competition in UK Banking", Don Cruickshank suggested the market was not sufficiently competitive, with these ten firms earnings excess pre-tax profits of perhaps £4-6bn (US$5.7-8.6bn).

Taiwan needs fewer banks . . .

Still, the danger of excess profits is not an immediate one for Taiwan's banking sector, and Taiwan's banking sector could clearly benefit from consolidation. This would not just lessen cut-throat competition. It would also raise cost efficiency. The "Report on Consolidation in the Financial Sector" published recently by the Group of Ten suggested that while the benefits of the mega-mergers recently seen in advanced countries were debatable, "up to a certain (relatively small)" size consolidation was advantageous because it allowed the realisation of economies of scale. The report suggested that the benefits of economies of scale were maximised in entities with assets of around US$10bn. Obviously this threshold cannot be applied precisely to all mergers and all countries, but it is at least useful in an illustrative sense: in 2000 the assets of two-thirds of Taiwan's listed banks fell below this level.

. . . but perhaps not as few as is often suggested

Accepting mergers are useful is one thing; saying just how many should take place is quite another. Most estimates assume that Taiwan's market is small enough to support only a handful – perhaps four or five – large players. We think, however, that it would be desirable for as many as seven or eight institutions to control 60-70% of the domestic market, with a number of smaller banks taking up the remainder. After all, these institutions will not only be earning money in Taiwan: many local banks consider that their main market will eventually lie on the other side of the Strait. And with the domestic economy relying so much on small- and medium-sized enterprises (SME), we believe a structure that is biased more towards competition than oligopoly would be the most suitable for Taiwan: SMEs tend to be more dependent on bank financing than larger companies.

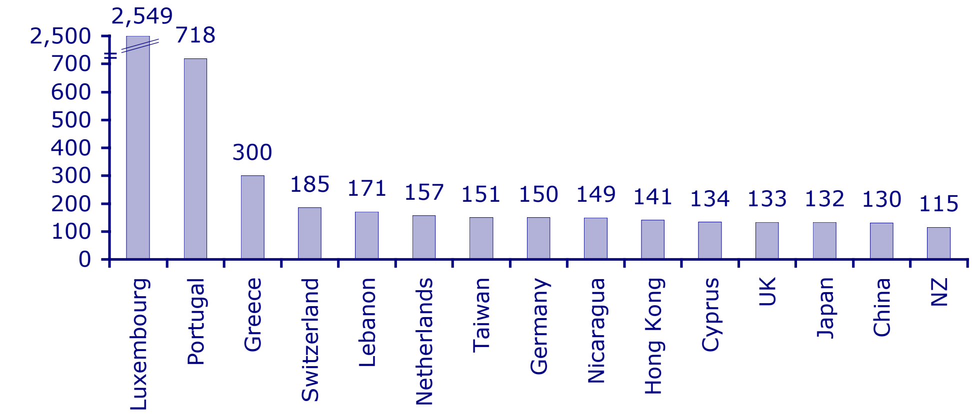
Appendix 3

The capacity of the banking sector needs to shrink

Credit is high as a proportion of GDP, . . .

Taiwan does not just need a cull of the number of banks; in coming years domestic lending capacity relative to the size of the economy will need to drop as well. As we have already seen, outstanding credit as a percentage of GDP is now high (according to the Economist Intelligence Unit, the ratio is one of the highest in the world). Admittedly, this ratio is inflated by Taiwan's large grey economy, the existence of which reduces the size of recorded GDP. But the existence of the informal economy also dampens official credit growth: it is, for example, particularly common in Taiwan to rely on friends and family, rather than banks, for loans.

Credit/GDP for selected countries (2000)

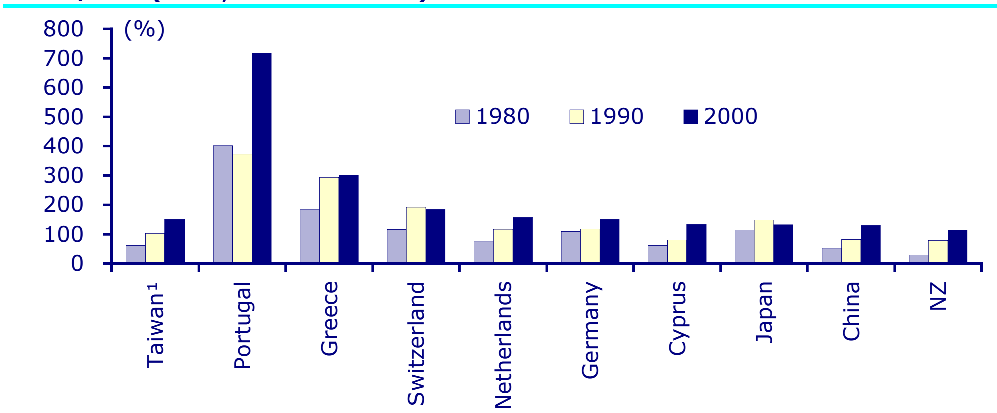


Note: Because of its status as an international financial centre, Luxembourg had a domestic credit/GDP ratio of 2549%; source: Economist Intelligence Unit; CLSA Emerging Markets

. . . and has risen rapidly

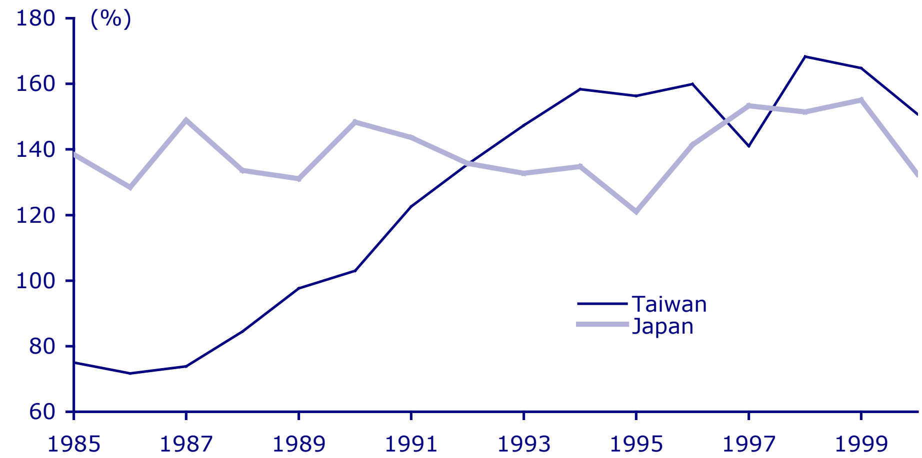
In any case, that official GDP is under-estimated does not nullify the significance of the surge in credit relative to GDP that began in around 1987. Credit started to rise along with the surge in property and stock prices that occurred in the late 1980s. A similar phenomenon was seen in Japan in the late 1980s, but credit fell relative to GDP as the bubble burst. In Taiwan even after asset prices fell dramatically in the early 1990s credit continued to outpace GDP growth as new banks eager for market share entered the market. Loan growth was further bolstered by local firms' investments in China.

Credit/GDP (1980, 1990 and 2000)



Note: Taiwan's 1980 data is unavailable and has been substituted by 1981 data; source: Economist Intelligence Unit; CLSA Emerging Markets, country data

Credit/GDP and credit growth for Taiwan and Japan (1987-2001)



Source: Economist Intelligence Unit; CLSA Emerging Markets

Credit growth will slow in coming years

Credit to the private sector as a proportion of GDP has already started to fall, and is likely to subside further in the near future.

Banking sector reform

Reform of the banking sector will in theory result in more responsible lending. And while a mushrooming of bank numbers boosts credit growth, the opposite is true of bank consolidation. Imagine a company has credit lines worth NT$100m each with two separate banks. If the two banks were to merge, the credit line is likely to be cut, from the combined NT$200m perhaps to as little NT$130m.

China economic development

As China's economy develops, fewer Taiwanese firms will need to rely on borrowing from banks on the island to finance their mainland investments. This is because in a few years time, Taiwan's banks will be able to offer local firms financing direct from their branches in the mainland. In addition, local firms will also probably start to feel more comfortable borrowing from mainland banks as these become more sophisticated.

Domestic capital market development

As we have already noted (Figure 24), Taiwan's banking sector has suffered from disintermediation in recent years. This process does not yet appear to have reached its conclusion. In Taiwan borrowing from financial institutions was equivalent to an average of almost 15% of the assets of listed firms in 1995-99. Borrowing (from all sources) by small- and medium-sized enterprises (SME) in the same period was equal to an average of 26% of assets. By contract, according to Takeo Hoshi and Anil Kashyap in their paper "The Japanese Banking Crisis: Where did it come from and how will it end", in the US – which has highly developed capital markets – bank borrowing in 1979-1997 was equivalent to an average of 7.5% of the total assets of large US manufacturing firms; for small firms the corresponding figure was 18.4%. If, as Taiwan's own capital markets develop, bank borrowing asset ratios trend towards those in the US, credit growth in Taiwan should slow, or even drop.

Notes

Notes

Table of figures

Key to investment rankings: BUY = Expected total return greater than >20%; **SELL** = the share price is expected to decline. **O-PF** = stocks with expected local market relative performance of more than 0%; **U-PF** = stocks with expected local market relative performance of less than 0%. Recommendations are made on a 12 month time horizon.

CLSA EMERGING MARKETS

Widescreen

economic, strategic & technical analysis

Taiwan

ECONOMICS

Speed but not width

2001 – The Jet Stream® odyssey

Strong growth in the fourth quarter
Taiwan grew by more than 2% (QoQ) in 4Q01. This was a much stronger acceleration than expected. It has lessons for 2002. Though we remain cautious about prospects for the first half (we are watching the US electronic orders to see if this view needs revising), the 4Q01 data demonstrate that, when Taiwan recovers, it will do so more rapidly than we previously thought. Risks for 2003 are also on the upside.

But imbalanced
The strength of this growth is entirely thanks to the IT sector. The rest of Taiwan's economy is performing much less well. Benefits of stronger IT shipments have had little trickle down to the rest of the economy. This pattern will continue. Tech will be the driver of GDP growth in 2H02 and 2003 but the rest of Taiwan's economy and, especially, the old-economy heartlands being hollowed out, will benefit little. Risks, principally based in the financial system, will therefore persist longer than the GDP numbers suggest.

Taiwan's banking system is broken, it cannot lend. The chance of a classic Asian-style banking crisis is low (but it cannot be ruled out) but the ongoing credit crunch raises risks of a corporate liquidity crisis (though few investors own these stocks, old economy stocks might be indirectly exposed). Secondly retch alone is not enough to return Taiwan to full employment. For a market driven by domestic liquidity this may be a drag on valuations for longer than people think. There is the final question of political risk. With an election due in 2004 there is a chance that the government start to worry about hollowing out and start taxing tech companies to pay for it. Not an issue now but a potential worry for

Economic outlook	00A	01CL	02CL	03CL
Real GDP growth	5.9	(1.9)	(1.7)	4.7
Domestic demand	4.0	(4.5)	(1.7)	4.2
Nominal GDP growth	4.0	(1.3)	(2.3)	4.0
Consumer prices (y/e)	1.7	(1.7)	(1.7)	(1.1)
Rediscount rate (y/e)	4.6	2.0	1.9	1.9
NT$/US$ rate (y/e)	33.1	34.5	35.0	34.0
Money supply M1 (y/e)	(0.9)	(0.4)	2.0	4.1
Current a/c bal (US$bn)	8.9	19.3	17.0	20.4
as a % of nominal GDP	2.8	6.8	6.6	7.3
PSBR (% of GDP)	4.5	4.9	5.9	5.7

Note: % YoY unless otherwise stated

Websight Insight

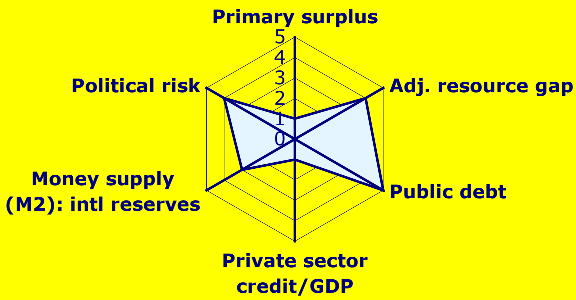
Bank and government finances are a problem
CLSA's macro spider web chart is a simplified version of our annual Macro Stress Test. Each variable is scored from 1 to 5 and the higher the score, the less risky is the country.

Taiwan scores 60% on our assessment This is a pass mark, but one which points to clear areas of stress. The fiscal position and the banking system are the main problems. The government budget is starting from a strong position. Using end-2000 data, the country scores full marks for government debt of 16% of GDP. But an extremely weak tax base plus budgetary rules that preclude countercyclical policy condemn Taiwan to a situation where fiscal policy cannot effectively be used to shield the economy from slump, but where slower growth causes the PSBR to balloon out anyway.

The banking system makes the fiscal position look healthy. Banks have ROA of only 0.5%. They are too unprofitable to provide either for current NPLs or to risk taking on new ones. The cyclical deterioration of risk profile of Taiwan's borrowers has caused a credit crunch, but the underlying problem of inadequate profitability has been present for some time. Taiwan scores a worst possible 1/5 on our bank credit relative criterion – the chart overleaf says it all.

Other areas are better. Taiwan's national balance sheet is strong. The scores for the adjusted resource gap and M2/forex reserves are good. It is too early to say whether KMT losses in the Legislative election will have removed the policy deadlock between the executive and the legislature. Pending new information, we have marked Taiwan one point down on the political criterion because of these execution problems.

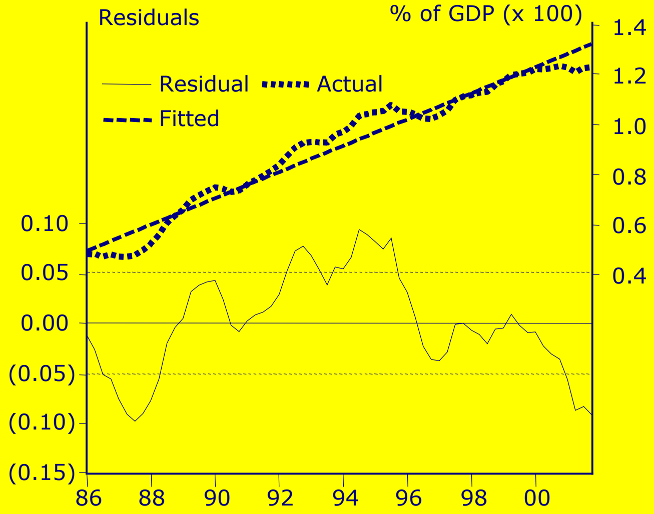
Websight – how safe is your capital?



The greater the surface area, the better the score.

ECONOMICS

Bank credit relative



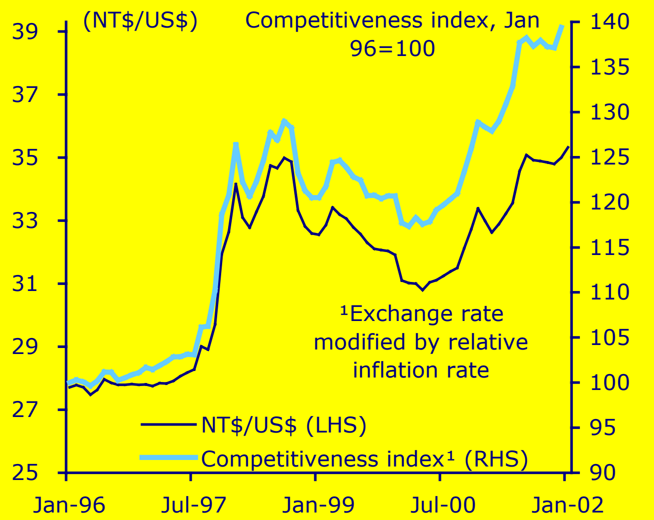
Source: CLSA Emerging Markets

Broken banks - big problem in an upturn

The deterioration in credit quality of borrowers, combined with banks' hobbled ability to take on new risk, has hammered the bank credit relative as the economy has slowed. The credit relative is now 2 standard deviations below trend, for a minimum score of 1/5 in our spider chart. Banks cannot afford to take on new risk because the return on their existing assets is so low. At the bottom of the cycle this is an additional risk for corporates.

A broken banking system will also be a factor restraining recovery. SME lending is virtually non-existent now and unlikely to pick up with stronger GDP growth. Though the risk profile of borrowers should improve as Taiwan's economy picks up, the risk appetite of banks will remain minimal.

Competitiveness and the exchange rate



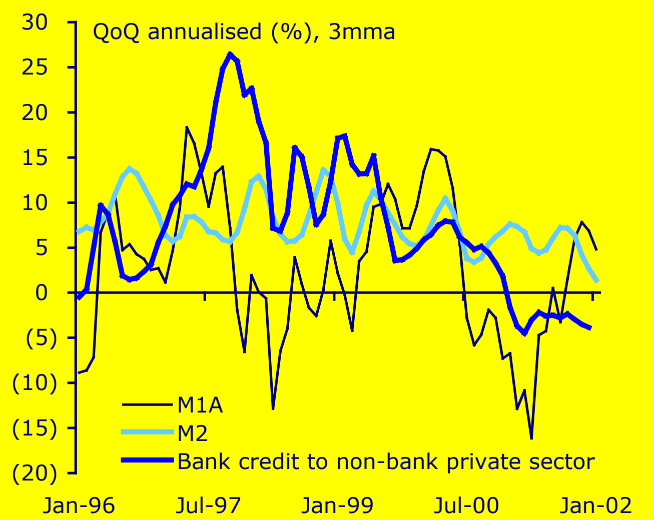
Source: CLSA Emerging Markets

Strong exports to support the NT$

The strength of exports in 4Q01 suggests that the NT$ will remain well supported. We have revised our end year forecast to NT$35. This is little changed from the current spot rate.

The competitiveness gains from this will be minimal. Taiwan's exports are led by high technology products the majority of which are dollar priced and for which the local cost component is low.

Money supply and credit



%QoQ saar 3mma. Source: CLSA Emerging Markets

Is "liquidity" rolling over?

Liquidity preference remains strong showing the effect of the accelerated deposit rate cuts in 4Q01. However, while the typically watched YoY growth rates for narrow and broad money remain relatively stable the higher frequency changes plotted to the right are worrying. M1A (and for that matter M1B) growth remains ahead of M2, but growth rates are converging and both are decelerating. If these trends continue the "liquidity" in favour of Taiwan equities (normally M2 growth less M1B growth) is close to rolling over.

On the credit side there has been little changed and no relief. Credit is contracting – there is no evidence that banks' risk aversion is dissipating.

ECONOMICS

CLSA view: consensus check

Moody's long term debt rating – Aa3
S&P's long term debt rating – AA
CEPD GDP growth forecast (2002) – 2.7%

On 26 July S&P cut Taiwan's sovereign credit rating to AA from AA+, keeping its outlook negative. While the rating may be notional given the absence of foreign currency debt, it is a clear warning. S&P cited the weakness of the financial system and the weakness of the government budget. Both concerns are more than justified. Our rating on the spider chart suggests that further downgrades are probable.

Even factoring the pace of fourth quarter growth into our forecast we do not expect the recovery to be as rapid as official projections. In particular we expect the first half of the year to be soft – a function of our conservatism on investment demand in the US. If this view is correct, expectations for an early recovery will be disappointed. In the second half of the year these concerns will be irrelevant. Taiwan will grow quickly.

Jet Stream® – In or out?

Fiscal responsibility: On a consolidated general government basis the deficit is large and because of the weakness of the tax base, getting larger. Official emphasis of the much smaller central government deficit is disingenuous. **OUT**

Monetary soundness: CBC is scrabbling to set policy in a deflationary environment and seems to have upped the pace of rate cuts in recent months. But while interest rate policy is OK (given the constraints on policy) we are less impressed by financial regulation. **IN**

Privatisation: Programme in place but it has been slow and largely ineffective. KMT corruption being uncovered by the DPP will lead to deadlock in the legislature re further liberalisation. **IN**

Capital allocation mechanisms: Profitability and robustness of domestic industry point to sound practices but recent banking sector disclosures indicate indentured banks of Thai and Japanese proportions. Worrying. **OUT**

Economist, Eric Fishwick (852) 2600 8246, eric.fishwick@clsa.com

TECHNICAL

Breakout, the chartist's view from Chris Roberts

At 6,137 the index had retraced 39% (Fibonacci 38%) of the 10,394-3,412 decline

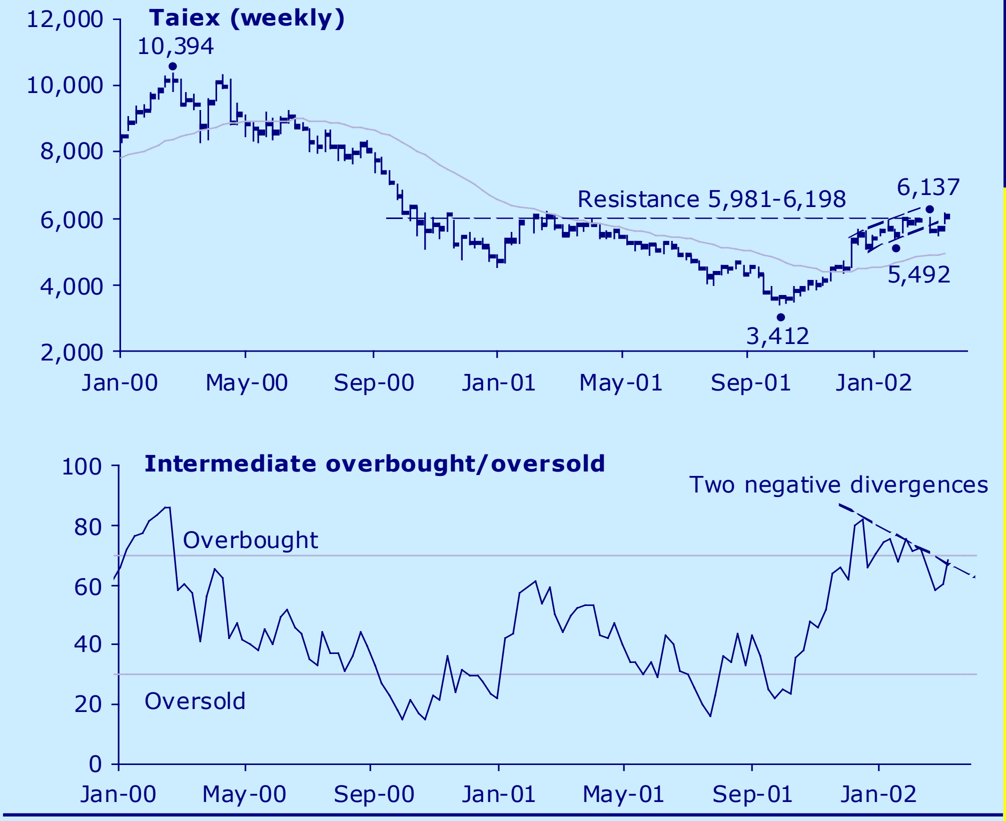
The index has again reached the important resistance zone at 5,981-6,198

Further strength now above 6,200 could lead to 6,824 (up 100% from 3,412)

At 6,903, 50% of the 10,394-3,412 decline would have been retraced

A break below key support at 5,492 is needed to confirm an index peak

The next significant event should be a 30%-60% retracement of the gains from 3,412



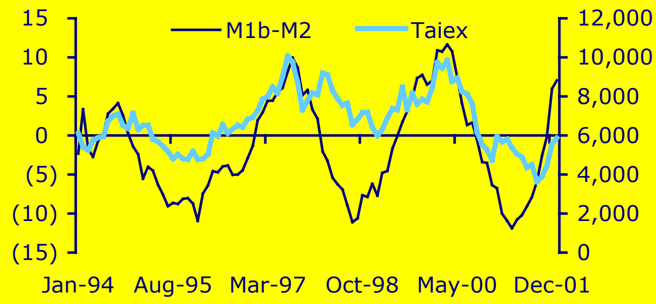
Source: CLSA Emerging Markets

Global Technical Strategist, Chris Roberts (852) 2600 8576, chris.roberts@clsa.com

Vintage 2002: Well made in Taiwan

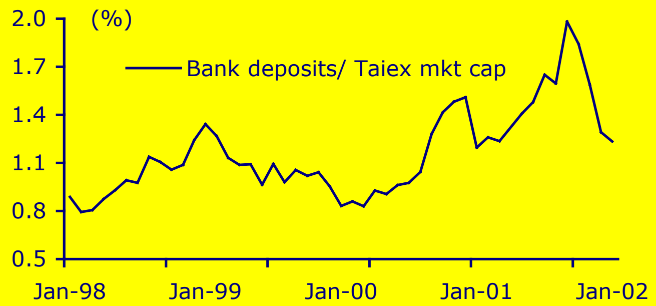
MARKET STRATEGY

M1-M2 differential



Source: CLSA Emerging Markets

Bank deposits and Taiex market cap

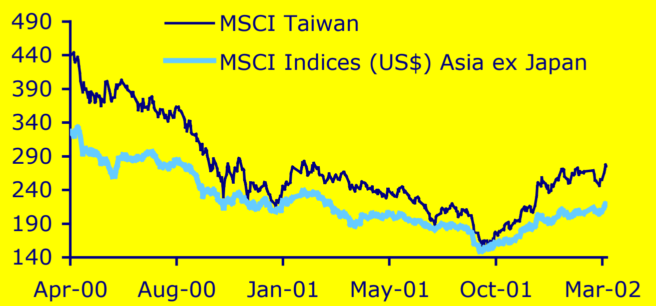


Source: CLSA Emerging Markets

Market values	00A	01CL	02CL	03CL
EPS growth (%)	56.7	(57.6)	69.9	64.5
Core EPS growth (%)	44.5	(56.9)	71.2	64.8
ROE (%)	21.1	7.3	10.6	16.0
PE (x)	18.0	42.5	25.0	15.2
Div yield (%)	0.7	0.7	0.6	0.7
EV/Ebitda (x)	12.4	19.5	14.1	9.7
PB (x)	3.0	2.9	2.6	2.2

Source: CLSA Emerging Markets

Taiwan Index performance



Source: CLSA Emerging Markets

Improving liquidity

Strategic market ranking

Our year-end index target is 7,900 based on a simple average of fair valuations derived using a target PE methodology and the Dividend Discount Model. This target puts the market at 20x 03CL PE, which is low compared to the average PE of 28x during 1990-present. We focus on 03CL earnings as we believe 03CL is the midpoint of the market's earnings cycle and therefore a better reflection of the market's normalised earnings. During the 1999-2000 earnings recovery period, the Taiex traded at 25-40x PE.

Liquidity drivers

Throughout 2002, we expect to see retail money returning to the equity market from the deposit system and expansion of the M1-M2 growth differential. This will occur because of cuts in local deposit rates and because the risk/return profile of the equity market looks much more attractive than that of other investments. We estimate that if an average household reduced its savings deposits by 2% to 22% of total assets and correspondingly increased its equity holding to 23%, roughly US$35bn would be injected into the market.

Political outlook/social stability

Year 2002 will be remembered as the year when direct links were finally forged. Our China strategist has learnt from Chinese officials that Beijing is willing to accept an aviation agreement between commercial carriers or non-governmental groups without any discussion of "one China." Either channel should be acceptable to President Chen as neither would require him to compromise on his "one China" stand.

Future market drivers

Following a 58% earnings decline in 01CL, we project the Taiex to record growth of 70% in 02CL and 65% in 03CL. Earnings recovery in Taiwan's electronics sector will come from three sources: 1) improvement in demand for technology products; 2) recovery in fundamentals for the foundries; and 3) an increase in outsourcing in the areas of handsets, notebook PCs, broadband products and motherboards. Taiwan's resilient electronics sector will emerge from the 2000-01 downturn as a winner of industry consolidation, shutdown of capacity globally and the increased pace of outsourcing to the lowest-cost producer.

CLSA EMERGING MARKETS

Research & sales offices

www.clsa.com

Operational hubs

Hong Kong
CLSA Hong Kong
18/F, One Pacific Place
88 Queensway, Hong Kong
Tel : (852) 2600 8888
Fax : (852) 2868 0189

Singapore
CLSA Singapore Pte Ltd
9 Raffles Place #19-20/21
Republic Plaza II
Singapore 048619
Tel : (65) 6534 3268
Fax : (65) 6533 8922

USA
Credit Lyonnais Securities (USA) Inc
Credit Lyonnais Building
1301 Avenue of The Americas
New York, New York 10019
Tel : (1) 212 408 5888
Fax : (1) 212 261 2502

United Kingdom
Credit Lyonnais Securities
Broadwalk House
5 Appold Street, Broadgate
London EC2A 2DA
Tel : (44) 207 696 9190
Fax : (44) 207 214 5401

Global Emerging Markets

Argentina
Credit Lyonnais Argentina
Torre Bouchard
Bouchard 547, Piso 11
1106 Buenos Aires
Tel : (5411) 4311 9949
Fax : (5411) 4311 9926

Brazil
CLSA-BCN
Av. Brigadeiro Faria Lima
1461 – 12 andar
01481-900 – São Paulo
Tel : (5511) 3030 3500
Fax : (5511) 3030 3530

Chile
in ass'n with Celfin S.A.
Apoquindo 3721, Piso 19,
Santiago
Tel : (562) 750 5000
Fax : (562) 750 5001

China – Beijing
CLSA Beijing
Unit 02-04, Level 20
China World Tower 2
China World Trade Centre
1 Jian Guo Men Wai Ave
Beijing 100004
Tel : (86 10) 6505 0248
Fax : (86 10) 6505 2209

China – Shanghai
CLSA Shanghai
Room 03, 16th Floor
Jin Mao Tower
88 Century Boulevard
Pudong, Shanghai 200121
Tel : (8621) 5047-1118
Fax : (8621) 5047-3533/4

China – Shenzhen
CLSA Shenzhen
Room 3111, Shun Hing Square
Di Wang Commercial Centre
333 Shennan Road East
Shenzhen 518008
Tel : (86) 755 246 1755
Fax : (86) 755 246 1754

India
CLSA India
8/F Dalamal House
Nariman Point
Bombay 400 021
Tel : (91) 22 284-1348
Fax : (91) 22 284-0271

Indonesia
CLSA Indonesia
WISMA GKBI Suite 1501
Jl. Jendral Sudirman No.28
Jakarta 10210
Tel : (62) 21 574 2626/2323
Fax : (62) 21 574 6920

Japan
Credit Lyonnais Securities (Japan)
Hibiya Kokusai Building 7th Floor
2-2-3 Uchisaiwai-cho
Chiyoda-ku, Tokyo 100 0011
Tel : (81) 3 5510 8650
Fax : (81) 3 5512 5896

Korea
CLSA Korea
15th Floor Sean Building
116, 1-Ka, Shinmun-Ro
Chongro-Ku
Seoul, Korea 110-061
Tel : (82) 2 397 8400
Fax : (82) 2 771 8583

Malaysia
CLSA Malaysia
Suite 15-2 Level 15
Menara PanGlobal
8 Lorong P Ramlee
Off Jalan P Ramlee
50250 Kuala Lumpur
Tel : (603) 2072 4288
Fax : (603) 2078 4868

Mexico
Credit Lyonnais Mexico
Prado Norte 125.
3er Piso. Col. Lomas de Chapultepec.
Mexico, DF 11000. Mexico
Tel : (525) 5202 0900/0911
Fax : (525) 5202 9101/0966

Philippines
CLSA Philippines
18th Floor, Tower One
The Enterprise Center
6766 Ayala Avenue
corner Paseo de Roxas
Makati City
Tel : (63) 2 886 5637-46
Fax : (63) 2 886 5692

South Africa
CLSA Africa
31 Impala Road,
Chislehurston
Sandton, 2196
Johannesburg
Tel : (27) 11 292 8000
Fax : (27) 11 783 0887

Switzerland
CLSA Geneva
4 Rue du Parc
1207 Geneva – Switzerland
Tel : (41) 22 718 0303
Fax : (41) 22 718 0313

Taiwan
CLSA Taiwan
6/F, No. 117, Sec. 3
Min-sheng E. Road
Taipei
Tel : (886) 2 2717 0737
Fax : (886) 2 2717 0738

Thailand
CLSA Thailand
16th Floor, M. Thai Tower
All Seasons Place
87 Wireless Road, Lumpini
Pathumwan, Bangkok 10330
Tel : (662) 253 2945
Fax : (662) 253 0534

Turkey
CLSA Istanbul
Nispetiye Cad.
Ozden Ishani
No:14 K:2
1.Levent 80680, Istanbul
Tel : (90) 212 339 3790-91
Fax : (90) 212 284 2406

Via the CL Bank network

Czech Republic
Credit Lyonnais Bank Praha
A.A. Myslbk Building, 6th Floor
Ovocny Trh8 1100
Prague, Czech Republic
Tel : (4202) 220 76101
Fax : (4202) 220 76109

Egypt
Credit Lyonnais Egypt
3 El Yemen Street
Giza, Cairo, Egypt
Tel : (202) 337 9622
Fax : (202) 360 6458

Hungary
Credit Lyonnais Bank Hungary
Jozsesnador No. 7
Budapest, Hungary
Tel : (361) 266 9000
Fax : (361) 267 4182

Morocco
Credit Lyonnais Morocco
Crédit du Maroc Capital
201, Bd Zerktouni
Casablanca, Morocco
Tel : (212 2) 94 07 44
Fax : (212 2) 94 07 66

Poland
Credit Lyonnais Bank Polska
Al. Jerozolinskie 6579
Warsaw, Poland
Tel : (48) 22 630 6888
Fax : (48) 22 635 4500

Russia
Credit Lyonnais Rusbank
1-6B Zlatonstinskiy per
101000 Moscou
Tel : (7) 095 564 85 00
Fax : (7) 095 564 85 49

Ukraine
Credit Lyonnais Ukraine
23a Volodymyrska street
252034 Kiev
Tel : (380) 44 490 14 00
Fax : (380) 44 490 14 02

Slovakia
Credit Lyonnais Bank Slovakia
Klemensova 2/A
811 09 Bratislava
Tel : (421) 7 59 26 21 11
Fax : (421) 7 59 26 21 19