COMPARATIVE STUDIES ON THE FINANCIAL HOLDING COMPANY LAWS AND PRACTICES IN THE U.S. AND TAIWAN

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A THESIS SUBMITTED IN PARTIAL FULFILLMENT OF
THE REQUIREMENTS FOR THE DEGREE OF

DOCTOR OF PHILOSOPHY

in

THE FACULTY OF GRADUATE STUDIES

(Law)

THE UNIVERSITY OF BRITISH COLUMBIA

December 2007

Abstract

Using the U.S. *Gramm-Leach-Bliley Financial Modernization Act* ("GLBA") as a model, I argue that this act of financial reform, promulgated in November 1999, is a result of "Re-regulation", rather than "Deregulation" as suggested by most scholars. I emphasize the linear development of the GLBA, from 'regulation' to 'deregulation' and then further to 're-regulation'. This linear direction denotes sequential regulatory development that concerns the gradual relaxation of permissible banking activities, which is correspondingly marked by the *Glass-Steagall Act of 1933*, the *Bank Holding Company Act of 1956*, and the GLBA of 1999.

The GLBA enabled the U.S. financial services industry to begin offering all round financial services under the single roof of the Financial Holding Company ("FHC"). The GLBA's mandate is to provide the U.S. financial services industry with a level playing field and allow them to compete with their strongest rivals from the European Union. European Union banks already operate under a liberal regime, following the success of the *Second Banking Directive of 1989* that embraces financial liberalization.

Taiwan's *Financial Holding Company Act* ("FHCA"), promulgated in July 2001, owes much of its content to its U.S. counterpart, the GLBA. Taiwan's FHCA is basically modeled after the U.S. GLBA but selectively adopts parts of the E.U. model. The U.S. model is represented by the GLBA while the E.U. model is represented by the *Second Banking Directive*. Through cross-selling and cross-marketing, financial holding companies in the U.S. model and universal banks in the E.U. model, both can achieve economies of scale and scope. This dissertation is otherwise devoted to providing a comparative analysis on certain key elements of the U.S. GLBA and Taiwan's FHCA, although I sometimes refer to the E.U.'s *Second Banking Directive*. I conclude that while Taiwan's FHCs lack the economic scale of U.S. FHCs, the adoption of the U.S. model in the FHCA offers Taiwan's FHCs better fire wall protection than the E.U. model would. More generally speaking, there are pros and cons to Taiwan's adoption of the GLBA. The GLBA and by extension the FHCA require its domestically established FHCs be pure holding companies, as opposed to the E. U. model which requires the parent companies (universal banks) to also be operating holding companies.

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Preface

This is a comparative study on the legal implications of the U.S. *Gramm-Leach-Bliley Financial Modernization Act of 1999* (hereafter "the GLBA") and Taiwan's *Financial Holding Company Act of 2001* (hereafter "the FHCA"), the governing laws for the financial holding companies ("FHCs") in their respective jurisdictions. Most scholars view the GLBA as a result of 'deregulation'. Even though this perspective is not fundamentally false, I contend that the GLBA is instead a form of 're-regulation'. That is to say, the word 'deregulation' is somewhat misleading; the GLBA does not mean total liberalization but rather that the scope of permissible financial activities for FHCs has been expanded. On a theoretical level, I compare and contrast the old and new banking law regimes in the U.S. that address the role and permissible banking activities for banks and their related FHCs. The linear direction of the GLBA (from 'regulation', to 'deregulation', and further to 're-regulation'), as I argue, denotes sequential regulatory development that concerns the gradual relaxation of permissible banking activities, which is correspondingly marked by the *Glass-Steagall Act of 1933*, the *Bank Holding Company Act of 1956*, and the GLBA of 1999.

Taiwan's FHCA is basically modeled after the U.S. GLBA (the U.S. model) but selectively adopts parts of the *Second Banking Directive of 1989* in the European Union (the E. U. model). In light of this, the latter part of this dissertation is also devoted to examining the essence of the E. U. model and discussing why Taiwan adopts such a two-pronged approach. In conclusion, I argue that while Taiwan's FHCs lack the economic scale of those FHCs in the U.S., for better firewall protection, Taiwan seems to have embarked on the right path in following the U.S. model, which requires its domestically established FHCs be pure holding companies only, as opposed to the E.U. model where the parent companies (universal banks) are also operating holding companies.

Banks in America, Asia, and Europe have provided much of the capital that has fuelled the massive economic growth of the 20th century. Many view banks as one of the

drivers of economic progress. The financial and legal structures within which they operate is of key importance to a strong economy. These structures are not static. They are ever-changing and are obliged to evolve with a variety of new circumstances to meet the needs of today and tomorrow's economy.

Only very recently has the world seen a push towards liberalization in all financial sectors including banking. When we examine the banking sector we observe this liberalization movement in addition to a corresponding drive to relax formerly restrictive legislative regimes. The question remains which legislative framework best serves an increasingly liberal and democratic banking environment. I use the word 'democratic' to refer to democratic principles of accountability and transparency, in addition to recognizing the interests of various stakeholders, including corporate and retail consumers and bank shareholders.

In America and Europe there have been dramatic changes within the banking sector over the last several decades. Developing countries such as Taiwan have the opportunity to learn from the U.S. experience and the European experience. In any event, legislative reactions to historical, cultural and financial events and developments, while varied, provide an opportunity to see exactly what drives legal reform itself and what impels the process of regulation, deregulation and re-regulation.

In Europe, banks operate under a universal banking system whereby the parent company operates and manages the banking business on a daily basis. In the U.S., banks are trending to operate under a financial holding company structure; and management and operations are divided between parents and subsidiaries respectively. Financial holding companies are embodied by the U.S. GLBA. After the GLBA came into effect, the financial holding company structure has been used by Taiwan and the U.S. to both rein in and at once liberalize their respective banking sectors, while at the same time trying to maintain a globally competitive presence.

I have traced back the enactment process of the GLBA, and simultaneously followed through the passing of the FHCA in Taiwan (also known as 'The Republic of China'). Taiwan's FHCA owes much of its content to its U.S. counterpart, the GLBA, especially in regards to the establishment and monitoring of the FHCs. It is against such a backdrop that my comparative examination of the U.S., E.U., and Taiwan banking law regimes and their recent developments, has been conducted. My aim is to provide an international perspective on the study of banking evolution in major jurisdictions.

Acknowledgements

I would like to thank my supervisory committee, Professors Pitman Potter, Robert Heinkel, Janis Sarra, and Ian Townsend-Gault, for their inspiration, attentive supervision and immeasurable assistance. Their limitless patience, guidance, and encouragement have made my graduate study possible and enjoyable.

I would like to extend additional thanks to my primary supervisor Professor Pitman Potter for his insightful comments and steadfast support. His invaluable suggestions enhance the text. His wealth of knowledge and experience in Chinese and Taiwan laws has tremendous influence on both my theoretical framework and comparative examination. He is truly my mentor.

I am very grateful for Professor Robert Heinkel for his generous help and tremendous support. I especially want to thank him for educating me on various economic theories and for addressing to my attention many important issues relating to commercial vehicles, which greatly help shape the research direction of this dissertation.

I am enlightened by Professor Janis Sarra's critical comments, which improved my dissertation considerably. Her academic precision and devotion to scholarly work in business law has motivated my study in this field.

Professor Ian Townsend-Gault has inspired me with both his teaching and research. The leadership role he took in guiding me through the last stage for completing my Ph.D. is greatly appreciated by me.

I would like to thank my grandmother, my parents and god parents for their constant support in my pursuit of legal education. I am indebted to my siblings for their caring and unconditional love and support. I especially want to thank my brother Dennis Lee, for continuing assistance and for being a constant source of inspiration.

Finally, I would like to thank my friends and colleagues, in particular Michael Molson, Yi-Shu Lin, Chih-Poung Liou, Dah-In Yeh, Tai-Yi Chih, Helena Chen, and law librarian Mary Mitchell, without whose help in my study and research, completion of this thesis would have been a much more difficult task. I also want to thank my friends, Professor Tae-Ung Baik, Anna Holeton, graduate program advisor Joanne Chung, and law secretaries Veronica Uy and Lillian Koh at UBC, for their continual friendship throughout my tenure as a Ph.D. student and candidate. Special thanks go to Michael Molson for lending me his banking experience and for reviewing my dissertation and providing very constructive comments.

In spite of all the assistance I have received, the sole responsibility for any errors or omissions in my dissertation is mine alone.

Introduction

I. Research Purpose

Taiwan has influence beyond its geographic size and borders by virtue of its importance to the world economy. In the last half century Taiwan has transformed itself from an underdeveloped, agricultural island to an economic power that is a leading producer of high-technology goods. According to the *Global Competitiveness Report*[1], published by the World Economic Forum, Taiwan was ranked the number five most competitive country in the world during 2003-2004. One year later (2004-2005), Taiwan's ranking increased to the number four position. Even though its latest report (2007-2008) indicates that Taiwan's global competitiveness ranking has dropped to 14th place (out of 131 (countries') economies that collectively account for more than 98% of the world's GDP according to the World Economic Forum's assessment), it is safe to say that Taiwan is still among the most globally competitive countries.

Taiwan is also often seen as the quintessential post-modern economy as defined by its significant lack of natural resources. Consequently, it is seen by many developing countries as a successful model of growth and development. Its economic success in the face of its natural parameters has already provided much journalistic and academic grist for the mill.

However, Taiwan's legal and business infrastructure has sometimes lagged behind its economic ambitions. To proceed to the next level of economic progress it has to undergo restructuring in some of its key sectors, including the banking sector. This mirrors the situation in many countries which have likewise been the beneficiaries of the global economic boom and yet have been ultimately faced with painful restructuring in a given industry in order to for the global business community reap such rewards. Nations like Taiwan have had to correct and align their business and legal systems with

[1] See the 'Introduction' on the World Economic Forum's website at [http://www.gcr.weforum.org/].

progressive economies. In the field of banking, progressive economies such as in North America and Europe are marked by a higher degree of integration along product lines and an ability to leverage across the securities and commercial banking sectors and departments. North America and Europe are continuing to progress towards banking sectors which are marked by fewer large banks providing integrated cost-efficient services to its customers. This is not to say that there do not exist smaller banks in these countries which coexist for niche markets, it is simply to say that at the top level of banking financial institutions, they are able to provide more sophisticated products at better prices to their corporate clients. In contrast, corporate clients in developing economies are not often able to be served in their country of origin after these companies have reached a certain period of growth and sophistication.

Therefore, developing the financial institutions of countries like Taiwan not only benefits the host country but also the global economy by forcing yet further innovation on the world's leading banks. The challenge that faces Taiwan is therefore also a challenge that faces the global economy and presumably other nations in the same paradoxical situation – i.e. nations which have leapfrogged ahead in terms of raw wealth and yet remain bound to financial systems which are in many cases simply archaic. The laws underpinning the financial systems in Taiwan are, of course, much to blame. While some argue the laws in Taiwan are merely a reflection of its institutional history, legislative reform in other countries has been proactive, responsive and ultimately effective in meeting the needs of their business communities.

I am interested in researching the history of banking legislative reform in the European Union (E.U.) and North America because their experience has much to pass on to Taiwan despite these regions' historical and cultural differences. The interests of capitalism can transcend these differences. This suggests that some of the lessons of legislative banking reform can be transposed among these regions and countries. In the course of my research I hoped to learn and share with my readers and fellow academics how Taiwan has chosen to reform its banking system, and to what extent it has chosen to adopt the E.U. model or the U.S. model. In turn, this analysis may serve as both the basis

for further research into the impending financial law reform happening in other countries and ongoing research and analysis into the continuing effectiveness of banking law reform to transform Taiwan's economy and banking sector in general.

I am interested in researching Taiwan's FHCA also because of its potential application to China. The FHCA may provide some inspiration for China. China has no financial holding company law but the first *de facto* financial holding company, the CITIC Group (China International Trust and Investment Corporation) (中國中信集團公司, in Chinese) has been established and officially launched its business on December 5 2002. According to People's Daily News, on December 6 2002 "China's first state-owned financial holding company, China International Trust and Investment Corporation (CITIC) Holdings, was established Thursday (December 5 2002) in Beijing."[2] In light of this, if China were to enact a financial holding company law, we should consider what model would cater to China's particular circumstances - the U.S. model, the E.U. model, or the Taiwan model. The Taiwan model adopts a two-pronged approach by selecting parts of both the U.S. and E.U. models.

Given that any systematic failure of China's financial holding company (FHC) would inevitably affect numerous shareholders and stakeholders both within and outside China, it is my view that research of the much anticipated Chinese financial holding company law is imminent and hence Taiwan's experience may be a lesson that China can learn from. Taiwan's implementation of the FHCA has been examined to various degrees in this dissertation, from both theoretical and practical perspectives.

This paper is therefore a comparative overview between the Taiwan banking system, its U.S. counterparts and to some degree its European counterparts. It will look at the major theoretical underpinnings of the respective U.S. and Taiwan's financial systems (and at times referring to that in the E.U.,) and the corresponding legal foundations thereof. A fuller assessment of Taiwan's adoption of the U.S. model, as

[2] "China's 1st State-owned Financial Holding Company Born", see People's Daily On-line [http://english.peopledaily.com.cn/] (This news was posted on December 6 2002.)

embodied by the Taiwan *Financial Holding Company Act* (FHCA), including the assessment of performance, is beyond the scope of this dissertation. I do not intend to discuss at any significant length the implementation of the FHCA and the effectiveness of the regulation thereof.

II. The Context of Historical and Theoretical Frameworks

This introductory chapter is intended to provide an analytical 'roadmap' for readers to better appreciate the more descriptive chapters to follow. By pointing readers to the relevant sections in each chapter, my goal is to give details on the rather evolutionary nature of deregulation, following the promulgation of the *Gramm-Leach-Bliley Financial Modernization Act of 1999* (hereafter the GLBA)[3] in the United States and the *Financial Holding Company Act of 2001* (hereafter the FHCA) in Taiwan. Deregulation is the central theme of the dissertation, which examines the legal implications for the establishment of financial holding companies (FHCs). Many believe that both pieces of legislation have inexorably changed the financial landscape in their respective jurisdictions.

Taiwan's FHCA owes much of its content to the U.S. GLBA. With a view to making a comparative analysis at the end (Chapter Five of this dissertation), I started by providing readers a brief banking history of Taiwan (Chapter One), which is ensued by an account of the establishment and operation of the FHCs in Taiwan (Chapter Two). I then look into the Pre-GLBA legislations pertaining to bank holding companies (Chapter Three) and subsequently the Post-GLBA legislations that focus on bank-led financial holding companies (Chapter Four). Concluded in Chapter Five is a reflection of certain key features existing in both the U.S. GLBA and Taiwan's FHCA, as enumerated on a comparative basis.

By comparing the regulatory situations in both the U.S. Pre-GLBA and Post-GLBA eras, it is fair to conclude that financial deregulation, epitomized by the GLBA of

[3] Gramm-Leach-Bliley Financial Modernization Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999).

1999, is evolutionary, rather than revolutionary.[4] Revolutionary changes are represented by the European Union's (E.U.) *Second Banking Directive of 1989*[5]. In a nutshell, the *Glass-Steagall Act of 1933*[6] ("GSA") in the U.S. marked the beginning of strict separation of commercial banking from investment banking. Although the *Glass-Steagall Act* created a firewall between commercial and investment banking, this wall is not impenetrable. By attempting to circumvent the law (GSA), banks at that time either set up or affiliated with holding companies, and through the holding company, commercial banks began to engage in non-banking activities. This is a loophole, as the GSA restriction only applies to banks, not bank holding companies. Subsequently, before the loophole was finally closed by the *Bank Holding Company Act of 1956*[7] ("BHCA"), banks continued to conduct securities business through the guise of its holding company. Given that these new entities (bank holding companies) were not banks, they were not implicated or limited by the GSA's proscriptions. Consequently, bank holding companies freely purchased both commercial and investment banks and ultimately served to circumvent the mandates of the GSA[8]. To close the loophole, the BHCA of 1956 was enacted, requiring bank holding companies to divest themselves of non-banking interests[9]. While the general rule of the BHCA is that a bank holding company is prohibited from acquiring direct or indirect control of a company that is not a bank, the general rule is nonetheless subject to a few exceptions. The most important exception to the general rule of the BHCA is set forth in Section (4)(c)(8), which states that the Federal Reserve Board ("FRB") may permit a bank holding company to acquire or control a non-banking company if its activities are "so closely related to banking or managing or controlling banks as to be a proper incident thereto". The second exception is Regulation Y, from where the FRB lists a number of "permissible non-banking

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[4] J. M. Jeannot, "An International Perspective on Domestic Banking Reform: Could the European Union's Second Banking Directive Revolutionize the Way the United States Regulates its Own Financial Services Industry?", (1999) 14 Am. U. Int'l L. Rev. 1715 at 1747.

[5] Directives EC, *Second Council Directive 89/646 of Dec. 15, 1989 on the Coordination of Laws, Regulations and Administrative Provisions Relating to the Taking Up and Pursuit of the Business of Credit Institutions and Amending Directive 77/780/EEC*, [1989] O. J. L 386. [hereinafter the Second Banking Directive].

[6] The *Glass-Steagall* Act refers to only four sections (Sections 16, 20, 21, 32) of the *Banking Act of 1933. The Banking Act of 1933*, 48 Stat. 162.

[7] *The Bank Holding Company Act of 1956*, 12 U.S.C.S. §§ 1841 et seq.

[8] Jeannot, *supra*, note 4 at 1727.

[9] *Ibid.*

activities" for bank holding companies. Thirdly, outside the bank holding company framework, the securities activities of commercial banks also expanded due to liberal interpretations of the *Glass-Steagall Act* by the Office of the Comptroller of the Currency ("OCC"). The OCC permits commercial banks to engage in an expansive array of securities and securities-related activities, such as the underwriting of government bonds (the United States government, state, and municipal obligations)[10]. In retrospect, the BHCA of 1956 actually started the process of the gradual relaxation of the GSA restraints. That also means strict separation of commercial from investment banking started to break down following the promulgation of the BHCA of 1956. Specifically, for commercial banks that intended to engage in non-banking activities (such as securities dealing or underwriting), the governance required them to form bank holding companies, under language in Section 20 of the *Glass-Steagall Act* (known as "Section 20 Subsidiaries"). That also means, before the GLBA, commercial banks had to rely on their subsidiaries to conduct securities business that banks wanted but could not be pursued by banks themselves.

Furthermore, before the enactment of the GLBA in 1999, the FRB required any Section 20 Subsidiary be limited to 5% of revenues from securities activities. A few years later, 5% increased to 10% and just two years before the GLBA (that is, in 1997), 10% again is increased to 25%. Deregulation had been moving so fast that the GSA restriction (a product of 1933) was not left with much content anymore. Suggested by one commentator, it seems at that time that "the only two significant banking activities that national commercial banks appear to be proscribed from engaging in are the general underwriting of securities that are not their own, and the purchasing of equity and other bank-ineligible securities for their own accounts"[11]. The GSA restriction is stretched so thin that it could explain why Citicorp and Travelers were gambling with Congress's agenda with the draft GLBA and came to merge into Citigroup. Interestingly, the Citigroup merger was precipitated one year before the GLBA came into place to legitimize it. Details of this discussion can be found in Chapter Three of this dissertation.

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[10] *Ibid* at 1727-1729.
[11] *Ibid* at 1729.

Deregulation is also progressive and ongoing. Subsequent to existing legal reform awaits another wave of development that intends to inject the market with more aggressive doses of financial liberalism. Based on such regulatory review, I further argue that the deregulation of the financial industry in the U.S. (manifested in the GLBA of 1999) is evolutionary, as opposed to the more revolutionary deregulation in the European Union (E. U.), following the *Second Banking Directive of 1989*. Consequently, I argue that "deregulation", as is used by many scholars in describing the historical development of GLBA, is somewhat misleading and should be replaced by a more appropriate term of "re-regulation". Hence, the evolution from "regulation" to "deregulation" and further to "re-regulation" (Regulation—Deregulation—Re-regulation) that concerns the gradual relaxation of permissible banking activities is correspondingly marked by the *Glass-Steagall Act of 1933*, the *Bank Holding Company Act of 1956*, and the *GLBA of 1999*.

I intend to use the framework below to feature certain characteristics in the financial holding company law regime.

(1) What is a financial holding company?
(2) What are the advantages and disadvantages of setting up a financial holding company?
(3) Does regulation as reflected in the GLBA increase the possibility of creating monopoly or oligopoly financial institution(s)?
(4) Why is there a "turf battle" between the Federal Reserve (Fed) and the Department of Treasury (Treasury) in connection with the "Subsidiary vis-à-vis Affiliation" choice?"
(5) What is functional regulation?

The first two questions (1-2) will be examined in the first part of this chapter (prologue) in order to pave the groundwork for tackling more technical issues (3-6) that are to follow. In the second part of this chapter (theoretical perspectives), answers to the

remaining questions (3-6) will be explored under the subheads of "deregulation" and "functional regulation.

I have highlighted a review of the legislative infrastructures (as in both GLBA and FHCA) with real life case studies and looked first into the corporate structure of Citigroup, the world's largest FHC, and then Cathay FHC, the largest FHC in Taiwan. Through both case studies[12], I conclude that a financial holding company is a relatively new kind of bank holding company which currently can draw on two types of regulatory models. The U.S. model is represented by the GLBA of 1999 while the E.U. model is represented by the *Second Banking Directive of 1989*. Taiwan's financial holding company law (FHCA) is basically modeled after the US model but selectively adopts parts of the EU model[13] . Financial holding companies (FHCs) can provide customers with one-stop shopping financial services; and at the same time enhance revenues and be cost efficient. An FHC is a financial conglomerate and parent company. In the U.S. model, the FHC is a "pure holding company" while in the E.U. model, it is an "operating holding company". Through cross-selling and cross-marketing, financial conglomerates of either model (FHCs in the U.S. model and universal banks in the E.U. model) can achieve economies of scale and scope.

Secondly, I argue that while the banking industry faces potential problems of monopoly and oligopoly, it is less susceptible to monopoly or oligopoly than other industries. On one hand, the maturity of competition law and banks' risk-based capital assets would prevent any single bank from monopolizing the financial industry, as it would not be able to absorb all risks linking to its over-expansion. On the other hand, bank products and services are more comprehensive, complex, and diversified than those provided by other industries. Furthermore, bank products and services are more "customer-tailored".

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[12] For details of the case study of Citigroup can be found in Chapter Three, while Cathay FHC, Chapter Two.

[13] This is especially true in the regard of minimum capital requirement.

Lastly, I looked into the U.S. Congressional Report in order to better appreciate the "turf-battle" between the Fed (the Federal Reserve) and the Treasury (the Department of Treasury) in determining whether the GLBA-granted financial activities are better carried out by a financial holding company's "subsidiary" or "affiliate". The Fed is "pro-affiliate", while the Treasury is "pro-subsidiary". Both the Fed and the Treasury argue that their views are based on the "safety and soundness" principle to protect the integrity of the federal reserve fund. This begs the question, given the equal treatment of "subsidiary" and "affiliate" by the *Federal Reserve Act*, from a legal perspective, it really does not matter whether the GLBA-granted financial activities are engaged by the subsidiary of affiliate (of a financial holding company). This probably explains why in the E.U. model, the financial institution was granted the freedom to choose between a subsidiary and an affiliate to engage in similar financial activities. More details are to follow in the second part of this chapter (Theoretical Perspectives) under the subheading of "functional regulation".

1. What is a Financial Holding Company?
(Definitions in both the U.S. GLBA and Taiwan's FHCA)

In the U.S., the term "financial holding company" (FHC) was first introduced by and encoded in the GLBA to refer to a relatively new kind of bank holding company. FHC is a concept adapted from "bank holding company", which was initially defined in Section 2(a) of the *Bank Holding Company Act of 1956* (BHCA) as any company that either (i) directly or indirectly owns or controls at least 25 per centum or more of the voting shares of each of two or more banks or of a bank holding company by virtue of the BHCA; or (ii) controls in any manner the election of a majority of the directors of each of two or more banks. The definition for "bank holding company" has otherwise been slightly changed following the promulgation of the GLBA on November 12, 1999. Currently, the BHCA Amendment of 2006 defines a "bank holding company" as "any company which has control over any bank or over any company that is or becomes a

bank holding company by virtue of the Act (i.e. BHCA)".[14] To this end, a *bank holding company* can have ownership or controlling interest over either a bank or another bank holding company, so long as it (1) "directly or indirectly or acting through one or more other persons owns, controls, or has power to vote 25 per centum or more of any class of voting securities of the bank or (another bank holding company); or (2) controls in any manner the election of a majority of the directors or trustees of the bank or company"[15]. As well, a *bank* can "hold" another company by virtue of owning or controlling at least 25 per cent of its voting shares or by controlling the election of a majority of the directors or trustees of another company. In this case, the "*bank*" is deemed a "*bank holding company*" at the same time. Emphasis needs to be made that even though both the BHCA of 1956 and its latest amendment of 2006 *generally* defines a bank holding company as the latter, a company will NOT be deemed as a bank holding company if its ownership or control of shares of a bank is held in a *fiduciary capacity*, unless by *trustees* for the benefit of a company or the shareholders, members, employees of a company[16].

On the other hand, according to the post-GLBA regulations[17], the FHC means a bank holding company that meets certain requirements. First, all of the depository institution subsidiaries of the bank holding company must be "well-capitalized" and "well-managed". Secondly, the bank holding company must file with the Board of Governors of the Federal Reserve System ("the Board") a declaration that the bank holding company *elects* to be a financial holding company to engage in activities or acquire and retain shares of a company that were not permissible for a bank holding company to engage in or acquire before the enactment of the GLBA. Thirdly, the FHC must (at the time of its election) attain at least a "satisfactory" or better CRA rating (as prescribed in the *Community Reinvestment Act*) and must *at all times* maintain this level, after being approved as an FHC by the Board. Unless these conditions are met, a bank holding company that wishes to become an FHC may not engage in "expanded financial

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[14] P.L. 109-351, 12 U.S.C.S. § 1841 (a)(2). As of writing, the latest amendment to the BHCA was made on October 13, 2006.
[15] *Ibid.*
[16] P.L. 109-351, 12 U.S.C.S. § 1841 (a)(5). See also P.L. 109-351, 12 U.S.C.S. § 1841 (g)(2)&(3).
[17] P.L. 110-6, 12 U.S.C.S. § 1841 (p), 12 U.S.C.S. § 1843(l)(1). Both are amendments to the *Bank Holding Company Act of 1956*, made on the same day (November 12, 1999) when the GLBA was promulgated.

activities"[18] prescribed under the GLBA but rather only those "closely related to banking activities", under Subsection 4(c)(8) of the BHCA, deemed as permissible for any bank holding company. In a legal sense, for any bank holding company that elects not to, or if it is not eligible to become an FHC, its applicable governing law is the BHCA (despite being amended), not the GLBA. In practice, the GLBA removes the artificial barrier that traditionally separates commercial banking from investment banking, due to regulatory restraints previously set by the *Glass-Steagall Act of 1933* and the BHCA (of 1956 and its later amendments prior to 1999). Deregulation of the old regulatory regime allows for an FHC (typically headed by a bank) to expand its subsidiary bank's commercial banking activities, through mergers or consolidations with affiliated securities firms and insurance companies. This is done within the framework of the GLBA, in name of "re-regulation".

Worth noting, the U.S. GLBA provides banks with the alternative of using a "financial subsidiary" of the bank (both national and state) rather than an FHC as the vehicle for conducting new financial activities. The most important difference between the FHC and the bank's financial subsidiary is that the latter is prohibited from engaging in certain financial activities as "principal". The non-permissible activities include: insurance underwriting, real estate development or investment, merchant banking, and "complementary (i.e. non-financial) activities"[19]. The same regulatory conditions apply for establishing a financial subsidiary as for establishing an FHC[20]. Adapted from Section 121 of the GLBA, it is fair to conclude that if the consolidated assets of the national bank's financial subsidiaries are less than US$ 50 billion, the national bank could opt NOT to become a financial holding company, even though it would still be allowed to conduct some of the new financial activities under the GLBA.

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[18] Such "expanded activities" are defined in Section 103 of the *Gramm-Leach-Bliley Act* as any activity the Board determines, by regulation or order, to be either (i) financial in nature or incidental to such financial activity, or (ii) is complementary to a financial activity and does not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally.

[19] Covington & Burling, Financial Modernization: The *Gramm-Leach-Bliley Act* Summary, American Bankers Association, 1999 (Hereafter the "Executive Summary", at 10.

[20] *Ibid.* According to the Executive Summary, the GLBA allows the bank to conduct new financial activities by amending the *National Bank Act* to authorize a national bank to own or invest in a new type of subsidiary called a "financial subsidiary". The Summary further points out that a state bank is equally permitted to establish such a financial subsidiary. See also Section 121 of the U.S. *Gramm-Leach-Bliley Act*, under the subtitle "Sec. 5136A. Financial Subsidiaries of National Banks".

In Taiwan, the FHC is defined in Article 6 of the *Financial Holding Company Act* (FHCA) as the same person or the same affiliated person who has a controlling interest in a Bank, Insurance Company, and/or Securities House that exceeds a "certain amount". To this end, the actual amount has been determined as NT$ 300 billion (equivalent to approximately US$ 9.2 billion), through an order[21] issued by the Ministry of Finance, effective as of November 1st 2001. That goes on to say, as long as the same person or the same affiliated person that holds a controlling interest of NT$300 billion or more, it shall apply to the Financial Supervisory Commission (FSC) for approval for the establishment of an FHC. Conversely, if the same person or same affiliated person does NOT CONCURRENTLY hold shares or capital of a company from any two of the banking, insurance and securities industry, or the aggregate amount of assets of the Bank, Insurance Company or Securities House in which such same person or same affiliated person has a controlling interest does NOT exceed NT$300 billion; then, such same person or same affiliated person need NOT establish an FHC. Worth noting, FHCs in Taiwan do not have to concurrently hold shares or capital from all three financial industries (banks, securities firms, and insurance companies), but only any two of these three.

As far as the percentage holding (i.e. "controlling interest") is concerned, Taiwan also adopts the U.S. model (GLBA) by requiring a company (which could or could not be a bank) to own at least 25% of the outstanding voting shares or capital stock of another company to qualify as a holding company. To qualify as a bank holding company, at least one of the companies that are being held by the former company has to be a bank. Accordingly, if a bank holding company meets certain requirements as set out in Taiwan's FHCA (such as meeting the minimum capital requirement of NT. 20 billion), and if it opts to become a financial holding company, then it could apply to seek for government approval to actually become one (an FHC). Article 4 (Paragraph 1) of Taiwan's FHCA clearly stipulates that "controlling interest" shall mean "holding voting-

[21] See Order of the Ministry of Justice (no. 0901000118), entitled "The Aggregate Amount of Assets Referred to in Paragraph 2 of Article 6 of the *Financial Holding Company Act*".

right-shares or capital stock of a Bank, Insurance Company, or Securities House of more than 25% or otherwise having the direct or indirect ability to designate the majority of the directors of a Bank, Insurance Company, or Securities House." To pare with this one, Article 4 (Paragraph 2) further defines "financial holding company" to mean "a company established in accordance with this Act (i.e. FHCA) and having a 'controlling interest' (as just mentioned earlier) in a Bank, Insurance Company, and/or Securities House."

2. What are the Advantages and Disadvantages for Becoming a Financial Holding Company?

There are both advantages and disadvantages for a bank or bank holding company in opting to become a financial holding company (FHC). Advantages, as summarized by many commentators, include the followings[22]:

(1) FHC establishment is attributable to conveniently provide clients with "one-stop shopping financial services", and through cross-selling and cross-marketing, economies of scale and scope can be achieved.

(2) The FHC, as a parent company, can effectively manage to maximize investment returns from utilizing the accumulated assets from each of its subsidiary. As both the U.S. GLBA and Taiwan's FHCA restrict their FHCs to be pure holding companies only, a parent FHC's only job is to ensure that the assets of all its subsidiaries should be well protected and well managed at all time.

(3) When it comes to variances in regional business productivity or revenue, cross-selling and cross-marketing can help redress the inadequacies experienced by one region, by the well-being of another. Likewise, as a result of mergers or acquisitions an FHC can utilize the variances in economic strength of one sector to help bring up the efficiency or profit level for the entire FHC. For example, in the U.S., after the merger

[22] Jin-Lung Peng, *Financial Hong Company Regulation and Strategy* (Taipei: Best Wise, 2004) at 18-19. (In Chinese)

between Citibank and Travelers' Insurance, Travelers' reputable services and good will in the insurance sector boosted consumer confidence in using the banking services provided by Citibank, and vice versa. Similarly, in Taiwan, Cathay United Bank (*Guo Tai Shi Hua Yin Hang*, in Chinese) is unquestionably benefiting from its predecessor Cathay Insurance Company's good will in the insurance sector. Before the merger in becoming the Cathay FHC, Cathay Insurance Company boasted having the largest capital assets in Taiwan's entire insurance sector.

(4) Cost saving is attainable as a result of lowered operational cost (e.g.: lay offs, department mergers) and management resources being fully utilized.

(5) FHC establishment can provide necessary transparency and accountability for both investors and shareholders, as all FHCs are subject to government supervision.

(6) Legally speaking, each subsidiary of the same FHC is a legal person enjoying rights in its own right and bearing responsibilities. This "fire wall" design works as a cushionable protection, separating one subsidiary from bankruptcy or any management failure caused by others.

(7) Generally speaking, an FHC would not interfere with the business operation of its subsidiary (subsidiaries). This factor, coupled with the fire walls erected to protect one subsidiary from being inflicted by another subsidiary's failure, works as the fundamental basis for lowering the risk of insider trading or conflict of interests.

There are also disadvantages, "myths", as I will call them, linked to the FHC establishment, as pointed out by some commentators[23]. To name a few,

- **Myth 1** Despite the fire walls in place, the closeness within the same company (e.g. all three financial sectors working within the same FHC) makes people skeptical about the efficiency and soundness of fire wall

[23] *Ibid.*

protections. Besides that, there exists a problem of lack of transparency arising from the complexity in FHC-conducted transactions.

My view is that although FHC structure cannot guarantee that insider trading will not happen; the truth is that such a problematic practice is not peculiar to FHC establishments. Prevention of insider trading relies on good corporate governance, combined with a strong regulatory enforcement structure, and not on absolute dismissal or disapproval of the FHC establishment. For the same reason, despite some commentators' attribution of the FHC establishment to a lack of transparency in that many transactions executed by the FHC are deemed extremely complicated, such a view or concern simply cannot justify a total dismissal of FHCs. To address the issue, FHC supervisory authorities in both countries, namely, the FRB (Federal Reserve Board) in the U.S. and the FSC (Financial Supervisory Commission) in Taiwan, have respectively issued necessary measures that require FHCs to disclose information with substantial importance to the general public.

- **Myth 2** As a result of cross-selling and cross-marketing, information sharing is both permissible and prevalent among all financial subsidiaries within the same FHC. Within this legal parameter set by the GLBA, there are allegedly three negative implications for customers.

(i) Customers are concerned that information sharing may affect adversely his/her interest and that could constitute a violation of the GLBA's protection of private information. Specifically, some argue that information sharing among FHC subsidiaries means that firewalls have been broken, which is in itself a form of conflict of interests. For example, a customer would allege that his/her interest be adversely affected if the FHC's insurance subsidy provides the FHC bank (another subsidiary) with the customer's "*financial* information", and based on which the FHC bank turned down the customer's loan application with a view to preventing non-performing loans.

(ii) Equally alarming to the customer is that in some incidents FHC employees (often part-time workers, suggested by a commentator[24]) sold *non-affiliated third parties* customers' private information that they obtained through their jobs.

(iii) Conflict of interests could also arise from *inappropriate* joint marketing arrangements (i.e. "*tying*") where the FHC bank would not agree to make loans to its customer unless he or she agrees to purchase the securities underwritten by the FHC's securities subsidiary. This is a typical case of conflict of interest.

In my view,

First, conflict of interests can be properly redressed or prevented by granting customers sufficient rights protections. Case in point, Title V of the U.S. GLBA sets out the privacy provisions that must be observed by FHCs in disclosure of *non-public personal information*. Specifically, this section summarizes the GLBA's four new requirements that will apply equally to *all* financial institutions[25], regarding the sharing of customer information with others. To comply with this law, each financial institution must (i) establish and annually disclose a *privacy policy*[26], (ii) provide customers with the *right to "opt-out"* of having their non-public information shared with non-affiliated third parties (subject to many significant exceptions[27]), (iii) not share customer account

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[24] Wen-Yu Wang, "Comments and Analysis on the Financial Holding Company Law" (*Jin Rong Kong Gu Gong Si Fa Zhi Ping Xi*, in Chinese) (2001) 77 Yue Dan Legal Journal (*Yue Dan Fa Xue Za Zhi*, in Chinese) 194 at 196. (In Chinese)

[25] The GLBA's privacy provisions apply to (i) Banks, thrifts, and credit unions; (ii) U.S. branches and agencies of foreign banks; (iii) Mortgage companies; (iv) Insurance companies and agents; (v) Securities brokers and underwriters; (vi) Investment advisors and mutual funds; and (vii) Certain other institutions engaged in "financial" activities or "incidental" activities as defined under GLBA. See "An Executive's Guide to U.S. Financial Modernization", published by PricewaterhouseCoopers, in January 2000.

[26] In this regard, a financial institution must provide a "clear and conspicuous" notice concerning its privacy policies and practices to a new customer at the "establishment of a customer relationship" and annually after. *Ibid.*

[27] Customers may *not* opt out of any of the following disclosures where a financial institution may disclose non-public personal information (i) As permitted or required by the Right to Financial Privacy Act or Fair Credit Reporting Act; (ii) At the customer's direction or consent; (iii) To comply with Federal, State, or local laws and to comply with properly authorized civil, criminal, or regulatory investigations, subpoenas, or summons; (iv) To insurance rate advisory organizations, guaranty funds or agencies, applicable rating agencies, persons assessing the institution's compliance with industry standards, attorneys, accountants,

numbers with non-affiliated third parties, and (iv) comply with regulatory standards to protect the security and integrity of customer information[28].

Secondly, according to a report by PricewaterhouseCoopers on the U.S. GLBA, "a financial institution and its affiliates may share nonpublic information *without restriction* (emphasis added) as long as they disclose to the customer that they will share the information. The customer cannot bar that information sharing among affiliates—although some firms voluntarily may permit a customer to 'opt out' of disclosure to affiliates."[29] "Non-public personal information" is defined by Section 509 of GLBA to mean *personally identifiable financial information* provided by a customer to a financial institution or resulting from any transaction with the customer or service performed for the customer, or as a catchall, information otherwise obtained by the financial institution[30]. Worth noting, the term "non-public personal information" applies to information that describes an individual's *financial* condition obtained from one of three sources set forth in the statutory definition, and by example would include experiences with the account established in the initial transaction or other private financial information[31]. In this regard, it seems apparent that the protection of "*non-public*

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and auditors; (v) In connection with the servicing or processing a financial product or service requested by the consumer; (vi) In connection with maintaining or servicing the consumer's account with the financial institution, or with another entity as part of a private label credit card program or other credit extension; (vii) In connection with a proposed or actual securitization, secondary market sale or similar transaction related to a transaction of the consumer; (viii) To protect the confidentiality or security of the financial institution's records; (ix) To protect against or prevent actual or potential fraud, unauthorized transactions, claims or other liability; (x) For required institutional risk control; (xi) For resolving customer disputes or inquiries; (xii) To persons holding a legal or beneficial interest relating to the consumer; (xiii) To persons acting in a fiduciary capacity on behalf of the customer; and (xiv) In connection with a proposed or actual sale, merger, transfer, or exchange of a business or operating unit. *Ibid.* [It is my view that the exceptions have grown so many that they would dramatically diminish the regulatory (GLBA's) intention for sound privacy protection. While GLBA is proclaimed to be the first comprehensive Federal law governing financial firms' use of customer information, it might be due to these substantial exceptions that the Clinton Administration criticized GLBA's privacy protections as being too weak and vowed to submit stronger privacy legislation to Congress in the year of 2000. There is no doubt that privacy protection is becoming a larger and larger public policy issue.]

[28] Covington & Burling, Financial Modernization: The Gramm-Leach-Bliley Act Summary, American Bankers Association, 1999 (See Executive Summary at p. 2). Covington & Burling is a Washington law firm, which is credited, by Hjalma E. Johnson, then President of American Bankers Association, to have one of the foremost banking practices in the U.S.

[29] PricewaterhouseCoopers, *supra*, note 25, at 32.

[30] K. R. Benson, K. M. Bianco & J. Hamilton, *Financial Services Modernization Gramm-Leach-Bliley Act of 1999 Law and Explanation* (Chicago: CCH Incorporated, 1999) at 100.

[31] *Ibid* at 101.

personal information" focuses only on any "*financial*" information pertaining to a customer. A continuation of Section 509 is Section 502 of the GLBA, where its title is quoted as "(financial institutions') obligations with respect to disclosures of *personal information*", along with its actual context, "unless as otherwise provided in this subtitle, a financial institution may not, directly or through any affiliate, disclose to *non-affiliated third party* any *non-public personal information*..." Given the subject matter of Section 502 is "non-public information" (statutorily defined to include individual's *financial* condition), and information sharing is otherwise permissible by GLBA as long as the disclosure is made among affiliates, it is most likely in our example that the customer has *no* legal basis to allege the FHC insurance company violated the privacy protection clause under the GLBA on account of his or her loan application being denied. If anything, Section 502 is to give customers the right to opt-out (with substantial exceptions) of information sharing with a nonaffiliated third party—it is the right to say no to the sharing or selling of non-public personal information.

In actual banking practice:

(a) There is usually an overriding obligation on banks to comply with court orders and statutory investigative powers conferred on federal and state authorities. In these cases, privacy agreements may sometimes be overridden.

(b) There may also be written provisions in loan agreements or otherwise (such as banking agreements) which provide, as between the two parties, under which circumstances the bank is permitted to disclose client information (non-public private information) to other divisions or departments (broadly defined, as commonly used to cover both the Universal Banking and Financial Holding Company systems). For example, there may be situations where information must be shared with the insurance department that is affiliated with the bank.

(c) As one can imply from the above discussion, there is a general duty of confidentiality between the bank and its customer subject to agreed-upon or statutory exceptions.

(d) In conclusion, conflict of interest is unlikely to be a basis for complaint because the customer consents to a certain amount of disclosure. And in any event, loan agreements and banking agreements often contain broad exculpatory clauses. It is also difficult to prove conflict of interest has adversely affected a customer, because such agreements give banks a lot of discretion in accepting or rejecting a customer's application for any banking products (loan applications, in our example).

(e) Informed banking practice and proper documentation will rebut many client complaints of conflict of interest. Consent to information sharing and the bank's ultimate discretion in dealing with loan or insurance products render such complaints without a legal basis. In the end, clients may exercise their free will to sometimes seek a banking product elsewhere in the free market, if they have been rejected at one institution.

Lastly, "anti-tying" laws have been enacted as early as in 1972 (12 USCS § 1972[32]), and in consideration of the BHCA 1956, exceptions were made in order to facilitate joint marketing arrangements between bank holding company affiliates. In the same vein, the GLBA currently permits a depository institution subsidiary (bank, for example) of a financial holding company (FHC) to engage in cross-marketing activities with non-financial companies held by an insurance underwriting affiliate through statement stuffers and interest websites. These activities must comply with "anti-tying" restrictions[33]. Therefore, a tying violation is less likely to occur with the statutory protection in place. In fact, commentators have suggested that any possible problems relating to tying and concentration are adequately dealt with under present law[34].

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[32] See 12 U.S.C.S. § 1972, P.L. 110-37, Title 12 Banks and Banking, Chapter 22 Tying Arrangements.
[33] Jonathan B. Engel, "Developments in Banking and Financial Law: 2003 XV. Merchant Banking Developments" (2004) 23 Ann. Rev. Banking & Fin. L. 179 at 184.
[34] (Author's Name Unknown) "The Demise of the Bank/Non-bank Distinction: An Argument for Deregulating the Activities of Bank Holding Companies" (1985) 98 Harv. L. Rev. 650 (original note 34). See also Robert Charles Clark, "The Regulation of Financial Holding Companies" (1979) 92 Harv. L. Rev.

- **Myth 3** Approval of FHC establishment may as well be enabling the producing of gigantic financial monsters that will be "too big to fail". In order not to dismantle the FHC and cause systematic financial disorder, the Federal Reserve is likely to come to the failing FHC's rescue with the reserve fund. This will not only breach the integrity of the fund but also increase the risk of moral hazard.

In my view, the U.S. GLBA, in Section108, mandates the use of "subordinated debt" to protect financial systems and deposit funds from becoming "too big to fail". The subordinated debt doctrine basically requires that all belongings of a financial subsidiary (say, a FHC bank) must be subtracted from the calculation of FHC's consolidated capital assets. Legally speaking and from a safety and soundness perspective, an FHC establishment would not be attributable to unsubstantial allegations that FHCs might just become too big to fail.

3. What is the supplementary legislation to the GLBA/FHCA as Major Governing Law(s)? (Relevant Laws Accompany the U.S. GLBA and Taiwan's FHCA)

In the U.S., the colossal *Gramm-Leach-Bliley Act* ("GLBA") is a comprehensive and complicated piece of legislation. The enormity of the GLBA also means that financial holding companies established in the U.S. are not only governed by its major governing law (the GLBA) but also other relevant laws, including but not limited to: *the Bank Holding Company Act of 1956 (and its subsequent Amendments), The Interstate Banking and Branching Efficiency Act of 1994, the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Securities Act of 1933, the Securities Exchange Act of 1934, the Community Reinvestment Act of 1977, the International Banking Act of 1978, Right to Financial Privacy Act of 1978, Riegle Community Development and Regulatory Improvement Act of 1994, Riegle-Neal Interstate Banking and Branching Efficiency Act*

787, 826-27, 835-36.

of 1994, the Federal Reserve Act, the Federal Deposit Insurance Act, the Federal Home Loan Bank Act, the National Bank Consolidation and Merger Act, Bank Service Company Act, Electric Fund Transfer Act, Fair Credit Reporting Act, and the Home Owners' Loan Act.[35]

As with the U.S., Taiwan's FHCA also prompted the enactment or amendment of a wide array of laws/rules for governing FHCs in Taiwan. Of particular importance are *The Banking Act, Securities and Exchange Law, Insurance Act, Company Act, Business Mergers and Acquisitions Law (2002), Fair Trade Law (Taiwan's Competition Policy), Financial Institutions Mergers Act (2000), Criteria Governing Preparation of Affiliation Reports, Consolidated Business Reports and Consolidated Financial Statements of Affiliated Enterprises, Computer Processed Personal Data Protection Law, Criteria Governing Information to be Published in Annual Reports of Public Companies, Corporate Governance Best-Practice Principles for Financial Holding Companies (2003), Regulations Governing the Acquisition or Disposition of Assets by Public Companies, Regulations Governing the Preparation of Financial Reports by Financial Holding Companies, Taiwan Stock Exchange Corporation Regulations for the Review of Stock Exchange Listing Applications by Financial Holding Companies, Regulations for the Examination of Financial Holding Company Merger Cases (2001), Regulations Governing the Consolidated Capital Adequacy of Financial Holding Companies (2001), Regulations Governing the Implementation of Internal Control and Audit Systems by Financial Holding Companies (2001), Regulations Governing Qualification Requirements for Responsible Persons of a Financial Holding Company and their Holding of Concurrent Positions in Subsidiaries (2001)*, and *Rules Concerning Cross-Selling by Financial Holding Company Subsidiaries (2002).*

It is worth noting that between 2000-2001, just two years prior to the promulgation of Taiwan's FHCA, several laws had been passed to pave the way for the ultimate promulgation of the FHCA in July 2001; a case in point the *Financial Institutions Mergers Act (2000).* Subsequently, *Business Mergers and Acquisitions Law*

[35] See "Table of Statutes Added or Amended" in Benson, Bianco & Hamilton, *supra*, note 30, at 9-13.

(*qi ye bing gou fa*, in Chinese, 2002) was issued later for better implementation of the FHCA, coupled with the amendment to the *Fair Trade Law* (amended 2002). This legislative stunt was taken against the backdrop of "over-banking", which as many believed to have caused by over-competition among banks in Taiwan that focus business mainly on personal/commercial lending (making loans). For details about over-banking in Taiwan, please refer to Chapter One of this dissertation. The overhaul of Taiwan's banking/financial market was launched through the government's provision of tax incentives to encourage the establishment of financial holding companies, a policy embraced by both banks and other financial institutions in Taiwan aiming to achieve "operational synergy". At this point, it seems clear that both the Taiwanese government and industry reached a consensus that a "financial holding company" could provide a viable solution for attaining optimal operational efficiency. Influenced by the more successful experience achieved by Citigroup in the U.S, the largest FHC in the world, both Taiwanese government and industry focused their initiative on FHC promotions, even though there were indeed other means to achieve operational synergy, such as (i) strategic alliance, (ii) reinvestment through subsidiaries, and (iii) comprehensive universal banking practice. Details for all these options will follow shortly.

Right now there are over 600 FHCs in the U.S. while up until June 2005, the total number of FHCs in Taiwan reached to 14. To drive the reforms even further, Taiwanese government also issued several measures aimed to encourage further mergers (2nd and even 3rd waves of merger) among existing FHCs and to draw foreign investment into Taiwan. According to one commentator, the government policy involved measures to (i) stop issuing operating license (for financial institution "wannabe(s)"—including those apply to become FHCs); (ii) no longer allow banks to open new branches[36].

If it is Taiwanese government's intention to purposely reduce the current number of domestic FHCs in Taiwan from 14 to 7 (even 5) in order to enable "healthy oligopoly",

[36] Yu-Chen Tu *et al.*, "The Operating Synergies of Financial Holding Companies in In-Market and Cross-Market Mergers" (2007) Taiwan Banking & Finance Quarterly Vol. 8 No. 1, 1 at 1. (In Chinese)

which allegedly could sustain the surviving FHCs' competence for global competition, it begs the question, would such "oligopoly" really help enhance domestic FHCs' revenues?

To correctly tackle these issues, it seems necessary for both government and industry to examine whether the existing 14 FHCs and other commercial banks have been able to attain a state of "complete market competition" (*wan quan jing zheng shi chang*, in Chinese). In other words, failure to consider the hypothesis of INCOMPLETE market competition will over-estimate the degree of cost-saving efficiency[37].

4. Recent Studies on Major Taiwanese Banks' Operational Efficiency

As mentioned earlier, Taiwan's *Financial Holding Company Act* (hereinafter Taiwan's FHCA) was promulgated on July 9, 2001, marking the beginning of a milestone change that made operational synergy possible among all three previously-separated financial services: banking, securities and insurance. In this regard, researchers in Taiwan were interested in finding out whether there is improvement in operational efficiency for major banks in Taiwan, as of July 9, 2001. Two empirical pieces of research, both conducted recently to examine operational efficiency pertaining to Taiwan's major banks, prove that, generally speaking, there is improved operational efficiency in these institutions, especially those that are affiliated with a financial holding company (i.e. FHC banks; FHC bank subsidiaries).

In order to correctly reflect the impact of Taiwan's FHCA, two pieces of empirical research have been selected that explain the operational efficiency gap between (i) two periods of time: referring to both the pre-FHCA and post-FHCA eras; and (ii) two research subjects: referring to both FHC banks (i.e. FHC bank subsidiaries) and non-FHC banks (i.e. individual banks that are not affiliated with or run by a parent FHC). Both pieces of research are considered as having "representative" value, as the first research involves the operational efficiency analysis for each and every 12 FHC banks, out of 14

[37] Yung-Chi Chen, "The Impact of Financial Holding Companies on the Banking Market Structure" (2007) Taiwan Banking & Finance Quarterly, Vol. 8, No. 1, 29 at 30. (In Chinese)

FHCs currently existing in Taiwan (that accounts for more than 85% of the effective samples; 12÷14=85.7%)[38]. Likewise, in the second research paper, of the 30 sample banks selected by researchers as "research subjects", their aggregated capital assets account for 71% of the total assets of all banks in Taiwan[39].

(4.1) Research Subject: FHC Banks and Non-FHC Banks in Taiwan

The first empirical research[40], aimed at examining the overall operational efficiency pertaining to both FHC banks and non-FHC banks, also suggests that the former (FHC banks) surpassed the latter (non-FHC banks) in overall operational efficiency. This research, conducted within a research period from December 2001 (that is, five months after Taiwan's FHCA was promulgated) to June 2004, has pointed to a few important empirical results:

(i) Firstly, by turning individual commercial banks into FHC banks, it helps raise the level of operational efficiency. Statistics (see Table 1, inserted below) indicate that from 2002 to 2003, the FHC banks' average operational efficiency is lower than that recorded in December 2001 (only six months following Taiwan's FHCA promulgation in July 2001). But in 2004, that is two and a half years following Taiwan's FHCA, the FHC banks' operational efficiency index rose to 0.991, even slightly higher than its original level kept in 2001 (0.990). This tells us that even though the FHC banks' operational efficiency had been adversely affected at the initial stage, due to structural changes, nonetheless, after FHC banks successfully integrated their financial subsidiary's resources (either "networking" or "financial and human

[38] Jwu-Rong Lin, Huey-Ling Shiao & Jun-Mauo Chiu, "Evaluation of Performance Difference for Financial Holding Companies in Taiwan" (2006) Zhong Yuan Business Administration Review (*Zhong Yuan Qi Guan Ping Lun*, in Chinese) Vol. 4 No. 1, 43-68. (In Chinese)
[39] Guo-Geng Gao & Jing-Kai Xiao, "Comparative Analysis of Operational Efficiency for Financial Holding and Non-Financial Holding Banks in Taiwan" (2006) Financial Law Review (*Cai Jin Lun Wen Cong Kan*, in Chinese) Vol. 5, 42-57. (In Chinese)
[40] Gao & Xiao, *supra*, note 39, at 42-57.

capital") their operational efficiency level rose to surpass the original levels prior to Taiwan's FHCA. On the theory that cross-selling and cross-marketing are more likely to be achieved within the FHC structure, this gives another incentive for the establishment of FHCs, as it brings forth a positive prospect in elevating operational efficiency level.[41]

(ii) Table 1. Operational Efficiency for Banks in Taiwan (adapted from original source[42])

Table 1. Operational Efficiency for Banks in Taiwan

Types of Banks	12/2001	06/2002	12/2002	06/2003	12/2003	06/2004
(1) FHC Banks	0.990	0.985	0.984	0.985	0.980	0.991
(2) Non-FHC Banks	0.948	0.947	0.968	0.978	0.970	0.966
(3) All Banks	0.964	0.962	0.974	0.981	0.974	0.976

(iii) Secondly, as shown in Table 1, the FHC banks' average operational efficiency is not that much higher than that of non-FHC banks. Pointed out by researchers, this indicates that there is a certain amount of *resource waste*. Once the problem has been properly identified and solved, it can be reasonably predicted that FHC banks' operational efficiency can increase significantly.

(iv) Thirdly, despite FHC banks have *in general* surpassed non-FHC banks in operational efficiency; this does not mean there are no exceptions. Certain non-FHC banks have actually outperformed other FHC banks. This might have to do with the increase in initial costs for FHC banks, following its merger or acquisition to become an FHC. Researchers suggest that increased operational costs are due for FHC bank subsidiaries as many of them were bound to work out differences in either corporate culture or management team style. On top of that, increased costs may be due to IT (information technology)

[41] *Ibid* at 42.
[42] *Ibid* at 50.

improvements. However, once the FHC banks have overcome various challenges, operational synergy can work as a leverage for improving operational efficiency and attaining revenue enhancement[43].

(v) Lastly, despite the fact that there are 14 FHCs currently in Taiwan, what remains unchanged (either prior to or following the FHC establishment) is that banks in Taiwan still make their earnings mainly through bank loans. This heavy reliance on loans makes Taiwanese banks extremely sensitive to interest rate changes (in either domestic or global market). Highly homogenous lending practice also intensifies price competition. This is attributable to Taiwan's over-banking problem, stemming from initial banking liberalization in the early 1990s. (For details about Taiwan's over-banking problem, please refer to Chapter One of this dissertation.) In light of this, researchers suggest that Taiwanese banks should model themselves after the U.S. FHCs by focusing their earnings on "service fee charges". That is to say, FHCs should rely more on developing new financial products that cater to different customers' needs, in order to maintain their sustainability and ensure their overall development[44].

(4.2) Research Period: Pre-FHCA and Post-FHCA

The second empirical research[45] that was conducted involves a research period from the first quarter of 2000 to the fourth quarter of 2004, totaling 12 commercial banks (all of them have repositioned themselves as FHC bank subsidiaries in 11 different FHCs) and 240 pieces of balance panel data. Its underlying purpose was to examine the changes reflected in each of these banks' operational efficiency, following the promulgation of Taiwan's FHCA. The research result suggests that operational efficiency changes were positive as a result of the FHC establishment. Certain factors have a tremendous impact

[43] *Ibid.*
[44] *Ibid.*
[45] Lin, Shiao & Chiu, *supra*, note 38, at 43-68.

on operational efficiency, including the scale of the bank, number of branches, and whether merging activities have been taken place. Researchers suggest that "both the profit and liquidity indices were 'obviously better' after than before the FHC establishment. The greater a bank's scale is, the higher its profitability grows; this in turn helps improve the bank's liquidity than ever before"[46].

Empirical results suggest that each commercial bank enjoyed business growth after they became an FHC as a direct result of its transformation. The "*profit indices*" assembled by researchers further indicate that among all 12 FHCs ("the research subjects"), the average growth rate increased 12 percent (from 38.3501% to 50.385%)[47]. Researchers suggest that FHC banks have now possessed a better profitability level than they had before. Emphasis needs to be made that for most commercial banks, prior to their turning into FHC bank subsidiaries, their respective profit indexes were all below the average rate of 45.160%, except for a very few such as Fubon Bank (47.178%), Cathay United Bank (58.213%), Jiao Tong Bank (55.264%), Jian Hua (also known as Bank Sinopac, 47.262%), and China Trust (56.169%)[48]. On the other hand, what is very exciting is that, after the FHC establishment, most commercial banks reported a profit level higher than the sampled average of 45.160%. Worth mentioning, the First Bank has recorded the highest growth—before it repositioned itself as an FHC bank, its profit index was as low as -8.603%, but after becoming an FHC, its profit index rose to 56.566%—which makes up for a growth rate at 65.169% (56.566% + 8.603%=65.169%)[49]. In conclusion, the study suggests that with only limited exceptions, FHC banks in general have outperformed their pre-FHC selves.

(4.3) What Do the Research Results Tell Us?

With respect to the two pieces of empirical research mentioned above, it should be noted that the first empirical research's focus was on the overall '*operational efficiency*'

[46] *Ibid* at 67.
[47] *Ibid* at 54.
[48] *Ibid.*
[49] *Ibid.*

of the FHCs being examined, while the second empirical research's focus was on their '*profitability*'. Given the results as noted above, we can therefore conclude that:

(1) 'Profitability' is not as useful an indicator of financial system reform as data on 'competitiveness' or 'financial intermediation'.
(2) While 'profitability' is not as good an indicator of the effectiveness of financial system reform as 'competitiveness' and 'financial intermediation', data retrieved concerning operational efficiency in the first empirical research does provide a partial picture of the effectiveness of financial system reform.
(3) 'Performance' (of the FHCs in Taiwan) may serve as the third indicator to show how implementation of Taiwan's FHCA might be assessed. However, as both research periods are relatively *short-term*[50], a full assessment of the performance of Taiwan's FHCA is not only impossible but beyond the scope of the dissertation.

As it stands now, both the FHC banks and non-FHC banks, if properly managed, can achieve satisfactory operational efficiency. In fact, in addition to FHC's cross-industry operation, there are three other means to achieving corporate synergy: (i) strategic alliance (e.g. "joint venture" or "strong-tied cooperation"), (ii) reinvestment (through subsidiaries, *Zhuan Tou Zi*, in Chinese), and (iii) universal banking (German model). This coupled with a policy concern that there are certain tradeoffs for opting to become an FHC; it is advisable for bank's management to decide whether it is worthwhile turning their bank into an FHC, after weighing all the pros and cons. The larger a financial institution gets, the more expensive it is to keep running. How to strike a balance is the key, as there is, with no doubt, lots of overhead to cover, among other costs. That being said, the overall operational expenses may otherwise be reduced due to the savings in both employment and IT development costs, as a result of operational synergy. The commentator has correctly pointed out that in the initial stage of synergy, operational costs tend to be higher than those already incurred prior to the establishment

[50] More specifically, in the first empirical research I reviewed, the research period spanned 4 years in total and only 2.5 years following the promulgation of Taiwan's FHCA. The 2nd empirical research spanned 2.5 years and only a half year after the FHCA.

of an FHC[51]. Synergy of all-round financial services institutions (including all three or at least two of them: banking, securities, and insurance) for transformation into an FHC involves not only the consolidation of capital assets but also the adaptation to different corporate cultures and management philosophies. Different corporate cultures can reflect on different management styles, too. For instance, banking business is short-term by its nature as opposed to the insurance business that is more long-term; consequently, bank management teams tend to take a more risky approach than their counterparts on insurance management teams, in assisting their parent companies to make investment decisions for the entire FHC.

5. ESSP (Environment, Strategy, Structure, Performance) Module and Theory

There are numerous reasons that attribute to financial services companies' cross-industry selling and marketing. Market competition is one major driving force, on top of the overall external financial environment change, said one commentator[52]. He proclaimed that although optimal *Performance* is the ultimate goal for operational synergy, from a strategic management perspective, however, the key in creating optimal operational efficiency is to "fit in" all other determinants, including *Environment*, *Strategy*, and *Structure*, to a satisfactory degree. In this light, the acronym ESSP stands for "Environment", "Strategy", "Structure", and "Performance" and ESSP also symbolizes their integration. In the ESSP module, a successful business must rely on a set of correct strategies that needs to be correspondent to external environmental change at all times. Once a strategy goes beyond the realm of the external environment, such a strategy might hardly achieve any projected performance target. That goes on to say, if the external environment changes, other variables (such as strategy and structure) should also be changed accordingly for the sake of adaptation. That means, once business strategies fail to respond to an external environment, the success of business operations are not attainable. In parallel, once the strategies have been devised, they would still need to seek for the most adaptive measures to apply and fit into the corporate structure.

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[51] *Ibid.*
[52] Peng, *supra*, note 22, at 5.

Only when the environment, strategy, and structure (all three factors) can adapt to each other and work together to the extent of total satisfaction then optimal operational efficiency can be achieved[53].

To apply the ESSP module to the development of financial holding companies in Taiwan (as part of Taiwanese government's aim to provide a solution for their over-banking problem), one can draw certain conclusions consistent with the theories that underlie ESSP. Prior to the promulgation of Taiwan's FHCA, that is, in the pre-FHCA era,

(5.1) In the Pre-FHCA Era

(5.1.1) "E" for (financial management) Environment

Taiwan's banking *environment* was previously as described below[54]:

(i) Banking business focused only on making loans rather than exploring other profit-making opportunities,

(ii) Banking information was not easily accessible to customers,

(iii) Customers generally lacked a sense of taking control of their own financial decisions. That is, customers were less sophisticated and therefore easily sold poor banking advice provided by banks or other financial institutions (such as securities firms or insurance companies).

(iv) Banks were subject to stringent market control (i.e. government interference).

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[53] *Ibid* at 5-6.
[54] *Ibid* at 7.

(5.1.2) "S" for Strategy

It is against such a backdrop that operational *strategy* calls for banks to focus their attention on its major lending business (i.e. making loans), in order to bring in revenues. As other business venues were left unexplored, suffice it to say, in the 1990s, banks in Taiwan started to get into price competition by lowering interest rates as much as they could in order to maintain their market standing. In retrospect, this ill-planned business strategy not only spawned the bad seed for the over-banking problem[55] in Taiwan but ultimately led to a series of bank runs and the banking storm in 2000 (the Zhong Xing Bank Scandal). For details, please refer to Chapter 1 of this dissertation in regards to a "Brief Banking History of Taiwan".

(5.1.3) "2nd S" for Structure

In terms of (corporate) *structure*, banks in the Pre-FHCA era were barred from engaging in other financial (or non-banking) activities such as securities or insurance dealing or underwriting, albeit with certain very limited exceptions. The most common exception is for banks to provide life insurance for customers residing in rural areas, as government policy required.

(5.2) In Post-FHCA Era

In juxtaposition to the Pre-FHCA era, ever since Taiwan's FHCA was promulgated in July 2001, banks (in the Post-FHCA era) have become more innovative and active in devising business strategies to attain optimal operational efficiency and to enhance revenue for the entire financial conglomerate. The global market *environment* called for business *strategies* that were more viable and innovative. Contrary to the "ill-

[55] The overbanking problem in Taiwan refers to the exceedingly large number of banking institutions, which often engage in price competition (or even, in some extreme cases, conduct unlawful lending practices) in order to remain competitive.

informed or less educated customers" in the Pre-FHCA era, there are now many more savvy customers who want to take control of their own financial situation by requesting financial institutions (including banks, securities firms, and insurance companies) to provide more professional, viable, and customer-tailored financial services. As customer awareness is elevated, so are the expectations and demands for all-round financial services.

(5.2.1) "E" for (financial management) Environment

The Post-FHCA era features:

(i) Savvy customers, who are more aware of their financial needs and want to take the initiative to decide their own financial future.

(ii) All-round Financial Services—as the demand for banking/financial information accessibility has been increased, this in turn prompted banks and other financial institutions (such as securities firms and insurance companies) to seek for opportunities for cooperation or synergy, in order to provide customers with "one-stop shopping financial services".

(iii) Reduced costs for financial transactions—Cooperation or synergy among all three types of financial services can result in reduced overhead and operational costs. This in turn is reflected in reduced transaction costs for customers.

(5.2.2) "S" for Strategy

Faced with strong competition, both locally and globally, financial institutions in Taiwan (as with those in the U.S.) have aggressively sought for opportunities for synergy. Synergy can build stronger ties with another company, as opposed to more informal tie (in a more loosely-connected situation). Regardless of whether it is an insurance company, a securities firm, or one bank seeking the opportunity

to merge with or acquire another bank in order to form a financial holding company (FHC); or one FHC seeking another FHC to merge ("second wave merger", such as Chinatrust FHC's attempt for aggressive takeover of Mega FHC in Taiwan in June 2006), both scenarios are reflective of the strategy devised by each management team (at all level, up from the parent FHC and down to each subsidiary) in the FHC to create revenue. For details about Chinatrust's attempted takeover of Mega FHC, please refer to Chapter 2 of this dissertation regarding "Financial Holding Companies in Taiwan".

Does bigger mean better? Even though the mega-size merger strategy has both its supporters and opponents, according to one recent study, in the U.S., 90% of all bank holding companies holding assets of US$ 10 billion have been rated as first-class companies. This high rating stands in sharp contrast with other holding companies that possess assets of less than US$ 1 billion—for these smaller-scaled companies, the chances for them to be rated as a first-rate company are reduced to only 35%[56].

(5.2.3) "2nd S" for Structure

The key for attaining optimal business performance, as one commentator pointed out, is to be able to devise management strategies that fit well into the financial company's structure, and would simultaneously adapt to any business environment change[57].

Structurally speaking, emphasis need be made that in addition to FHCs (which represents the ultimate form of operational synergy), there are three other ways to seek cross-industry cooperation, namely strategic alliances (with strong ties), reinvestment (through subsidiaries), and universal banking. The advantages and

[56] Peng, *supra*, note 22, at 4 (original note 2). [The author quoted the research result published by Zhong-Hua Shen, "The CAMEL Analysis 1997-1998 for both Financial Holding Company's Bank Subsidiary and Independent Bank" (2002), Taiwan Banking & Finance Quarterly, Vol. 3, No. 2, pp. 73-82.]
[57] *Ibid* (Peng) at 7.

disadvantages of each of the four types of cross-industry operations will be discussed shortly in the next section (sub-conclusion).

(5.2.4). "P" for Performance

At this point, it seems awfully clear that the ESSP module proposes a theory that emphasizes the "cause and effect" sequence of (i) studying business *Environment*, to (ii) devising business *Strategy* that would (iii) *fit* well into the corporate *Structure*, in order to (iv) achieve the optimal *Performance* of a financial institution (in our case, the financial holding company). Only when "environment", "strategy", and "structure" are integrated can optimal performance be attained. Since all these factors are closely intertwined, when the "environment" (be it local or global financial environment) changes so should the other variants (such as "strategy" or "structure") be changed in order to reflect environmental changes. In doing so, it can be reasonably expected that optimal performance would be attainable.

6. Sub-conclusion

(6.1) Taiwan and the U.S. Both Adopt a "Two-Pronged" Approach (FHC + Subsidiary Reinvestment)

Having weighed in on both the advantages and disadvantages of the FHC, and as well having referred to the competitiveness studies focusing on both FHC banks and non-FHC banks, it is apparent that the FHC is not the only option for financial services development. As an alternative, financial service providers typically choose to make investment through their direct subsidiaries. For this very reason, Taiwan adopts a "two-pronged" approach by encouraging FHC establishment on the one hand, and permitting the use of direct subsidiaries (*Zhuan Tou Zi*, 轉投資, in Chinese) on the other, so as to provide a platform for company seeking investment ventures. Likewise, such a two-

pronged approach is also adopted by the U.S. That is to say, both the U.S. and Taiwan allow the so-called "dual system" to co-exist: (i) FHC and (ii) Reinvestment through Subsidiaries (*Zhuan Tou Zi*, 轉投資, in Chinese). In doing so, financial institutions in both countries can engage in all-round financial services or diversify their investment venues.

In the U.S., holding companies with lower capital levels can opt to make their reinvestments through their direct subsidiaries, without having to broaden their capital base (by lending or issuing corporate bonds) in order to become an FHC. That would be too cumbersome for many relatively small-sized holding companies in the United States. Other than holding companies, banks in the United States (including both the national and state banks) can also engage in new financial activities through their direct subsidiaries if certain conditions are met.

First, for *national* banks, in order for them to own or invest in a financial subsidiary that engages in new financial activities, as granted by the GLBA, the bank and all of its affiliated depository institutions must be "well capitalized", "well-managed", and CRA[58]-rated "satisfactory" or better. But unlike an FHC, the following additional conditions apply: (i) The consolidated assets of the national bank's financial subsidiaries must not exceed US$ 50 billion or 45% of the bank's consolidated assets, whichever is less, (ii) If the bank is among the 100 largest in the United States, its long-term debt must receive one of the top three investment grade ratings, (iii) The bank must receive prior approval from the OCC[59] to engage in any of the newly-authorized activities, (iv) A national bank must also satisfy certain "safety and soundness firewall requirements" to ensure that the risks assumed by any of the bank's direct subsidiaries (for investment purposes) is truly separate from their parent bank, (v) In a similar vein, the national bank's equity investment in a financial subsidiary must be deducted from the bank's capital in applying regulatory capital adequacy standards, (vi) The national bank must have risk management procedures in place to protect it from risks relating to the financial

[58] CRA is a short name for the *Community Reinvestment Act*.
[59] OCC is a short name for the Office of the Comptroller of the Currency.

subsidiary and to preserve the separate corporate identity and limited liability of the bank[60].

Secondly, for *state* banks, the GLBA makes clear that a state bank also will be eligible to own or invest in a financial subsidiary, provided that state law allows the bank to do so. The Act imposes federal conditions on such ownership by state banks that are similar, but not identical, to the conditions imposed on a national bank's ownership of a financial subsidiary. Case in point, a state bank is subject to the "well capitalized" and "CRA-rated satisfactory or better" requirements, but unlike a national bank, state banks are not subject to the statutory "well managed" requirement. Nonetheless, as state banks are allowed to engage in activities authorized for national banks, this would ensure competitive equity between the two types of charters[61].

(6.2) Debate about FHCs vis-à-vis Universal Banks

As there are both advantages and disadvantages to the universal banks (typically represented by the German universal banking model), so is the case with FHCs. There is indeed no consensus yet which system is better, the FHC or the Universal Banks? Most scholars settle the issue by saying that there is no definite answer to this question, and there is no common way either to describe which system is better than the other. And yet, skeptics about universal banks mainly focus their concerns on whether universal banks uphold too much economic power and whether they have effective firewalls. Universal banks can engage in a wide range of financial businesses—under this system, banks are allowed to engage *directly* in both banking and securities business and *indirectly* in the insurance business through a banks' subsidiary. The German Universal Banking System, which is the prototype of a universal bank, where banks' permissible activities include commercial banking, securities, foreign exchange, trade of gold, and investment trust is such an example. The German Universal Banks are basically designed to be able to provide "one-stop shopping financial services"—their banks are said to be the most open

[60] Covington & Burling, *supra*, note 19, at 8-9.
[61] *Ibid* at 9.

(uninhibited) banks in the world[62]. To this end, a commentator suggested that the universal banking system is vulnerable to concentration of economic power by only a few selective banks; this could in turn impede competition and cause conflict of interests.

Though there is a historical reason for U.S. to adopt the FHC system—before the FHC was introduced in November 1999 (by GLBA which substantially modified the BHCA of 1956), for 43 years, the U.S. financial industry has relied on the bank holding company structure to engage in similar activities as FHCs. Commentators also generally agree that the FHC structure is less cost-effective (more costly) than universal banks[63]. This not only refers to the fact that the parent company (FHC) cannot directly engage in any of the banking, securities, or insurance business and therefore has to set up each subsidiary to do every business as indicated above but also that FHC supervision is more costly than single-head universal banking supervision. Taking FRB, the "umbrella regulator" for FHCs in the U.S. as an example, the FRB has to oversee and incorporate the supervisory work done by all its subordinated "functional regulators", including banking by OCC, securities by SEC, and insurance by SIC.

The E.U. *Second Banking Directive* of 1989 proclaimed to have set out three principles for their member banks to observe: (i) the principle of home country control (i.e. the derogations to the country of origin principle), (ii) the single-license principle, and (iii) mutual recognition. The *Directive* introduced the basic idea that individual member states belonging to the E.U. should "mutually recognize" their respective banking laws and banking licenses. In actual effect, the *Directive* requires that the banking license issued by one member state be recognized by other member state (mutual recognition); as a result, no second banking license needs to be issued for home country banks to conduct similar banking business in the host country member state. The *Directive* stipulates that the host member state shall renounce its regulating functions in relation to foreign credit institutions in favor of the home member state[64]. As "mutual

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[62] Wang, *supra*, note 24, at 196.
[63] *Ibid* at 197.
[64] "Banking Legislation in Transition Economies" by Professor Ing. Otto Sobek, CSc. [On-line information, http://www.nbs.sk/BIATEC/SOBEKAN.HTM]

recognition" would force the less-liberalized countries to forgo a higher degree of government supervision that is currently the situation in Taiwan, in my view, this might explain why Taiwan follows the more "revolutionary" U.S. model rather than the fairly "evolutionary" E.U. model. Referred to as "evolutionary"—after all, the U.S. model (the GLBA of 1999) did not come about until a decade later than the E.U. model (the *Second Banking Directive* of 1989). Unlike in the U.S., Taiwan does not have 43-years of bank holding company experience. Rather, before Taiwan's FHCA was promulgated in July 2001, Taiwanese banks' "permissible activities" included almost full service financial services (commercial banking, life insurance, bill finance, credit cards, securities etc.), which are obviously more in line with the universal banking model. In the light of this, one commentator in Taiwan suggested that Taiwanese banks' "scope of permissible financial activities" has NOT been substantially expanded, as a result of the FHCA. He further suggested that before Taiwan's FHCA was promulgated in July 2001, Taiwanese banks could engage *directly* in almost any financial service; this flexibility has nonetheless been constricted with the FHCA. That is because similar to the U.S. GLBA, Taiwan's FHCA requires banks to set up an additional FHC (as a parent company) to oversee all FHC businesses done by each of its direct subsidiaries (banks, securities firms, and insurance companies). It also means that the "FHC bank" cannot engage directly in any of the banking business but must do so by additionally setting up a banking subsidiary. Hence, an "FHC bank" would only refer to the banking subsidiary of an entire FHC, which is very different from the "universal banks" (in the pre-FHCA period) where banks in Taiwan can engage *directly* in nearly any financial service. A commentator has suggested that the "scope of permissible financial activities" for Taiwanese banks has actually been "reduced", rather than "expanded"[65].

Though there is some truth to this explanation, my view is that the commentator has failed to recognize that the very essence of an FHC is structurally designed for "risk diversion". By erecting "fire walls" between each and every subsidiary of an FHC, be it subsidiary banks, insurance company, or securities firms, the risk assumed by each of

[65] Ming-Sheng Dai, "Comments and Analysis on the Financial Holding Company Law" (*Jin Rong Kong Gu Gong Si Fa Zhi Ping Xi*, in Chinese) (2003) 69 Law Commentary (*Fa Luu Ping Lun*, in Chinese) 20 at 30. (In Chinese)

these subsidiaries can be effectively contained without spreading risk to other subsidiaries within the wholly integrated entity of the FHC. That is to say, each subsidiary of the FHC, whether it is the banking arm or other insurance or securities arm, has its own legal person status. In juxtaposition, the commentator's view of the "Taiwanese banks' scope of permissible activities has been reduced rather than expanded" is only projected from the angle of the "bank" itself, rather than "universal banks" in regards to its entire function. There is no denying that the concept of "fire walls" equally exists in universal banks, although due to the closeness in business relationships, such fire walls are more easily penetrable than those in FHCs. For the sake of avoiding "conflict of interests", the advantage of the FHC structure should be stressed. The empirical study as mentioned above also supports this view by attesting to the reduced "risk index" of the FHCs, compared to that of Taiwanese "universal banks" in the pre-FHCA stage (prior to the FHCA's promulgation in July 2001).

(6.3) Tax Benefits for FHCs in Taiwan—Causing "Unfair Competition"?

In order to encourage FHC establishments in Taiwan, tax incentives have been provided by the Taiwanese government in order to reach that goal. Embodied in Articles 28, 49, and 50, the FHCs in Taiwan enjoy preferable tax treatment to other non-FHC financial institutions. Specifically,

(i) Article 28 prescribes that if a financial institution has been approved by the FSC to be transformed to become an FHC, and the land directly used by the financial institution is to be transferred (to the FHC), "the registration of transfer of ownership of such land shall be done after the current value of such land has been determined in accordance with the Land Tax Law. The land value increment tax payable on such transfer may be accrued and *deferred* until the next transfer of such land by the transferee company....(Paragraph 2)"; in the same vein, "[t]he stamp tax, deed tax, income tax and securities transfer tax arising from transfer of business *shall not be levied.* (Paragraph 3)"; furthermore, "[t]he income

tax and securities transfer tax arising from transfer of shares shall not be levied. (Paragraph 4)".

(ii) Article 49 of Taiwan's FHCA, further permits the FHC and its subsidiaries to file a *consolidated enterprise income tax return*, if the FHC is entitled to declare itself as the taxpayer by holding an overwhelming majority of outstanding shares of its subsidiaries. It is stipulated that "[w]here a Financial Holding Company holds more than ninety percent (90%) of the outstanding issued shares of a domestic Subsidiary, such Financial Holding Companies may, for the tax year in which its such shareholding in the Subsidiary has existed for the entire twelve (12) months of the tax year, elect to be the taxpayer itself, and jointly declare and report profit-seeking enterprise income tax and the ten percent (10%) tax surcharge on surplus retained earnings of a profit-seeking enterprise in accordance with the relevant provisions of the Income Tax Law. Other tax matters should be handled separately by a Financial Holding Company and its domestic subsidiary."

(iii) Article 50 of Taiwan's FHCA dismisses FHCs on certain liability that would otherwise be regarded as circumvention of a taxpayer's obligation, and instead would only make necessary tax adjustments for such FHCs. "With regard to transactions between a Financial Holding Company and its domestic Subsidiary, or, between a Financial Holding Company or the Subsidiary of a Financial Holding Company, and domestic or overseas individuals, profit seeking enterprises, or educational, cultural, social welfare, charitable or [other] groups, where the amortization of income, cost, expenses, profits and losses are based on a *non arms-length* arrangement *for purposes of avoiding or reducing the obligations of a taxpayer*, the Financial Holding Company or Subsidiary has *improperly*, for itself or others, sought to avoid or reduce tax obligations by means of acquisition of shares, asset transfer, or other fraudulent arrangements, an auditing agency may, upon report to and approval of the FSC, *adjust* such income and tax payable based on normal business practices or [other

relevant] information for purposes of the accurate calculation of the income and taxes payable by the relevant taxpayer. (Paragraph 1). However, the above shall not apply to transactions between a Financial Holding Company and a domestic Subsidiary in which the Financial Holding Company holds over ninety percent (90%) of the outstanding issued shares (Paragraph 2). The consolidated tax reporting provisions of the preceding Article shall not be available to a Financial Holding Company or its Subsidiary for the year in which an auditing agency, in accordance with the provisions of the preceding paragraph, has adjusted the income and tax payable for such Financial Holding Company or Subsidiary. (Paragraph 3)".

(iv) A commentator pointed out that the aforementioned preferential tax treatments pertaining to the domestic FHCs in Taiwan runs in the face of the "tax equity principle", as the same prerogative does not apply to non-FHC financial institutions[66]. Though it is understandable that the Taiwanese government uses this to encourage FHCs, it is imperative to note that the same tax incentive could otherwise become causes for both "unfair competition" and "moral hazard". Specifically, the preferential tax treatments (embodied in both Articles 49, 50 as mentioned above) only applies to domestic FHCs, and NOT non-FHC financial institutions; this also means that the differences in tax treatment have nothing to do with both horizontal and vertical equity, and consequently such a tax incentive violates the tax equity principle. Vertical equity focuses on the equitable tax treatment in the vertical relationship between the enterprise (FHC or non-FHC) and its respective shareholders (FHC shareholders or non-FHC shareholders), and horizontal equity, the revenue income generated by both types of enterprises (FHCs or non-FHCs). Referring to it as "horizontal" is because on principle, one enterprise (non-FHC) at the same revenue level should receive the same unbiased tax treatment as

[66] Yuan-Yao Wu, "Financial Holding Company's Preferential Tax Treatment and Related Issues" (*Jin Rong Kong Gu Gong Si Zhi Zu Shui You Hui Ji Xiang Guan Wen Ti*, in Chinese) (July, 2004) National Lawyers (*Quan Guo Luu Shi*, in Chinese) 67. (In Chinese)

another enterprise (FHC). That is to say, horizontal equity focuses on the horizontal basis between the FHCs and non-FHCs financial institutions and if these two company types have each generated an equal amount of revenue in the same taxable year, they should be taxed on the same scale. Without doing so, Articles 49, 50 of Taiwan's FHCA subject both FHCs and non-FHCs to different tax scales; consequently, the tax equity principle is violated.

(v) A violation of the tax equity principle, due to differential tax treatments between FHCs and non-FHCs, as intended by Taiwanese government through Articles 49 and 50 of Taiwan's FHCA, can further lead to "unfair competition". There are currently 14 FHCs in Taiwan and it is predicted that the number will be reduced from 14 to 7 (or even 5) in light of the Taiwanese government's command of a second or even third wave of mergers among domestic FHCs. Under the theory of "the bigger, the stronger, and staying on longer" (大者恆大, *Da Zhe Heng Da*, in Chinese), government interference will undoubtedly result in an "oligopoly" market. (Oligopoly is less likely to happen in the U.S. as it is market rule, instead of government interference, that has more influence in its banking movement.)

(vi) As a result of tax filing on a consolidated basis, subject to Article 49 of Taiwan's FHCA, the FHC is allowed to offset its tax bills by filing a consolidated enterprise income tax return to include a "problematic subsidiary" (ill-performing subsidiary suffering huge revenue loss) into the FHC's financial system. In doing so, the FHC can conveniently offset its tax liability by the amount of revenue loss arising from the problematic subsidiary's poor performance. Moral hazard is likely to occur where the subsidiary is "designated" by the FHCs to conduct risky investment activities, as long as the FHC (a parent company) holds more than ninety percent (90%) of the outstanding issued shares of its (ill-performing) subsidiary, as prescribed by Article 49 of Taiwan's FHCA.

The U.S. GLBA inspired Taiwan's enactment of FHCA, with the same vision (or hindsight, really) of providing a level playing field for their domestic FHCs to compete on a global stage, faced with strongest rivals from the E.U. member countries where they had benefited from operating in a less regulated financial environment, following banking deregulation in 1989 by the *Second Banking Directive* that was promulgated a decade prior to the U.S. GLBA of 1999. The number of FHCs in the U.S. is now over 600, and there are currently 14 FHCs in Taiwan. Given this information, there is no doubt that FHCs have grown into significance in shaping the financial landscape in both countries. Though the interpretation and application of their respective governing laws are nitty-gritty elements of a research undertaking, this dissertation, however, does not intend to provide a comprehensive account of the internal elements of both the U.S. GLBA and Taiwan's FHCA due to their complexity and the time and space constraints. That being said, a review of regulatory intentions behind both the GLBA and the FHCA has been conducted to see their reflection on both nation's laws. To imbue this dissertation with some theoretical perspectives, I further seek insight from the U.S. Congressional Report that carefully records the Senate's consideration of the bill, the "Financial Services Modernization Act of 1999", before it was officially passed by Congress.

III. Theoretical Perspectives

1. Deregulation

The GLBA forms the basis for a comparative study aiming to shed light on similar deregulation in Taiwan's banking industry, following the enactment of Taiwan's *Financial Holding Company Act* of 2001. While this dissertation accredits many scholars' adoption of the term "deregulation" to describe the breakdown of the imaginary wall that separates commercial banking from investment banking, emphasis needs to be made that "deregulation" herein does not equate with "absolute liberalization" but rather "radical modification". Deregulation of the banking industry entails a new (and even

more complicated) set of regulation, such as the GLBA, to fill in the place of the old regulatory regime. Consequently, I argue that the word "deregulation" is somewhat misleading and which can be replaced with a much better term "re-regulation". Suffice it to say regulation has changed rather than diminished.[67]

Despite most scholars referring to the GLBA as a result of deregulation, I argue that the GLBA is rather a form of "re-regulation". I want to emphasize the "evolutional development" of the GLBA, from "Regulation" to "Deregulation" and further to "Re-regulation". The linear direction denotes sequential development. "Regulation" is represented by the *Glass-Steagall Act of 1933*, followed by "deregulation", which is typically represented by the *Bank Holding Company Act of 1956*. In fact, the *Bank Holding Company Act of 1956* started the gradual relaxation of the *Glass-Steagall Act of 1933*. "Re-regulation" is otherwise represented by the GLBA. I prefer the term "re-regulation" because the GLBA does not intend total liberalization, but rather the scope of permissible financial activities has been expanded. There are still requirements to be met, for example: financial subsidiaries must be "well-capitalized", "well-managed", and their CRA (Community Reinvestment Act) rating must be satisfactory or better, and the so-called "permissible financial activities" must be financial in nature or incidental or complementary to financial activities.

This dissertation first brings under the microscope the deregulation in the banking industry in the U.S., reaching its climax following the enactment of the *Gramm-Leach-Bliley Act* (the GLBA). Legally speaking, by the time the GLBA was promulgated in 1999, it officially repealed the then 66-year-old *Glass Steagall Act of 1933* and substantially modified the then 43-year-old *Bank Holding Company Act of 1956*. Remarked by continuous efforts in updating the *Bank Holding Company Act* (the BHCA) to ensure its consistency with the GLBA, the BHCA itself has by far gone through another four amendments[68], subsequent to the GLBA's promulgation on November 12,

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[67] Richard A. Posner, "The Economic Analysis of the Law Approach—The Effects of Deregulation on Competition: The Experience of the United States" (2000) 23 Fordham Int'l L.J. 7 at 8.

[68] These four amendments refer to, in chronological order, (1) Oct. 26, 2001, P.L. 107-56, 12 U.S.C.S. § 1842; (2) Oct. 30, 2004, P.L. 108-386, 12 U.S.C.S. § 1841; (3) Feb. 15, 2006, P.L. 109-173, 12 U.S.C.S. §§

1999. The latest amendment, the BHCA of 2006[69], as commentary suggests, is an expression of sentiment that the U.S. as a nation has often been distrustful of concentrated economic power that may accrue to organizations providing economic services, such as financial holding companies by virtue of the GLBA. Bearing this in mind, in passing the BHCA, Congress thought both to limit concentration of banking resources and to implement policy that bank holding companies ought not to manage or control non-banking assets having no close relationship to banking[70]. The aspiration of limiting banks' undertaking of "activities that are not closely to banking" continues today and is enshrined as one of the tenets set out by the GLBA in the context of legislative restraints. In summary, the GLBA does not alter the old BHCA principle of limiting banks' undertaking of "non-banking activities" but simply broadens the scope of "permissible banking activities" which may have otherwise been trapped in the category of "activities that are not closely to banking", according to and as determined by the BHCA of 1956 and its later amendments prior to November 1999.

In order to foster competition and innovation in the financial services industry, Title I of the *Gramm-Leach-Bliley Act* repealed Sections 20 and 32 of the *Glass Steagall Act* and amended Section 4 of the *Bank Holding Company Act of 1956*[71]. While the primary focus of Title I is to remove firewalls between banks, securities firms and insurance companies and to remove the prohibition on interlocking management, the GLBA did not change the fact that any activities in which a bank holding company wishes to engage in must be "closely related to banking". As mentioned earlier, only the definition of this phrase, "closely related to banking", has been broadened. In essence, a financial holding company is again authorized to engage in the same activities as bank holding companies (either directly or through non-bank subsidiaries), and is further permitted to engage in activities deemed to be "financial in nature or incidental to such financial activity". Consequent to the "deregulation" of the previous regulatory restraints, the GLBA "re-regulates" permissible activities for a financial holding company. More

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1841, 1842; and (4) Oct. 13, 2006, P.L. 109-351, 12 U.S.C.S. §§ 1841, 1843.

[69] Oct. 13, 2006, P.L. 109-351, 12 U.S.C.S. § 1841.

[70] "Interpretive Notes" for Oct. 13, 2006, P.L. 109-351, 12 U.S.C.S. § 1841, provided by the Lexis Publishing ™ Companies.

[71] 12 U.S.C. §1843 (2000).

specifically, deregulation has initially been implemented by the *Bank Holding Company Act of 1956* et seq. (the BHCA). The BHCA started breaking down the barrier between commercial and investment banking which was once set up and strongly upheld by the *Glass Steagall Act of 1933*. Further, the BHCA ameliorated the regulatory restraints in the *Glass Steagall Act of 1933* and broadened the scope of permissible financial activities for banks to conduct certain investment activities as long as they are done so through the so-called "Section 20 Subsidiary" of the bank holding company. Taking it one step further, the GLBA of 1999 profoundly redefines and re-regulates the permissible financial activities for a bank holding company that wishes to transform itself into a new type of entity called "financial holding company".

(1.1) Deregulation in the Banking Industry

There are certain prominent features pertaining to the deregulation of the banking industry in the U.S.. First, the banking industry sought to boost its competitiveness through mergers. The GLBA is premised on the presumption that mergers between banking, insurance, and securities industries to become financial holding companies (FHCs) would boost global competitiveness for the U.S. financial industry. Taking this view, one congressman who was in favor of mergers further quoted then Federal Reserve Chairman Alan Greenspan's statement as saying "Consumers of financial services are denied the lower prices, increased access and higher quality services that would accompany the increased competition associated with permitting banking companies to expand their activities...We cannot afford to be complacent regarding the future of the U.S. banking industry. The issues are too important for the future growth of our economy and the welfare of our citizens."[72] The Congressman who lobbied vehemently for mergers also accredited the GLBA as "a win for America's international competitive

[72] "Conference Report on S. 900, Gramm-Leach-Bliley Act". U.S. Congressional Record—Extensions, Wednesday, November 10, 1999, 106th Congress, 1st Session, 145 Cong Rec E 2343. The text of the conference report mirrors the speech of Hon. Edward R. Royce of California in the House of Representatives on Thursday, November 4, 1999.

position, as it will allow U.S. companies to compete more effectively with foreign firms for business around the world."[73]

Secondly, the banking industry has come a long way from being heavily regulated to being deregulated. Deregulation in the banking industry had resulted in fierce price competition; with a view to correcting the market disorder, the U.S. government had provided large subsidies in order to (i) meet the "political need" for a plurality of ownership, (ii) to protect home industry from foreign ownership and (iii) to ensure the safety and soundness of the overall banking/financial system. In order to prevent the amount of government subsidy from reaching into an unsustainable level, the banking industry was handed over to the invisible hand of market rule. This situation inevitably called for another wave of mergers and acquisitions between banks and other financial companies.

Thirdly and of utmost concern is the hazard of creating monopoly, oligopoly, or cartels; this was a concern in both the banking and financial industries. According to one commentator, circumstances that lead to monopoly or oligopoly include when the products at issue in the relevant market are homogenous, transactions are frequent, pricing is standardized, information on the pricing and output strategies of rivals is easily accessible, or customers are insensitive to price changes[74].

In my view, however, the banking industry is less susceptible to monopoly or oligopoly because banking products and services are more individualized and customer-oriented. Furthermore, banking products and services are more diversified and complicated than those provided by companies in other industries. In the realm of customer relationship management, banks strive to "woo" their customers by providing better services at a lower cost in exchange for customer loyalty; on the other side of the same spectrum, bank customers also like to form a longer relationship with their chosen banks so that they are in a better position to negotiate for a better banking deal at a

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[73] *Ibid.*

[74] Thomas A. Piraino, Jr., "A New Approach to the Antitrust Analysis of Mergers" (2003) 83 B. U. L. Rev. (Boston University Law Review) 785 at 820.

relatively lower cost. As one can see, this relationship works both ways. In addition, in catering to bank customers' needs, banking services tend to be "customer-tailored" and hence being provided on a more personal and even negotiable basis. A case in point is when bank customers are likely to get a more favorable interest rate for consumer loans; in this regard, customer loyalty is beneficial for the customer. In the banking business, as one can see, it is "trust based" and "relationship-oriented"; consequently, the level of familiarity and comfort that bank customers feel for their own banks makes one bank less indispensable than the other. This helps explain why bank monopoly is less likely to occur on the theory that bank services are "less homogenous" than services provided by other industries.

Another reason that is attributable to this phenomenon is that banking products and services are more complex and highly diversified. Categorically speaking, bank products and services comprise (i) investment banking, (ii) commercial banking, and (ii) personal and (small) business banking. Retail banking covers both personal and small business banking, where transactions are executed in smaller amounts. If small business banking reaches a certain level, then small business must upgrade to use commercial banking services instead. The level is set differently depending on the bank's internal decision on what the limit should be, for example the defining line between small business and commercial banking may be up to CND$ 0.5 million. Commercial banking could be more advantageous for medium to large businesses because commercial banking departments can provide more complete and personalized services (such as insurance against U.S. foreign exchange) for corporate clients that are otherwise not available for smaller businesses. Business banking (and personal banking) includes bank products and services ranging from credit lines, credit cards, foreign exchange, investment services, and customer loans. Loan products are normally grouped into three categories, real estate lending (mortgage and equity lending), student loans, and auto loans. Commercial banking, on the other hand, caters to the needs by large corporations, such as offering strategic and financial advisory services, including acquisitions, mergers, divestures, financial restructurings, loans, foreign exchange, cash management, structuring, underwriting and distributing equity. Taking Citigroup as an example,

economies of scale allows the financial conglomerate to simultaneously engage in several businesses, including commercial banking, consumer finance, credit cards, investment banking, securities brokerage, asset management, property casualty and life insurance etc. Its comprehensive financial services could be as complex as it can be customer-tailored. By this definition, bank customers tend to be more loyal than customers in other industries, as they are more dependent on bank managers' financial advice to make a sound banking decision. "Principal-agent" theory explains banks' obligation in ensuring the effectiveness of firewalls (between various departments) in order to prevent or reduce opportunities for conflict of interest (for details, see Part II: Theoretical Perspectives). On top of that, based on the "source of strength doctrine" (for details, see Chapter 3) and good corporate governance, a financial holding company (FHC) is obliged to assist its subsidiary banks, insurance companies, and securities firms when they are in financial distress; consequently banks will seek to maintain their sustainability by avoiding over-expansion. In this regard, I am of the view that a banking monopoly is less likely to occur if the industry is shaped by market rule, rather than government interference. On this point, the maturity of competition law also helps to rebut any chances of bank monopoly.

(1.2) How did the U.S. GLBA Inspire Taiwan's FHCA? A Canadian Perspective

In combating the over-banking problem in Taiwan, which was blamed for the failure of certain lesser-capitalized banks, a series of bank runs, and eventually the banking crisis in 2001, the Taiwanese government resolved to promote mergers among local banks and financial institutions to become FHCs, following the promulgation of the *Financial Holding Company Act* of 2001 (FHCA). In fact, Taiwan's FHCA, promulgated on July 9, 2001, owes much of its content to its U.S. counterpart, the GLBA, which was promulgated on November 12, 1999.

Worth noting, despite both countries (the U.S. and Taiwan) sharing the economic aspiration of employing mergers to boost domestic banks' global competitiveness, this

optimism, however, is challenged by an employee of the TD Financial Group (hereafter "TD"), one of the "big five" national banks in Canada. In a recent interview, this employee spoke of the fact that Canadian banks have long pushed the government for allowing the existing "big five" to merge and hence build a bigger and stronger capital base. In a suggestion to reduce the current number of five national banks to three ("the Triad") and accordingly form a "healthy oligopoly", the Triad's enhanced capacities for generating higher profit margin is slated to gain a stronger global competitive edge, said many. Contrary to the wide spread myth of "the bigger the better", the TD representative emphasized that "*growing bigger* does not necessarily mean *going global*". A case in point, he indicated that "TD had been granted permission to buy a U.S. bank. Though the merger has grown TD into an even bigger financial group, TD however, has not yet figured out where to reallocate the newly acquired assets in a global market. As a matter of fact, the extra cash still remains in the domestic market and has not yet been taken to the global market for further reinvestment."[75]

(1.3) Lessons for the Banking Industry to Learn

Deregulation was the legislative response to counteract the problems bogging down the banking industry.

Overcapacity, a problem reflected in the imbalance of capacity and demand poses a serious threat to many U.S. companies, including those in the financial industry. Deregulation ensued by the *Bank Holding Company Act of 1956* (the BHCA) had dramatically increased the number of bank holding companies in the U.S. as they intend to participate and hence profit from the more lucrative securities business. In practical effect, the BHCA allows banks to affiliate with non-banking institutions for providing securities underwriting and brokerage services, provided that such activities should be conducted through the so-called "Section 20 Subsidiary" and that any Section 20 Subsidiary be limited to 5% of revenues from securities activities. As more bank holding

[75] Interview with Michael Molson, counsel to TD Bank Financial Group (Legal Department, Western Canada and Territories). The interview took place on October 30th, 2006.

companies are jumping into the financial market to share the customer base, deregulation through the BHCA only leaves many banks with flat revenue and become less competitive. Faced with growing challenges, both domestically and internationally, the U.S. financial industry had lobbied vehemently for Congress to pass the GLBA for allowing mergers across all three financial sectors (banking, insurance, and securities). It was generally conceived that mergers of this magnitude would help level the playing field for the U.S. financial industry and enhance their global competitiveness. By pooling together a stronger capital base, banks are now enabled to make profits at a higher margin. For example, banks are poised to benefit from conducting large-scaled lending practice at a lower cost, as mega-size mergers would typically boost the confidence from banks' depositors or shareholders. Likewise, banks can also benefit from reinvesting their revenue surplus by underwriting securities, purchasing government bonds, or subscribing to shares in an open market, such as New York Stock Exchange. For the very reason, the U.S. financial industry was counting on the formation of FHCs to substantially raise banks' profit margin and to render themselves more competitive, both nationally and globally.

Deregulation, on the other hand, closely mirrors the reality in financial market practice. Supporters of the H.R. 10 (the House of Commons' presented bill for GLBA) have correctly pointed out that "without this bill, banks will continue to expand into the securities and insurance business as they have been doing for some years under current law. However, they will do so without CRA (Community Reinvestment Act) coverage, without privacy protections, without the regulatory oversight and regulatory protections enhanced in this bill, and with artificial structural limitations that will place the U.S. financial services industry at a clear competitive disadvantage. Without this bill, commercial firms will continue to move more and more into the banking business, with no real limitations."[76] This view also closely mirrors the popular use and acceptance of "securitization", a securities-like financial product that has overtime become a basic element of commercial banking practice. Securitization is regarded as a permissible

[76] "Congress Report on S. 900, *Gramm-Leach-Bliley Act*", 145 Cong Rec E 2308 (1999), during 106th Congress, 1st Session. (Congressional Record Extensions, Vol. 145, No. 156)

banking activity, seeing as it is a good measure for banks to distribute their risks. Concerning this fact, there is no denying that the traditional demarcation of securities and banking activities has been blurred. As it is now, securities underwriting in the realm of securitization does not necessarily increase but rather alleviate and diversify commercial banks' own risk undertaking from extending loans or approving mortgages.

While those in favor of passing the bill for the GLBA stressed that in banking practice nowadays, the strict separation of commercial from investment banking no longer exists nor does it serve the people's banking needs. Such a viewpoint is not shared by strong opponents of the bill who instead emphasized the importance of maintaining the old rule that demarcates the two traditionally-defined banking divisions.

Opposition to the S. 900 (the Senate's presented bill for GLBA) nevertheless held that "it authorizes banks' direct operating subsidiaries to engage in risky new principal activities like securities underwriting and, in five years, merchant banking with Treasury and Federal Reserve approval. The flimsy limitations and firewalls will not hold back threats to taxpayers and depositors."[77] Clearly, this commentary was premised on Section 3(a)(2) of the *Bank Holding Company Act of 1956* (BHCA)[78]. Indeed, before the GLBA came into being in November 1999, under the then-current law of the BHCA, bank holding companies were generally prohibited from acquiring more than five percent (5%) of the voting shares of any company whose activities are "not closely related to banking". Pertaining to this, the Federal Reserve had determined that a securities affiliate of a bank holding company cannot acquire or retain more than five percent (5%) of the voting shares of a company in a market-making or dealing capacity. In addition, for purposes of determining compliance with this five percent (5%) limit, the Federal Reserve had required that the voting shares held by the securities affiliate be aggregated with the shares held by other affiliates of the same bank holding company.[79]

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[77] "Conference Report on S. 900, Gramm-Leach-Bliley Act", 145 Cong Rec E 2302 (1999), during November 8, 1999, 106th Congress, 1st Session. (Congressional Record—Extensions, Vol. 145, No. 156)
[78] 70 Stat., Public Law 511, the *Bank Holding Company Act*, May 9, 1956.
[79] *Supra* note 76, "Congress Report on S. 900, *Gramm-Leach-Bliley Act*", 145 Cong Rec E 2308 (1999).

This "sticking to the old rule" approach was rebutted by supporters of S. 900 as follows. First, supporters indicated, "by permitting financial holding companies to engage in underwriting, dealing and market making, Congress intends that the five percent limitation no longer apply to *bona fide* securities underwriting, dealing, and market-making activities...(Indeed) the elimination of the restriction applies only to *bona fide* securities underwriting, dealing, and market-making activities and does not permit financial holding companies and their affiliates to control non-financial companies in ways that are otherwise impermissible under the bill."[80] Secondly, in order to ensure fair competition, "voting securities held by a securities affiliate of a financial holding company in an underwriting, dealing or market-making capacity would not need to be aggregated with any shares that may be held by other affiliates of the financial holding company. This is necessary under the bill so that bank-affiliated securities firms can conduct securities activities in the same manner and to the same extent as their non-bank affiliated competitors, which is one of the principal objectives of the legislation."[81] Otherwise, contrary to the principle of horizontal equity, financial holding companies (or similarly, the bank holding company) would be put at a competitive disadvantage vis-à-vis other less regulated companies. It should be noted that the GLBA does not change the five percent limitation. As a result of the GLBA, the revised BHCA (most recently updated on October 13th, 2006) mandates that "for the purposes of [the Board's determination as to whether a company directly or indirectly exercises a controlling influence over the management or policies of a controlled bank or company], there is a presumption that any company which directly or indirectly owns, controls, or has power to vote less than *5 per cent* of any class of voting securities of a given bank or company does not have control over that bank or company."[82] The GLBA, by sustaining the five percent limitation, clearly does not overextend the power of financial holding companies (or their affiliates) so that they can control non-financial companies. An extreme example is the aggressive takeover of non-financial companies, which is still classified as a non-permissible activity. However, liberalization, as manifested by the GLBA, does alter the definition of "controlling influence". Accordingly, the *exemption* of the five

[80] *Ibid.*
[81] *Ibid.*
[82] Oct. 13, 2006, P.L. 109-351, 12 U.S.C.S. § 1841 (a)(3).

percent rule applies where the financial holding company's owning or controlling of the controlled bank or company's voting shares is derived from the FHC's *bona fide* securities underwriting or dealing activities.

(1.4) Almost-Equal Treatment of Subsidiaries and Affiliates by Sections 23A & 23B of the *Federal Reserve Act*

It should be noted that the five percent limitation is not the same as other limitations applicable to subsidiaries or affiliates of bank holding companies. The GLBA amended Section 23A of the *Federal Reserve Act* treats a bank's financial subsidiary as its affiliate and establishes several special rules that apply to transactions with financial subsidiaries[83]. Both Sections 23A and 23B of the *Federal Reserve Act* are important statutory provisions designed to protect against a depository institution suffering losses in transactions with affiliates. More importantly, both Sections 23A and 23B also limit the ability of a depository institution (for example, a bank) to transfer to its affiliates the subsidy arising from the institution's access to Federal reserves in the event of an emergency or crisis. Consequently, Sections 23A and 23B apply, by their terms, to banks that are members of the Federal Reserve System ("member banks").[84]

It should be noted however, according to the FRB's final rule issued in December 2002; Sections 23A and 23B now applies to all insured depository institutions and uninsured member banks[85]. The GLBA necessitates a financial holding company meet

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[83] 67 FR 76560, Federal Register, Vol. 67, No. 239. . Title: 12 CFR Part 223 [Regulation W; Docket No. R-1103] "Transactions Between Member Banks and Their Affiliates". This final rule was issued on December 12, 2002 by the Board of Governors of the Federal Reserve System ("FRB"). It should be noted that the proposed Regulation W was issued by the Board on May 11, 2001 to implement comprehensively Sections 23A and 23B of the *Federal Reserve Act*.

[84] *Ibid.* (Page 2 of 119)

[85] *Ibid.* (pp. 2-3 of 119). As indicated in the FRB's final rule, "Section 23A originally was enacted as part of the *Banking Act of 1933*, and the restrictions of Section 23A applied only to member banks. Since 1933, Congress has amended the statute several times, including a comprehensive revision in 1982. Congress also amended the *Federal Deposit Insurance Act* ("FDI Act") in 1966 to apply Section 23A to insured nonmember banks in the same manner and to the same extent as if they were member banks. In addition, Congress revised the *Home Owner's Loan Act* ("HOLA") in 1989 to apply Section 23A to insured savings associations in the same manner and to the same extent as if they were member banks. Congress enacted Section 23B of the *Federal Reserve Act* as part of the *Competitive Equality Banking Act of 1987* and has

the requirements set by both Sections 23A and 23B, which in turn limits the exposure of a bank to a financial *subsidiary* to the amount of permissible exposure to an *affiliate*. The amount of permissible bank exposure to both subsidiaries and affiliates is about the same, except where subsidiary has a higher level of permissible quantitative limit than affiliates do. Section 23A achieves this goal by limiting a member bank's "covered transactions" with any *single "affiliate"* to no more than 10 percent of the bank's capital stock and surplus, and transactions with *all "affiliates" combined* to no more than 20 percent of the bank's capital stock and surplus[86].

The final rule issued on December 12, 2002 by the Board of Governors of the Federal Reserve (FRB) explains that "covered transactions" include (i) purchases of assets from an affiliate, (ii) extensions of credit to an affiliate, (iii) investments in securities issued by an affiliate, (iv) guarantees on behalf of an affiliate, and (v) certain other transactions that expose the member bank to an affiliate's credit or investment risk. Further, a member bank's "affiliates" include, among other companies, any companies that control the bank, any companies under common control with the bank, and certain investment funds that are advised by the bank or an affiliate of the bank[87]. Consistent with the GLBA, Section 223.32(a) of the final rule provides that the 10 percent quantitative limit in Section 23A does *not* apply with respect to covered transactions between a member bank and any individual financial *subsidiary* of the bank. Accordingly, a member bank's aggregate amount of covered transactions with any individual (i.e. single) financial subsidiary of the bank may exceed 10 percent of the bank's capital stock and surplus. Emphasis needs to be made that a member bank's covered transactions with all financial subsidiaries, however, are still subject to the aggregate 20 percent quantitative limit in Section 23A.

As noted above, since the GLBA amended Section 23A to treat a *financial subsidiary* of a bank as an *affiliate* of the bank, it is fair to conclude that a member bank

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subsequently expanded its scope to cover the same set of depository institutions as are covered by Section 23A. Consequently, Sections 23A and 23B now apply to all insured depository institutions and uninsured member banks."

[86] *Ibid.* (Page 3 of 119)

[87] *Ibid.* (Page 3 of 119)

may not engage in a covered transaction with *any affiliate* (including a financial *subsidiary*) if the bank's aggregate amount of covered transactions with *all affiliates* (including financial *subsidiaries*) would exceed 20 percent of the bank's capital stock and surplus[88]. Also indicated in the final rule, although the financial subsidiary of an affiliated depository institution is deemed an affiliate of the member bank for purposes of Sections 23A and 23B, the GLBA states that only "covered transactions between a bank and any individual financial subsidiary of the bank" (as in "direct relationship") are not subject to the 10 percent limit as prescribed in Section 23A of the *Federal Reserve Act*[89]. Accordingly, a member bank is barred from engaging in a covered transaction with the financial subsidiary of an affiliated depository institution (as in "indirect relationship"), should the amount of the member bank's covered transactions with that financial subsidiary (of the affiliated depository institution) exceed 10 percent of the bank's capital stock and surplus.

As a complementary safeguard measure, Section 23B of the *Federal Reserve Act* protects the member bank by requiring that certain transactions between the bank and its affiliates occur on market terms. "Arm's-length dealing" between these two entities requires that any transaction be conducted on terms and under circumstances that are substantially the same, or at least as favorable to the bank, as those prevailing at the time for comparable transactions with unaffiliated companies[90].

Another measure relating to the safety and soundness perspective is "capital deduction", which will be explained in more detail below under the subtitle of "functional regulation".

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[88] *Ibid.* (Page 52 of 119)
[89] *Ibid.* (Page 52 of 119) See also 12 U.S.C. 371c(e)(3)(A)
[90] *Ibid.* (Page 3 of 119)

2. Functional Regulation

(2.1) Deregulation vis-à-vis Separation of Power: Is there a "Turf Battle" between the Fed and the Treasury?

According to one Congressional Report[91], the bill for the GLBA creates new financial services in order for financial holding companies to offer a full range of financial products, under a strong regulatory regime that is based on the principles of "functional regulation". "Functional regulation" refers to the regulation of similar financial activities by the same financial regulator, for instance, banking by bank regulators (OCC, FRB, and FDIC), securities by the Securities Exchange Commission (SEC), insurance by State Insurance Commissioners, and holding company or affiliate regulators' reliance on that industry specific regulation and supervision[92]. Functional regulation is premised on mutual cross-industry reliance and cooperation among the regulators. In view of this, the regulator with the most experience and expertise in an industry will oversee each of the FHC's diverse activities. The purpose of functional regulation is to promote interagency consultations. Hence, the GLBA directs the Fed not to intrude on the supervision of FHC subsidiaries or activities another agency functionally regulates[93]. To that end, the Act directs the Fed to rely to the "maximum extent possible" on examinations and reports prepared by functional regulators; publicly reported information, and reports filed with other regulators, for instance the SEC or the State Insurance Commissioners. That is to say, the GLBA requires the Fed (as an umbrella regulator) to defer to the considered judgment made by its subordinated functional regulators.

In connection with the functional regulation is the alleged "turf battle" between the Fed and the Treasury, which was clearly summarized by Senator Sarbanes who cited

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[91] Conference Report, *supra*, note 76, at 2.
[92] PricewaterhouseCoopers, *supra*, note 25, at 42, available at: [http://www.pwcglobal.com/extweb/indissue.nsf/2e7e9636c6b92859852565e00073d2fd/5f8b28031aa7f4b0852568b200603732/SFILE/final%20exec%20guide-GLBA.pdf]
[93] *Ibid* at 11.

an article written by three previous FDIC chairmen, both in Democratic and Republican administrations; Ricki Tigert Helfer, William Isaac, and William Seidman, were quoted as saying "the debate on banks conducting financial activities through operating subsidiaries has been portrayed as a battle between the Treasury and the Federal Reserve. The Treasury believes banks should be permitted to conduct expanded activities through direct subsidiaries. The Fed wants these activities to be conducted only through holding company affiliates[94]."

According to another Congressional Report[95], the Senate went on about a "turf battle" between the Fed and the Treasury in the context of functional regulation. A few senators proposed that in determining the regulatory authority for those "newly permissible financial activities", because the Fed does not directly regulate banks, the Treasury may as well receive the supervisory power to oversee such activities. "Pro-Treasury" senators sided with the Secretary of the Treasury's assertion that "banks, by providing these new services inside the bank, will find it cheaper to do that, more profitable, and they will fold their holding companies, which they only set up because the law required them for safety and soundness to undertake these riskier activities outside the bank. As they fold up these holding companies, the Federal Reserve loses regulatory control over them and the Comptroller of the Currency, and therefore ... the Treasury [should be conferred with] regulatory authority that the Federal Reserve now has".[96] Contrary to this view, the opposition ("Pro-Fed") otherwise contended that despite the fact that no single bank in the U.S. is regulated directly by the Fed, the Fed does regulate holding companies that control banks; given those holding companies have 97 percent of the assets of banks, hence the regulatory authority should be conferred to the Fed[97].

Statistically speaking, Pro-Fed senators further stressed that at that point in time, the Fed was still the regulator for the 43 largest holding companies in the U.S. Besides

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[94] "Financial Services Modernization Act of 1999", Congressional Record—Senate, Thursday, May 6, 1999. 106th Congress, 1st Session, 145 Cong Rec S 4848, Vol. 145, No. 65 (hereafter Congressional Report, 145 Cong Rec S 4848), at 53.
[95] *Ibid.*
[96] *Ibid* at 39.
[97] *Ibid* at 36.

that, there were another 6,824 holding companies. Since those Pro-Treasury senators also recognized the fact that the Pro-Fed squad thus found the Pro-Treasury argument as far-fetched as the latter seemed to suggest that for the 43 largest holding companies, they will be forced to maintain their holding company, so that the Fed could continue to regulate them; while the 6,824 other holding companies will be allowed to change their structure (to become banks) as driven by the profit motive to do it[98]. Such inconsistency provides another reason for the Pro-Fed squad to criticize its rival's position of shifting from the Federal Reserve to the Treasury, equally speaking, from an independent agency to an arm of the President of the United States, in implementing the banking policy.

Indeed, the Treasury is an arm of administration in the President's Office. For this reason, if the Treasury is put back in the position of setting banking policy (and ultimately monetary policy) in the U.S., it might as well open the door for the President to have the ability to use banking policy as a political tool. However, since the Fed was established in 1913 as an independent agency, it reflects on the regulatory intent of taking banking policy away from Congress as well as the executive branch of government[99]. In light of this, it seems more appropriate to ascribe to the Fed, as an independent agency, the supervisory power over these expanded activities (i.e. GLBA's newly permissible financial activities).

After the "turf battle" started to look like a non-issue, the majority of Senators who supported the Fed began to simultaneously credit the separation of power for a strong U.S. economy. Interestingly, by trying to smooth things over, one senator was recorded as saying:

> "Nothing in our bill (S. 900, the predecessor of GLBA) takes power away from the Treasury. A lot of people have gotten confused that this is just a power struggle, where this bill would give the Federal Reserve more authority, and the Treasury wants to share it, or the Treasury wants more. Look, the Fed regulates bank holding companies. Virtually all the wealth is already in bank holding

[98] *Ibid* at 37.
[99] *Ibid* at 38.

> companies. The Comptroller (short for the Office of the Comptroller of the Currency, also known as OCC) audits national banks. There is no shift in the regulatory authority in our underlying bill. But the amendment (to S. 900) that Senator Shelby has offered with Senator Daschle (hereafter the Shelby-Daschle amendment), supported by the Clinton administration, is the biggest regulatory shift, the biggest power grab, by a Federal bureaucracy...And it is absolutely critical that we slam the door on this power grab, not because Rubin (the Secretary of the Treasury) is a bad guy and Greenspan is a good guy, but because Rubin is a political appointee controlled by a President, who, by the very nature of the Presidency—whether it is President Ronald Reagan or President William Clinton—he has political concerns to deal with, as he should."[100]

Perhaps what is really missing in this picture within the Shelby-Daschle amendment is that it adversely takes "a step toward repealing the *Federal Reserve Act* by giving the control of bank regulation over to the Treasury instead of the Federal Reserve"[101]. From the safety and soundness perspective, in the public interest and for competition reasons, this amendment is also viewed by certain senator as a detrimental piece of wording because "banks receive a subsidy from the Government because they have their principal assets—deposits—insured by the FDIC (short for the Federal Deposit Insurance Corporation). They have deposit insurance. No other non-banking institution has that guarantee. Your insurance salesman does not have it. Your securities broker does not have it. The stock exchange does not have it. The bank has it."[102] In a nutshell, as long as banks are members of the FDIC and accordingly banks' customers are protected with the federal deposit insurance, the Federal Reserve should have regulatory authority over banks, regardless of whether or not such banks elect to or are permitted by the GLBA to conduct expanded financial activities. Public interest is in the realm of concerns here because even though the federal deposit insurance fund comes mainly from the insurance premium paid by member banks, it is also subsidized by the taxpayers' tax money. Hence the accumulated federal deposit insurance fund is managed by the government for purposes of safeguarding the entire banking system. This is especially true in that the "source of strength" doctrine applies to the bank and its

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[100] *Ibid* at 39-40.
[101] *Ibid* at 40.
[102] *Ibid.*

subsidiaries. For more details about why the "source of strength doctrine" necessitates a bank holding company to bail out its failing subsidiary, please refer to Chapter One of this dissertation.

(2.2) "Operating Subsidiary" and "Holding Company Affiliate" Are Both in Practice Now

The Treasury and the Fed's extensive debate on how expanded financial activities should be carried out, either through subsidiaries or holding companies affiliates is not particularly significant as one does not necessarily exclude the other. A case in point is that for those bank holding companies that do not elect to become, or are not qualified to become, a financial holding company (FHC), through their affiliates, such holding companies can continue to engage in the newly permissible activities enumerated in the GLBA, even for investment purposes. In these circumstances, the safety and soundness requirement entails that bank holding companies must comply with the ratio limit capped in Sections 23A and 23B of the *Federal Reserve Act*, in connection to these investment activities. Likewise, for bank holding companies that elect to be FHCs, by using their bank (the operational subsidiary; also known as the "op-sub") to conduct the same investment activities, Sections 23A and 23B of the *Federal Reserve Act* are equally applicable. Explanations concerning the limitation prescribed in both Sections 23A and 23B of the *Federal Reserve Act* have been provided earlier in this introductory chapter.

Worth noting is that the GLBA conforms to traditional practice by requiring FHCs to conduct newly permissible financial activities through the so-called "Section 20 Subsidiary". The "Section 20 Subsidiary" is borrowed from the definition of affiliates in Section 2(b) of the *Banking Act 1933*. In Section 121 of the *Gramm-Leach-Bliley Act* (GLBA), with respect to "limiting the exposure of a bank to a financial *subsidiary* to the amount of permissible exposure to an *affiliate*", it is clearly stipulated that "*financial subsidiary treated as an affiliate*". Specifically, by quoting the exact words in the Act, "a financial subsidiary of a bank shall be deemed to be an affiliate of the bank; and shall not

be deemed to be a subsidiary of the bank."[103] The benefit of this legislative treatment is to keep banks (being FHC's operational subsidiary) on a level playing field with other non-banking commercial institutions, which has been explained in previous subsection of this introductory chapter. More detailed discussion of a "Section 20 Subsidiary" can be found in Chapter Three of this dissertation.

(2.3) Is the Issue of a "Subsidiary" a False Issue?

As indicated in the Congressional Report concerning an article written by three previous FDIC chairmen (Ricki Tigert Helfer, William Isaac, and William Seidman, men who have served during both Democratic and Republican administrations and with many years of direct experience in the federal deposit insurance area) these former chairs have all reportedly offered strong support for the operating subsidiary approach[104]. Underlying this strong support is the safety and soundness concern in that the federal deposit insurance provides guarantees for banks and their subsidiaries. Although the integrity of the federal deposit insurance system itself is a legitimate concern, unfortunately, it does not fully address the issue of preventing banks from dominating the entire financial services industry. Indeed, banks' easy access to the Fed-wire's low interest bearing loan creates an un-level playing field for other financial organizations which wish to compete with banks for the same services; for example, securities underwriting, securities and insurance brokerages[105].

On the other hand, then FDIC chairman, Donna Tanoue, suggested that banks should be given the choice between using a subsidiary or an affiliate as a preferred organizational structure for conducting new GLBA-granted financial activities. In his view, banks should be given the flexibility to choose a subsidiary over an affiliate, or vice versa, as they deem fit for their business purposes. The congressional report indicates that Tanoue had written a letter to the Senate's Banking Committee, saying

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[103] 12 U.S.C.A. §371c(2)(A)(B)
[104] Congressional Report, *supra*, note 94, at 53.
[105] *Ibid* at 40-41.

"with the appropriate safeguards, the operating subsidiary and the [affiliate in the] holding company structures both provide adequate safety and soundness protection. We see no compelling public policy reason why policymakers should prefer one structure over the other. And absent such a compelling reason, we believe the Government should not interfere in banks' choice of organizational structure."[106] This view strikes a remarkable resemblance to the E.U. Model, where deregulation contained in the *Second Banking Directive of 1989* provides banks the flexibility of providing "non-traditional banking services" (a concept similar to the new GLBA-granted financial services) either through its subsidiary (ies) or its affiliate(s). This is a good point considering that "when a bank holding company is attempting to go to the equity markets to raise equity through stock offerings or through commercial debt paper, no one looks exclusively, uniquely, solely at the bank; they look at the combined activities of the bank holding company."[107] To this end, the monolithic "safety and soundness" principle applies equally to bank's subsidiaries and the bank holding company's affiliates. This is not difficult to understand from a regulatory perspective. First, as stated above, subsidiaries are treated as affiliates in the context of Sections 23A and 23B of the *Federal Reserve Act*. Secondly, in Chapter Three of this dissertation, certain explanatory examples are also provided to prove the point that distinctive legal treatment of the two legal entities (subsidiary and affiliate) has diminished as a result of capital deduction requirements; hence, it poses no threat to the ultimate test of the safety and soundness benchmark. More details concerning capital deduction will follow.

To summarize, since both views (i.e. the "pro-subsidiary view" and "pro-affiliate view")—the former sees the exclusive use of bank's "subsidiary" is more appropriate for conducting newly permissible financial activities than the latter which otherwise supports the use of bank holding company's "affiliate"—are perceived from the same "safety and soundness" angle, the question of whether the subsidiary is a more appropriate venue than affiliate is not answered. Suffice it to say, if both views purport that the safety and

[106] *Ibid* at 53.
[107] *Ibid* at 48.

soundness benchmark can be withheld one way or another, the turf battle between subsidiary and affiliate will be in the margins and of no particular importance.

First, from the safety and soundness perspective, the "capital deduction" method as required by the GLBA provides a viable solution and thus diminishes the importance of the distinction between subsidiary and affiliate. To fully appreciate the regulatory treatment of "subsidiary" and "affiliate" in the context of the GLBA, certain explanatory examples are provided in Chapter Three and I note that distinctive legal treatment of the two legal entities has diminished as a result of applying the capital deduction method; hence, it poses no threat to the ultimate test of the safety and soundness benchmark.

Secondly, the limited investment requirement notes that "any subsidiary is either dissipated through the holding company system or is offset in [the GLBA)] by the requirements to deduct capital [and] to limit the investment into a subsidiary to the amount that you could upstream to a holding company for further investment in an affiliate."[108] Statutorily speaking, the GLBA amended Section 23A of the *Federal Reserve Act* to treat a financial "subsidiary" of a bank as an "affiliate" of the bank. Further, both Sections 23A and 23B of the *Federal Reserve Act* limit the ability of a depository institution (such as a bank) to transfer to its "affiliates" the subsidy from the Federal Safety Net; the same restriction also applies to a bank's "subsidiary", *mutatis mutandis*. The GLBA necessitates a financial holding company meet the requirements set by both Sections 23A and 23B, which in turn limits the exposure of a bank to a financial "subsidiary" to the same amount of permissible exposure to an "affiliate". To this end, a member bank cannot invest in its affiliates (including subsidiaries) exceeding the aggregate amount of 20 percent of the bank's capital stock and surplus. In other words, the ceiling of the 20 percent limit applies to bank's investment in riskier businesses (such as underwriting) from both its affiliates and subsidiaries, jointly together to be calculated on the same basis. All details have been provided in an earlier section, and it shall not be repeated here again.

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[108] *Ibid* at 49.

(2.4) Freedom to Choose Which Type of Corporate Structure- the E.U. Model Compared

Again, does the subsidiary issue really matter? From the surface, it looks as if the "turf battle" between the Fed and the Department of Treasury is boiled down to only one issue—whether the GLBA granted financial activities would be more appropriately carried out by the bank's subsidiary or by the bank holding company's affiliate, from the safety and soundness perspective? The oversight, however, is that the "turf-battle" does not seem to have been properly addressed—an even more fundamental question remains. How do we put U.S. financial institutions on an international level playing field? Comparing the E.U. Model (typically, the German universal banking model), it is obvious that regardless of whether such activities are to be engaged by the (bank's) "subsidiary" or the (bank holding company's) "affiliate", the U.S. banks do not *directly* benefit from the diversification intended to be achieved by the GLBA ("economy of scope"). The relatively new financial holding company structure (FHC), first introduced by the GLBA, is still designed within the old framework of the *holding company structure*. In this regard, any U.S. *bank* whose legal status is a subsidiary of the FHC itself, does not have the flexibility to directly engage in the GLBA's newly-granted financial activities and hence does not directly benefit from the economies of scope. As summarized by one commentator:

> The American holding company approach enables the bank entity of an FHC to participate in securities, while maintaining a structure that insulates its banking activities from the greater risk of securities trading. In contrast, the European Union approach permits banks to conduct both commercial banking and securities activities without these protective firewalls. Essentially, rather than restricting specific banking activities or mandating financial segregation through a holding company structure with firewalls, the European Union's regulations establish minimum standards of conduct and minimum requirements for the financial indices of stability. One criticism of the proposed American FHC approach is that such a change does not truly revolutionize the domestic banking industry because banks will not be able to take advantage of expanded power, given the inevitable result that most, if not all, of the benefits of diversification will accrue to the FHC and not to the banks[109].

[109] Jeannot, *supra*, note 4, at 1745-1746.

That is to say, compared with the E.U. banks, the U.S. banks have a competitive disadvantage. Restricted within the holding company structure and the GLBA, U.S. (domestic) banks are forced to compete against foreign banks that benefit from the economies of scale and scope that result from the freedom to choose their particular corporate structure. The E.U. Model defers the choice to banks in the belief that banks will know their business best and thus will be better positioned to decide whether deregulated financial activities can be better carried out by either a *bank subsidiary* or a *holding company affiliate*. The same commentator says:

> In a deregulated financial system, there are a number of possible corporate structures banks can adopt to integrate commercial banking with securities activities. The European Union permits its commercial banks to choose their corporate model, though there is an inherent preference for the universal bank. With its proposed financial reform legislation, the United States resists the European Union's liberal approach, opting instead to impose the familiar holding company structure upon American banks. While the holding company structure has supporters, the justifications for selecting this corporate model are questionable and, arguably, reflect the agencies' self-interest, rather than an analysis of which corporate structure would best suit the reformed financial marketplace. Moreover, the holding company structure is now foreign to every other banking system in the world, except the United States, thereby strongly implying that an alternative solution is preferable[110].

Suffice it to say, the "turf-battle" between the Fed and the Treasury will mostly be perceived as a battle of the agencies' self-interest. As pointed out by the above-mentioned Congressional Report, taking the Fed as an example, it is a self-sufficient agency and the money they are able to spend is derived from supervisory fees imposed by the Fed on financial institutions under their supervision.

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[110] *Ibid* at 1748-1749.

(2.5) Functional Regulation in Practice

The GLBA envisions that the prototypical FHC will be organized as a holding company that owns various "functionally-regulated subsidiaries": e.g. a bank, a securities broker-dealer, and an insurance company.[111] A "Functionally-regulated subsidiary" refers to a subsidiary within an FHC that is (i) a bank, or (ii) a broker-dealer, investment adviser or investment company, or (iii) an insurance company.

"Functional regulation" is established for FHCs through their major governing law, the GLBA. Functional regulation is premised on mutual cross-industry reliance and cooperation among the regulators. With this framework in mind, the regulator with the most experience and expertise in any industry will oversee each of the FHC's diverse activities. The U.S. Treasury Department's Office of the Comptroller of the Currency ("OCC"), the Federal Reserve (the Fed, which is the Central Bank in the U.S.), and the Federal Deposit Insurance Corporation ("FDIC") will oversee banks. A state insurance commissioner (SIC) will oversee insurance activities. The Securities and Exchange Commission (SEC) will oversee securities activities (including those executed by a broker-dealer, investment adviser or investment company), in joint force with the National Association of Securities Dealers ("NASD") and state securities regulators[112]. On top of the OCC, FDIC, SEC, and SIC etc., the Fed will work as the FHCs' overall "umbrella regulator". Each regulator, including the Fed, will rely on the work of the other functional industry regulators, who Congress presumed to be the most expert in their respective fields[113]. In this light, regulations for functional regulatory institutions require that federal banking regulators and the Securities Exchange Commission (SEC) share the results of any examination, reports, records, or other information regarding the investment advisory activities of any bank, bank holding company, or separately identifiable department registered as an investment adviser. The purpose of this regulation is to promote interagency consultations.[114]

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[111] PricewaterhouseCoopers, *supra*, note 25, at 4.
[112] *Ibid.*
[113] *Ibid* at 11.
[114] Benson, Bianco & Hamilton, *supra*, note 28, at 71.

Related to functional regulators, it should be noted that the GLBA restricts not only the Fed, but also the FDIC, the OCC, and the Office of Thrift Supervision ("OTS") from examining or regulating bank affiliates that another authority functionally regulates. That being said, there are exceptions to this 'no-interfering' rule. A case in point is that the FDIC may still examine any depository institution affiliate in order to determine the relationship between the affiliate and the insured depository, and the effect of that relationship on the bank or thrift[115]. Likewise, the SEC can still take action that affects the loan loss reserve of a bank, bank holding company, or FHC. This is particularly important for those existing bank holding companies that may not choose, or may not qualify, to become an FHC. In this regard, as all major bank holding companies are publicly owned; they must file financial and other required disclosures with the SEC. The SEC has a history of questioning bank holding companies on their financial statements, particularly with regard to the level of the loan loss reserve. The SEC may assert that the reserve is inadequate for expected losses in bad financial times; or conversely that the reserve is too large in good financial times. To maintain this balance Congress specifically addressed this matter in the GLBA by requiring the SEC to consult with the appropriate Federal banking agency before taking any action that affects the loan loss reserve of a bank, a bank holding company, or an FHC[116].

More detailed explanation of the actual practice of functional regulation can be found in both Chapters Four and Five. The GLBA, by making the Federal Reserve (the Fed) the umbrella regulator of a consolidated FHC, directs the Fed to be concerned with (i) the FHC's overall financial condition and its systems for monitoring and controlling financial and operating risks, (ii) transactions with depository institution subsidiaries, and (iii) compliance with legal restrictions on the FHC[117]. In doing so, the FRB, working in joint effort with its subordinated organs (including SEC, OCC, State Insurance Commission etc.) for supervision of the consolidated FHC, acts as a watchdog to safeguard the federal deposit fund and meanwhile, to ward off moral hazard.

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[115] *Ibid* at 12.
[116] *Ibid* at 13.
[117] PricewaterhouseCoopers, *supra*, note 23, at 11.

As mentioned above, the GLBA is designed on the premise of functional regulation, with the Fed being the functional regulator. In theory, for preserving the integrity of the federal reserve fund as well as preventing moral hazards, the Fed must monitor the FHCs at all time to ensure that these financial conglomerates keep deposit taking assets separate from other riskier assets. In actual practice, the Fed would not know how the FHCs operate on a daily basis. The same situation also occurred in the Pre-GLBA era, where the Fed was not able to monitor at any given time the daily operation of various banks. Game theory is often applied to explain why bank managers have a tendency to take advantage of the asymmetric information problem for the Fed, in order to maximize the self-interest of the banks' shareholders.

3. Game Theory

"Game theory" is a subset of the economic theory of law. The economic theory of law provides for the basic infrastructure upon which almost all the theoretic perspectives applied in my thesis (including deregulation, game theory, globalization, corporate governance, the principal-agent theory, moral hazard, externalities, economic institutions and institutional power etc.) would relate to such interpretation. The economic theory of law builds on a pioneering article by Ronald Coase. The "Coase Theorem" holds that where market transaction costs are zero, the law's initial assignment of rights is irrelevant to efficiency, since if the assignment is inefficient the parties will rectify it by a corrective transaction[118]. We can better understand the Coase Theorem by borrowing Posner's rational maximization theory in his introduction of a definition of economics. According to Posner, economics is the science of rational choice in a world—our world—in which resources are limited in relation to human wants. The task of economics, so defined, is to explore the implications of assuming that man is a rational maximizer of his ends in life, his satisfactions—what we may call his "self interest"[119].

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[118] R. H. Coase, "The Problem of Social Cost" (1960) 3 Journal of Law and Economics 1.
[119] Richard Posner, *Economic Analysis of Law*, 3rd. ed. (Boston and Toronto: Little, Brown & Company Ltd, 1986) at 3.

That is to say, maximizing "self-interest" is the central concept of economics, and the mechanism for assessment relies on a person's economic strategy. An economic actor's strategic behavior is regarded as rational when it conforms to Posner's "model of rational choice", whatever the state of mind of the chooser[120]. In addition, efficiency would be another main factor that affects the individual's choice and further gives him/her enough incentive to work out a solution (corrective transaction) with parties who stand in the way of the individual's pursuing of maximized self-interest[121].

In order to ensure their maximized self-interest (usually property rights) best protected by the law, economic actors in general have to engineer their strategic behavior within a set of rules. However, if the "expected value" outside the legal framework is much greater than the potentially maximized self-interest, they are more likely to figure out how to work with probabilities and how to update probabilities in a response to things that are observed[122].

According to one commentator, game theory, at a high level of generality, studies what might be regarded as the social scientific question of how should, individuals conduct themselves when each realizes that the consequences of his individual acts will depend in part on what other independent actors do? How, in other words, does he best pursue his own objectives (or self-interest in Posner's language), whatever that might be, in an interdependent milieu? Game theory formalizes that question by positing players and endowing them with moves, specifying what information is available to each player at each point at which he may be called upon to move, assigning payoffs to the ways all

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[120] *Ibid* at 3-4.

[121] Borrowing from Posner's explanations for "Coase Theorem" as an example—Suppose that a farmer has a right not to have his crop destroyed by sparks from railroad locomotives that come regularly next to his farm; that the value of the crops to him is $100, based on the difference between revenue of $330 and labor and capital costs of $230, but the cost to the railroad of installing spark arresters is $110; and that transactions between railroads and farmers are costless. The real cost of the crops to the farmer is not $230; it is between $330 and $340, for it includes the price that the farmer could get by agreeing with the railroad not to use his property in a fire-sensitive way. Since the true cost of exercising his right to grow crops exceeds his revenues, he will sell that right, and the use of his land will be the same as if the railroad had had the right to emit sparks freely. In this example, the initial assignment of the property right really does not dictate the use of the affected property. *Ibid* at 7.

[122] Stephen W. Salant & Theodore S. Sims, Book Review of *Game Theory and the Law*, by D. G. Baird, R. H. Gerther, and R. C. Picker (1996) 94 Michigan Law Review 1839 at 1874.

players' moves can be combined to play the game, and then investigating the kinds of conduct that might plausibly arise[123]. To economic scholars and analysts, by borrowing the concept of a chess game and using it as a metaphor, game theory is used as a mechanism to foresee, detect, or analyze how economic actors would conduct a set of strategic behaviors on an interdependent basis and within a set of rules, in order to pursue maximized self-interest.

One of the benefits of game theory is its ability to help economic actors assess what situations they are in by modeling that situation as a game. As long as there are games, there are rules. In game theory, each player is assumed to know the rules of the game, including not only all the moves available to each player and precisely what past choices are observable by each player at each move, but also the payoffs associated with every possible way in which the players' choices might be combined. What is more, each player is taken to assume that each other player also knows the rules, usually described by saying the structure of the game is "common knowledge"[124]. For economic actors enticed by a greater gain than maximized self-interest, they are encouraged and thus have the incentive to develop strategic behaviors within a set of legal rules. Under such circumstances, it is fair to conclude that game theory is the formal study of conduct by economic actors, whose payoffs are jointly determined by the interaction of their individual choices (or by the combination of their strategic moves), within the confines of a completely specified, commonly known set of rules[125].

In 1998 when Citicorp merged with the Travelers group, the merger stood opposed to the U.S. regulatory framework (the *Glass-Steagall Act 1933*), nevertheless, Citicorp and Travelers Group still merged to become Citigroup, outside the old regulatory framework and before the new legislation. As far as game theory is concerned, Citigroup's strategic behavior hedged its bets while forcing the hand of Congress to legitimize the merger through reform legislation. In order to fully address the issues and

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[123] *Ibid* at 1846.
[124] *Ibid* at 1847.
[125] *Ibid.*

theories contained in the case study of Citigroup merger, game theory is one of the important theories to apply.

4. The Principal-Agent Theory/Agency Problem and Conflicts of Interest

There is an intricate and inextricable relationship between principal-agent theory, the problem of moral hazards (in the context of deposit insurance) and externalities, as they all relate to the concern of conflicts of interest.

As aforesaid, after the U.S. *Gramm-Leach-Bliley Act* (and also Taiwan's *Financial Holding Company Act*) came into place, a financial holding company was now permitted to provide both commercial and investment banking under one roof. Before the new law, there was a strictly defined firewall separating commercial banking from investment banking, according to the old *Glass-Steagall Act*. Therefore, in order to better appreciate the problem of conflicts of interest, it is worthwhile to review first the fundamental agency problem existing in a bank having involvement in both commercial and investment banking. The problem of conflicts of interest is likely to become magnified as a result of financial holding companies' being able to do cross marketing and selling activities. Therefore, by pointing out the problem of conflicts of interest, I hope to point out that despite the new law repealing the restriction in the old *Glass-Steagall Act*, it is still very important to prevent conflicts of interest from taking place in financial holding companies, such as inappropriate "tying" where a financial intermediary may use its lending power to influence a client to use its securities or advisory advices as well—or the reverse, denying credit to clients that refuse to use other (more profitable) services[126].

[126] Ingo Walter, Conflicts of Interest and Market Discipline Among Financial Services Firms, a paper presented at a Federal Reserve of Chicago-Bank for International Settlements conference on "Market Discipline: Evidence Across Countries and Industries," October 30-November 1, 2003. Available at http://www.stern.nyu.edu/fin/workpapers/papers2003/pdf/wpa03032.pdf (at p. 4)

The agency problem refers to conflicts of interest between shareholders of a firm and the managers who operate that firm[127]. In classic agency relationships, principals control and direct the activities of the agent[128]. But the very reasons to delegate responsibility to another suggest that principals often lack the expertise, access, or power to control their agents. Such asymmetries between principal and agent are labeled "fiduciary" or "impersonal trust" relationships[129]. Agency is simply the engine of the division of labor. A case in point is where commercial banks act as a financial intermediary in providing liquidity services. The principal agent relationship comes about where there is *asymmetric information*[130], or where information is not readily available to everyone. Specialization thus permits people to concentrate on those tasks in which they have a comparative advantage[131]. For commercial banks, one potential issue which occurs is *conflict of interest*. If there were no conflict of interest, the existence of asymmetric information would not matter. Commercial banks' exposure of conflicts of interest creates a rich array of temptations or opportunities for them to ignore "the principal" at best, and to indulge in unbridled self-interest at worst.

Conflicts of interest exist where there are two "principals", and commercial banks' managers, being an "agent", work simultaneously for both of them. Acting on behalf of their principal, managers of commercial banks have a fiduciary duty, which arises from their role as an agent and subsequently obliges them to work only for the best interests of their principal. Commercial bank managers have two principals. One of the principals is the commercial bank's depositors (lenders, the "1st principal"), and the other, the commercial bank's own shareholders (the "2nd principal"). Conflicts of interest arise when the commercial bank's managers not only have to act in the best interests of the

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[127] Tim S. Campbell, *Money and Capital Markets*, 1st ed. (Glenview, Illinois/Boston/London: Scott, Foresman & Co., 1988) at 337.
[128] Susan P. Shapiro, American Bar Association, 28 Law & Soc. Inquiry 87, at 92.
[129] *Ibid.*
[130] In Tim S. Campbell's definition, "asymmetrical information" refers to information which is held by only one party to a transaction and which may be used by that party to her advantage. The concept of asymmetrical information is also used to explain problems of moral hazard, adverse selection, and ultimately market failure through what is called the "lemons" problem. See Campbell, *supra*, note 127, at 327.
[131] Martin Ricketts, *The Economics of Business Enterprise*, 3rd ed. (Cheltenham, UK, Northampton, USA: Edward Elgar, 2002) at 136.

bank's depositors but also in the best interests of the bank's own shareholders. The best interests of a commercial bank's depositors and those of a bank's shareholders are not always the same. Quite often, their best interests contradict each other's.

For example, at relatively little cost, commercial banks (the intermediary) accept money from depositors (lenders) on the one hand, and on the other hand make loans (with depositors' money) to borrowers (loan takers). The managers, acting on behalf of depositors, manage the depositors' money through extending loans (investments). Depositors then get a fixed (and usually very low) rate of interest on their deposits, for instance, two per cent (2%). If the investments do well, depositors do not get to share the profits and would only be entitled to get a return of one hundred and two percent (102%) from the bank. On the contrary, if the investments do poorly, the depositors do not get their money back—which is especially true before deposit insurance was introduced in 1933 (through the *Banking Act of 1933*). This provides an incentive for commercial banks to engage in extending risky loans because they often come with higher returns. Commercial banks' managers act on behalf of bank shareholders, too, so if the bank indulges in too much risk in the name of the shareholders, irrespective of the other principal's (depositors)' potential loss, the depositors' interests may be subordinated to the shareholders. This type of lending practice may easily lead to a conflict of interest as shown above. As long as commercial banks are inclined to make risky loans, depositors are left with no choice but to take on the responsibility of monitoring a bank's lending practice. This was particularly true prior to the new era of regulation, in particular the advent of deposit insurance.

5. Deposit Insurance and Moral Hazard

The U.S. government's reaction to the bank runs of 1929-'33 after the one-week "bank holiday" was the enactment of the *Banking Act of 1933*. Through this law, the Federal Deposit Insurance Corporation (FDIC) was created, which reformed the commercial banking regulation. The provision of federal insurance for deposits is said to

be the most important element of the *Banking Act of 1933*. With the implementation of deposit insurance, the backing of bank deposits became a government promise rather than any individual bank's promise (the "Gold Standard").

The "Gold Standard" refers to a time before deposit insurance was created; the monitoring and regulatory function fell mainly on depositors. Depositors (the owners of deposits) had to monitor irregular banking practices for themselves in order to try and prevent actions bank management might take on their behalf that were not in their best interests. Suffice to say that the "gold standard" was a system created to complement depositors' monitoring responsibilities. To prevent banks from expropriating deposits without appropriate compensation[132], the "gold standard" was created for banks to effectively insure their deposits (or the antecedents of deposits called notes). Under such a system, banks promised to redeem their notes or deposits in gold at a pre-specified price. As a result, notes or deposits were titles to gold, and gold essentially fulfilled the role of *collateral*.[133] Depositors could protect their funds by demanding commercial banks convert their deposits. In this regard, deposits are simply another type of debt claim, such as a bond or loan. Where depositors were suspicious or distrustful of whether banks were acting in their best interests, depositors could present the total volume of deposits to be converted into gold. Although the gold standard was fairly stable for many years, practice was sometimes different than reality. In the instance of demand deposit, even though theoretically depositors were entitled to present at any time the titles to gold and ask for the return of their money, in reality this promise to convert deposits into gold on demand was easily broken. Banks invested only a small portion of their funds in gold as most funds were committed to loans and other investments. As a result, the commitment to convert deposits to gold could be honored only if a small portion of the total volume of deposits was presented for conversion at once.

After the FDIC was established, insuring depositors if private banks reneged on their own promise, depositors no longer had an incentive to carefully assess each

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[132] Campbell, *supra*, note 127, at 334.
[133] *Ibid* at 373.

individual bank's stability. That responsibility now lay with the government[134]. That is to say, the creation of deposit insurance through the *Banking Act of 1933* changed depositors' incentives to monitor the banks in which they had deposits. Deposit insurance shifts depositors' monitoring responsibility to the government, who becomes the party ultimately responsible for bank monitoring.

With deposit insurance comes government control of risk. After the creation of deposit insurance, the responsibility of bank monitoring lay with the government, and in order to fulfill this new mandate, a more elaborate system of regulation and control of risk was necessary. Three significant methods—(i) auditing, (ii) competition controls, and (iii) restrictions on the allowed activities of bank holding companies (BHCs)—were used by the U.S. commercial bank (CB) regulators to control the risk-taking activities of CBs. First, auditing refers to the government's direct examination of bank loans and investments to ensure they are accurately reported and that they comply with regulations on permissible bank activities[135]. Secondly, competition control aims to eliminate commercial banks' excessive risk-taking activities. And, thirdly, restrictions on the permitted activities of BHCs, according to the *Bank Holding Company Act 1956* and its amendments, which restrict bank holding companies' activities to those which are "closely related to banking". Deposit insurance exempts depositors from their bank monitoring responsibilities, which consequently makes the government the ultimate source for depositors to recover their losses, if commercial banks become insolvent. In this regard, the government's taking on of bank monitoring responsibility implies its assumption of risk for depositors. The risk taken by the government, in its worst form, can be a type of moral hazard.

A moral hazard arises when bank failures are settled by government subsidies. These remedies often come about using public tax money. In the U.S. in the 1930s, when commercial banks on the one hand engaged aggressively in securities underwriting, and on the other hand, participated in the Federal Deposit Insurance Corporation (FDIC),

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[134] *Ibid* at 393.
[135] *Ibid* at 381.

moral hazards erupted when commercial banks tried to exploit government subsidies to redress their loss from securities underwriting. That is to say, the "safety net" (within which the major mechanism undertaken are deposit insurance, central bank's discount window and riskless settlement of payment system guarantees)[136] used to ensure the safety and soundness of depository institutions was taken advantage of by opportunists. In order to prevent moral hazards that take the form of inappropriately allotted government subsidies, CB regulators have devised the above mentioned three methods to curtail government's monitoring responsibilities.

Discussions of deposit insurance and moral hazards are related to my study of financial holding companies. As previously mentioned, after the new FHC laws came into effect obligating a financial holding company to assist its subsidiary banks, insurances companies and securities firms, a higher level of overall operating risk resulted for the group. As deposit insurance, in the U.S. for example, originally insuring only up to the amount of $2,500 and today insuring up to $100,000 was designed to protect only depositors of commercial banks that become members of the FDIC, and therefore did not include those of financial holding companies. Since financial holding companies now have access to federal deposit insurance, it is important to address how to correctly assess (or reassess) the premium for federal deposit insurance—taking into consideration the expansion of its coverage to include financial holding companies (as a whole) while observing principles of equity.

6. Externalities

When private costs differ from social costs, we usually label the situation a problem of "*externalities*" because individual decision makers are not *internalizing* all of the costs which society is bearing[137]. Externalities are important in my thesis discussion because the theory of externalities can be used to understand issues around deposit

[136] Wen-Yu Wang, *Holding Company and Financial Holding Company Law* (Taipei: Yuan Zhao, 2001) at 140. (In Chinese)
[137] Roger Leroy Miller, *Economics Today* (New York/Evanston/London: Harper & Row, 1973) at 636.

insurance. Problems of externalities need to be built upon the premise of deposit insurance and moral hazard (previous theoretical perspective), and within such a context, externalities refer to a taxpayer's liability under deposit insurance. After we identify what the externalities are, we next have to figure out ways to "internalize" them. As far as my thesis is concerned, with respect to internalizing the risk resulting from those entities (for example, banks' equity shareholders) taking advantage of deposit insurance (i.e. moral hazard), there are three mechanisms being (1) government monitoring, (2) risk-adjusted insurance premium, and (3) preventing poor corporate governance. Details are provided as follows.

Suppose a new bank starts up and under the "assets" ledger is listed the sum of 100 dollars in loans, and on the other side under "liabilities" is listed the first 50 dollars from bank depositors and the second 50 dollars from banks' equity shareholders. The loan interest results in a payment of 10 dollars while the deposit interest results in a payment 5 dollars. To better explain externalities, I set up three scenarios as follows:

Scenario (1): loans do well, — payoff = 110

In this situation, suppose the payoff (from extending loans) is 110 dollars, consisting of 100 dollars loans and 10 dollars in loan interest—from there, depositors get 55 dollars (i.e. 50 + 5) and equity shareholders get the rest of the money equals to 55 dollars (i.e. 110-55). Banks' depositors get 55 dollars that contain 50 dollars of their original deposit money plus 5 dollars from deposit interest. Equity shareholders get the rest of 55 dollars from the payoff, that is 110 dollars after being deducted by the 55 dollars belonging to the depositors. In this scenario, equity depositors made a "spread" of 5 dollars (i.e. 55-50)—that is, 5 dollars surplus from its original investment of 50 dollars in the bank.

Scenario (2): suppose loans do poorly—payoff = 70

In this situation, suppose the payoff is 70 dollars—from there, depositors still get 55 dollars (i.e. 50 + 5), and equity shareholders get the rest of the money, equal to 15 dollars (i.e. 70-55). Because bank depositors always get paid first for their deposit interest, banks' depositors still get 55 dollars back, which includes their original deposit money (50 dollars) plus the 5 dollars deposit interest. What is important here is that banks' loss in this scenario is not enough to trigger deposit insurance. Equity shareholders here only get 15 dollars back and have a loss of 35 dollars, as their original investment in this bank was 50 dollars.

Scenario (3): suppose loans do very badly—payoff = 10

In this situation, the payoff is only 10 dollars— the depositors only get 10 dollars back and equity shareholders get none (0). What needs to be considered here is what happens to the 45 dollars (i.e. 55-10) depositors still owed by the bank? Without deposit insurance, the depositors are left with only 10 dollars. However, with deposit insurance in place, when bank failures are settled by government subsidy, depositors still get 55 dollars back where the taxpayers pay for 45 dollars. That is because deposit insurance is a government subsidy and these remedies often come using public tax money. So, when banks make risky loans (scenario (3) would happen) taxpayers often pay for the loss. This social cost (taxpayers' loss of public tax money), resulting from the problem of "externalities", explains why externalities need to be internalized while assessing all the costs involving individual decision makers (bank's manager and equity shareholders).

Equity shareholders want their commercial bank to make risky loans in order to obtain greater returns (as in scenario (1)). With or without deposit insurance, it does not matter to equity shareholders, because it only matters to banks' depositors. Greater returns are what equity shareholders really care about because once risky loans are repaid, equity shareholders have the opportunity to receive multiple interest returns. Equity shareholders who invest in banks thus earn money as the banks make profits. The profits

made by the bank are always used to pay back first the banks' depositors for their interest return. Paying banks' depositors always comes first before equity shareholders' distribution of the remaining profit made by the bank. This creates an incentive for equity shareholders to direct banks to make risky loans (which is not to say that the more risky the loan is, the higher return it gets – the higher the potential the return only). Depositors, on the other hand, only care about deposit insurance. Once the deposit insurance is in place, depositors can obtain a certain amount of their money back whether banks make good or bad loans (i.e. the monitoring responsibility shifts from bank depositors to the government). What matters in the end is how to internalize "externalities" (put into the same/whole picture). What is the means to do this? The methods include government's monitoring, adjusting deposit insurance premiums appropriately and thus reflect its true cost, and preventing bad corporate governance. After the financial holding company law comes into effect, a bank/financial holding company is allowed to provide full financial services including those more risky activities originally only provided by securities firms and insurance companies. Most importantly the financial conglomerate has access to deposit insurance. The most important question arising out of the implementation of this legislation is how to internalize externalities and prevent bank/financial holding companies extending themselves into excessively risky behaviors. The latter is a hot-button topic. Other pressing questions have also arisen such as whether "corporate governance" plays a role in safeguarding the safety and soundness of a country's banking and financial systems. Should government impose certain instructions and rules in guiding or better improving corporate governance? Where should one draw the line because corporate governance is not within the scope of government intervention? How does government appropriately use its administrative power to streamline banks' corporate governance practices?

7. Institutions and Institutional Power

In discussing the Citigroup merger, there are two supplementary functions attributable to the strategic game. First, the economics of institutions recognizes that

individuals seek to better their position not only by investing in economic activity within a given framework of institutions, but also, in the long run, by investing in strengthening their property rights through altering the institutional framework[138]. Suppose "legal reform" represents the economics of the institution. Legal reform underlies economic reasons which call for repealing the old law and replacing it with the new law. The new law not only stands for a renewed/formal type of legal institution, but also more importantly reflects individuals' demands to maximize their self-interests through prompting more favorable rules to be applied to them. In the same vein of thought, in *Institutional Change and American Economic Growth*, two scholars Lance E. Davis and Douglas C. North, hypothesize that institutions develop in response to changing private needs or profit potentials. According to them, it is the possibility of profits that cannot be captured within the existing structure that leads to the formation of new (or the mutation of old) institutional arrangements[139].

Secondly, changes in law reflect government power (or, the power of the rule makers)[140]. The government, backed by state power, plays a very important role in lowering the operational costs of individual actors[141] and insuring their property rights. By upholding and enforcing a clear legal framework, the government provides economic actors with full protection and full certainty. The dominant forces of globalization, led by industry (such as the Citigroup), gave the U.S. government an impulse to eventually repeal the old laws' restrictions, through legal reform that embodied much-anticipated liberalism. One lesson learned from the Citigroup merger is that legal reform can often follow pressing economic demands that emerge from the private sector. Put simply, economic development sometimes leads to legal development, and the gap bridged by law accounts for the relationship between law and economics. In order to boost a country's economy or maintain its competitiveness, legal reform is an important government tool.

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[138] Lee J. Alston, Thráinn Eggertsson & Douglass C. North eds., *Empirical Studies in Institutional Change* (Cambridge, U.S.: Cambridge University Press, 1996) at 17.
[139] Lance E. Davis & Douglas C. North, *Institutional Change and American Economic Growth* (Cambridge: Cambridge University Press, 1971), at 34-35.
[140] Alston, Eggertsson & North eds., *supra*, note 138, at 12.
[141] *Ibid* at 9.

8. Globalization

Globalization represents the wealth created by the world's economically active and dominant countries, through their intricately intertwined economic performances. In the case of the Citigroup merger, it is clear that legal reform toward deregulation, which brought about the *Gramm-Leach-Bliley Act*, is to implement the ultimate goal of achieving financial globalization. To this end, the intricate relationship between legal institutions (change of law) and globalization can be understood whereby the employment of institutional power can lead to nation-wide or even global-wide economic success, through the means of financial liberalization and internationalization.

"Financial globalization" implies unfettered and increasing capital flows coupled with the emergence of new financial techniques (securitization), instruments (derivatives), and actors (institutional investors). The progressive globalization of financial markets has created a financial landscape that makes it far easier for firms to realize their global aspirations. Spurred on by the liberalization of financial regulations and the lifting of capital controls, both domestic and foreign investors today have much more freedom in managing their investments, and have available new risk management techniques, to enable them to take on or hedge risks. The global capital market has become a core force, breaking down the barrier to real sector globalization and creating the conditions for an accelerated flow of goods and technology overseas[142].

A concept related to financial globalization is capitalism. Capitalism is a characteristic feature in the Citigroup merger and the overall U.S. economic system. Capitalism is an economic system in which a country's trade and industry are organized and controlled by the owners of capital, the chief elements being competition, profit, supply, and demand. Citigroup provides world wide financial services and enjoys a clientele (of both individual and corporate customers) in nearly 100 countries. The rapid

[142] Wolfgang Reinicke, *Global Public Policy: Governing Without Government?* (Washington D.C.: Brookings Institution Press, 1998) at 50.

expansion of international financial activity has been one of the central features of globalization during the last decade. Financial markets are today larger and more liquid than at any other time in history.

9. Corporate Governance

Corporate governance is one key element in improving economic efficiency and growth as well as in enhancing investor confidence. Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure in which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. The presence of an effective corporate governance system, within an individual company and across an economy as a whole, helps to provide a degree of confidence that is necessary for the proper functioning of a market economy. As a result, the cost of capital is lower and individual firms are encouraged to use resources more efficiently, thereby encouraging growth. Corporate governance is only part of a larger economic context in which firms operate that includes, for example, macroeconomic policies and a degree of competition in product markets. The corporate governance framework also depends on the legal, regulatory, and institutional environment[143]. Other factors relating to this include, for example, business ethics and corporate awareness of the environmental and societal interests of the communities in which a company operates; they all can have an impact on the individual company's reputation and its long-term success.

A financial holding company is obliged to assist its subsidiary banks, insurance companies and securities firms, which means a higher level of overall operating risk for the group. As a result, good corporate governance can help a financial group/conglomerate identify early signs of conflict of interests and/or non-compliance of

[143] See "Corporate Governance Principles 2004 – OECD" at [http://www.valuebasedmanagement.net/articles_oecd_corporate_governance_principles_2004.html] (in "Preamble" section)

applicable laws. Consequently, I consider corporate governance a central focus in my study of financial holding companies (FHCs).

IV. Methodology

The methodology of my thesis concerns comparative studies, details of which can be further divided into several parts. First, for background research, a case study of the Citigroup merger is helpful in understanding the controversies and concerns of different economic analyses, before the U.S. FHC law officially took effect in March 2000 (promulgated in November 1999). Various commentators' debates on the Citigroup merger illuminate what the issues are when allowing financial conglomerates to provide full financial services (commercial banking, securities and insurance underwriting/brokerage). My materials come from journal articles, Citigroup's company profiles and its related news previously published in financial magazines, as well as those relevant web sites of the U.S. government (supervisory institutions, such as the Federal Reserve).

Various sources also include the statutes of the U.S. *Gramm-Leach-Bliley Act* and *Taiwan's Financial Holding Company Law* (primary basis), the Basle Committee[144]'s rules on capital adequacy ratio, the OECD[145]'s corporate governance principles, as well as textbooks, journal articles, and financial magazines (secondary material) concerning the formation and development of financial holding companies. Four case studies will be provided: Citigroup in the U.S., Cathy FHC and Mega FHC (both in Taiwan), and the Zhong Xing Bank scandal. The first three case studies form the basis for a comparative study that examines the global competitiveness of FHCs in both countries (U.S. and Taiwan), mainly based on their capital assets and client base (both globally and locally). The Zhong Xing Bank scandal was nevertheless used to account for the over-banking problem in Taiwan, which many believe prompted the enactment of Taiwan's FHCA. Once the parameters are set, I will compare the U.S. financial holding company law with

[144] The Basle Committee is the short form for the committee in Basle, Switzerland, of the Bank for International Settlements (BIS).
[145] OECD is the short form for "The Organization for Economic Co-operation and Development".

the German universal banking system, and determine how one system or the other might work better in attending to Taiwan customers' needs for full financial services. I will also discuss the impact of Taiwan's membership in the WTO as of November 2001 on the consideration of this issue.

Thirdly, I will extend my thesis discussion to cover recent banking law reform in Taiwan. Observers of Taiwan's banking system have suggested that a crisis of "overbanking" has occurred in Taiwan. Banks have slowly proliferated in Taiwan after the earliest commercial banks were established in the Japanese colonial period (1895-1945), then the relocation of specialized banks originally set up in mainland China in the 1970s, the opening of trust investment companies in the 1980s, and after 16 private banks permitted to set up between 1991-1992 (following the "big-bang" banking law reform in 1989). "Overbanking"[146] has further increased the already fierce competition among domestic banks in Taiwan. Faced with pressure to survive in the local market, Taiwanese banks have no choice but to merge. After Taiwan officially joined the WTO in November 2001, local competition further deepened in response to global competition—foreign banks were now allowed to set up financial holding companies in Taiwan. Therefore, from a historical perspective, I will explain why the recent banking reforms in Taiwan (from 1989 to 2001) affected the developing trend of mergers and acquisitions in the rush amongst Taiwanese banks to become financial holding companies. Financial holding companies can be divided into two types: one is a pure financial holding company (typified by the Citigroup in the U.S.), and the other is an operating financial holding company (exemplified by the Deutsche Bank in Germany). I will analyze these types of companies from a systemic dimension and determine which type is more suitable for Taiwan banks to follow. My comparative analysis was made through conducting statutory reviews of both the U.S. GLBA and the E.U. *Second Banking Directive*, with emphasis on the major differences between the pure financial holding company and an operating financial holding company.

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[146] Yi-Kun Lee, *The Brave New World of Financial Holding Company* (Taipei: Da Shu Lin, 2003) at 101. (In Chinese)

Fourthly, as many jurisdictions typically use application procedures to review the qualifications and prospects of new financial holding companies, it is necessary to figure out on what basis the supervisory authorities assess and monitor the safety and soundness of financial holding companies. *Minimum capital requirements* are some of the most commonly regulatory tools used to preserve the solvency of financial holding companies. Minimum capital requirements are reflected by how much capital a financial holding company possesses and can control against their risk-taking. From a regulatory perspective, by requiring financial holding companies to meet a minimum capital requirement, the quality and quantity of capital assets a financial company is able to offer is assured. It also safeguards the public interest in that the investors and stockholders of such a financial holding company are better protected. In Taiwan, for example, the minimum capital requirements for setting up a financial holding company are prescribed as NT$ 20 billion, equivalent to about US$ 670 million. A more complicated solvency regulation is in the U.S., where "bank regulators impose consolidated capital requirements not just to banks, but also on a consolidated basis to bank holding companies. (In other words, a bank holding company in the U.S. must meet mandatory capital requirements not just in their bank subsidiaries, but also for the entire holding company system.)."[147] The *Bank Holding Company Act 1956* and related statutes impose substantial restraints on companies with controlling interests in depository institutions in the U.S. The premise of such regulation is that "without mandatory capital rules, bank holding companies might become undercapitalized and threaten the solvency of subsidiary banks—either through extracting resources from those institutions or through encouraging subsidiary banks to pursue high-risk, high-return business strategy"[148]. With the liberalization and globalization of financial institutions, exchange and interest rates transactions, and the creation of new financial products (such as derivatives), financial holding companies, like other financial institutions, are engaging and exposing

[147] Howell E. Jackson, "The Regulation of Financial Holding Companies—Entry for New Palgrave Dictionary of Law and Economics" (1997), see http://cyber.law.harvard.edu/rfi/papers/fhc%20paper.pdf

[148] *Ibid* at pp. 1, 6, 7. Nevertheless, in the U.S., such practice of consolidated capital requirements (to both the bank subsidiaries and their entire holding company system) is not generally extended to all types of financial holding companies, such as insurance holding companies and securities holding companies. One commentator has pointed out that presumably in these contexts, the costs associated with the imposition of holding company capital requirements, both in terms of administration and the disruption of holding company activities, outweigh whatever benefits such regulation would provide.

themselves to more high-risk taking activities. On such a basis, the Basle Committee on Banking Regulations and Supervisory Practices (hereinafter "the Basle Committee") of the Bank for International Settlement (BIS), announced a set of rules to evaluate the *capital adequacy* of bank holding companies. The minimum capital adequacy ratio is 8% of risk-based capital assets. That basically means in order to maintain such a ratio, mandated either by the law or application requirement, a bank holding company must possess an equal amount of capital assets comparable to the loss which might occur from risk-taking activities. By ensuring the bank holding company has enough assets to offset its loss, risks can be controlled and monitored. Taiwan's supervisory authority (the Ministry of Finance) on financial holding companies imposes a minimum capital requirement of N.T. 20 billion for companies wishing to apply for FHC status in Taiwan. On the other hand, the U.S. supervisory authority (Federal Reserve) on bank holding companies also imposes consolidated minimum capital requirements. Therefore, in my thesis, I did a comparative study of capital requirements from three perspectives. First, I considered U.S. consolidated capital requirements, secondly Taiwan's minimum capital requirements and thirdly the Basle Committee regulations on capital adequacy. The Basle Committee regulations provide for international standards. Relying on these regulations, we can evaluate whether financial holding companies in both the U.S. and Taiwan have reached adequate levels of capital stability.

Finally, the operational success of a financial holding company also relies heavily on good *corporate governance* within the business entity. The Organization for Economic Co-operation and Development (OECD)'s corporate governance principals agreed and announced in May, 1999, the beginning of the formation of the basis for corporate governance initiatives in both OECD and non-OECD countries alike. The OECD principles of corporate governance represent a common set of standards that OECD member countries consider essential for the development of good governance practices. These principles have also been adopted by the Financial Stability Forum as part of twelve key standards for Sound Financial Systems. Accordingly, they are the basis of the corporate governance component of the World Bank/International Monetary

Fund (IMF) Reports on the Observance of Standards and Codes (ROSC).[149] Therefore, on the basis of the OECD corporate governance principles, I intend to emphasize the importance of good corporate governance in a financial holding company's overall well-being. The OECD principles of corporate governance cover six different aspects, which include various concerns or discussions on ensuring (1) the basis for an effective corporate governance framework, (2) the rights of shareholders and key ownership functions, (3) the equitable treatment of shareholders, (4) the role of stakeholders in corporate governance, (5) disclosure and transparency, and (6) the responsibilities of the board. Because market forces are the ultimate criterion for determining the success or failure of a financial holding company, I also examined the role and effect of market forces and their relationship to the ability of a financial holding company to be competitive.

[149] OECD, *supra*, note 143, (in "Introduction" section).

Chapter One

A Brief Banking History of Taiwan

I. Introduction

The formation of Taiwan's Financial Holding Companies (hereafter "FHCs") represents a financial system overhaul that encourages consolidation of smaller financial institutions into viable financial conglomerates with a global competitive advantage. Studying Taiwan's banking history helps one better understand why Taiwanese banks are not as internationally competitive as other countries' major banks, such as Citibank. The problem is mostly a lack of economic scale. This has been of serious concern to both industry and government, given that Taiwan has endeavored, for more than a decade, to build itself into a regional financial centre. Reform efforts toward this end further resulted in recent banking law amendments and, by extension, the establishment of FHCs in Taiwan. It is against this backdrop that this thesis will embark on a brief introduction of Taiwan's banking history. Further, an explanation will be provided as to why the recent banking liberalization starting in 1990s is attributed to the overbanking problem in Taiwan, rendering many banks' performance stagnant with mountainous debts of non-performing loans (NPLs). The problem of overbanking reached an apex when overbanking allegedly led to the 'banking storm' in Taiwan in 2000, an apparent fallout from the Zhong Xing Bank scandal. Therefore, the last part of this chapter will be devoted to explaining the Zhong Xing Bank scandal. In the aftermath of the banking crisis, the Taiwan government encouraged Taiwan's banks and other financial institutions to merge and become FHCs. The recent banking crisis had an impact on the FHC establishment, which will continue to be discussed in the next chapter.

Overbanking is often blamed for high NPL ratios. Citing statistics by the Central Bank of China, a commentator in Taiwan noted that non-performing loans rose from a

moderate 3.5 percent of all loans at the end of March 1996 to a worrying 8.8 percent six years later in 2002[1]. He also stressed that the financial sector is in an even worse state than these figures suggest as the definition used by the Taiwanese authority to calculate bad loans is much looser than the internationally accepted standard. In Taiwan, NPL is defined as those loans on which the borrowers have failed to pay interest for 6 months or principle for 3 months. However, if the period for the non-payment of interest is shortened to 3 months in accordance with the international standard, Taiwan's NPL increases by NT$ 460 billion (US$ 13.5 billion) to NT$ 1.56 trillion (US$ 45.8 billion) and the NPL ratio rises to 10.9%[2]. The NPL problem has heavily burdened Taiwan's banking system. One Asian Banker report notes that typically about 2-3% of loans in a healthy bank will be non-performing—with a percentage of up to 5% considered acceptable[3]. In this light, as pointed out by most private sector analysts, Taiwan's financial sector is burdened by an NPL ratio of 15 to 20 percent. Even worse is Taiwan's grassroots financial institutions (including local Credit Cooperatives and credit departments of both Farmers' Association and Fishermen's Association), with an average NPL ratio of over 18 percent.[4]

The high level of NPL is worrying because it signals a pending financial disaster that in large part has to be forestalled with government subsidies. One commentator indicates that although some of the bad loans will be recovered, a good proportion (30 to 40 percent is a reasonable rule of thumb) will not. He spelled out the seriousness of the problem by assuming an NPL ratio of 17.5 percent. This means that Taiwan's financial sector is currently sitting on losses of NT$1.6 trillion (US$ 46.3 billion), equivalent to approximately 16 percent of Taiwan's GDP (Gross Domestic Product). He continued to say that in theory, banks would use their own profits and capital reserves to write off the

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[1] Paul Cavey, "Banking Blues" [On-line information: http://taiwanreview.nat.gov.tw/ct.asp?xItem=792&CtNode=128]

[2] (Headline) "Government to Boost Financial Restructuring Fund to NT$1.05 Trillion by Philip Liu with Its Resolution Trust Fund Having Achieved Some Positive Initial Results Since its Setup Last Year, The Central Government Now Plans to Boost the Size of the Fund Enorm", Global News Wire, China Economic News Service, Taiwan Economic News, September 10, 2002. [Information is available in Lexis Nexus "News & Business" research database.]

[3] "The Asian Banker 300", Special Report, The Asian Banker Journal September 20, 2002. [Information is available in Lexis Nexus "News & Business" research database.]

[4] Cavey, *supra*, note 1.

NPL deficit (some individual banks in Taiwan have indeed been doing so), but such a self-financed workout is not possible for the system as a whole. He observed that the overall profitability (for Taiwan's banking industry) is too weak, and its capital reserves too low relative to the size of the deficit. Eventually, from a macro economy point of view, the Taiwanese government had no choice but stepped in to fund these outstanding losses, which most estimates suggested amount to NT$ 1 trillion (US$ 28.9 billion), or nearly 10 percent of Taiwan's GDP[5].

Equally alarming, and suggested by the same commentator, is the fact that Taiwan's financial sector problems are structural, not cyclical—they are not likely to be resolved by a pickup in GDP growth alone. A case in point, much of the NPL build-up occurred during the 1990s, when the economy *grew* by at least 4.5 percent a year[6]. Evidently, the high NPL ratio is not just a function of the economic problems of 2001—the year when Taiwan's governing Democratic Progressive Party (DPP) proclaimed the "year of financial-sector reform"[7].

To solve the high NPL ratio, measures taken by Taiwanese government are embodied through two strategies; first, *the financial restructuring fund* and secondly, *the financial holding companies*.

The financial restructuring fund was initially set up in 2001. It involves setting aside and accumulating NT$ 140 billion (US$ 4.3 billion) to write off the non-performing loans that became epidemic and threatened the soundness of Taiwan's financial system. Supplemental to this measure, in the same year of 2001, the Asset Management Companies (AMC) were established with the government's approval to help resolve the NPL problem. As a practical manner, the AMC purchased NPL from banks (with NPL) at a discounted price (typically at 30%) and then divide NPL into small-share units that can further be sold to interested investors. Because the unit price for NPL is usually much lower than its original value, if things go well (for example, the

[5] *Ibid.*
[6] *Ibid.*
[7] *Ibid.*

NPL is recovered), the profit margin can be great. Legally speaking, pursuant to the *Statute for the Establishment and Management of the Executive Yuan's Financial Restructuring Fund* (hereafter "the Statute"), the Central Deposit Insurance Corporation (CDIC) is at the behest of the government to help problematic financial institutions shed their NPLs. The financial restructuring fund is used to deplete "failed financial institutions", especially those "community financial institutions" (including cooperatives and farmers' and fishermen's associations)[8]. "Failed financial institutions", as used in the Statute, refer to one of the following: (i) adjusted net worth is negative after the examination by the competent authority of bank, agriculture finance or with certificated auditing by Accountant; (ii) failure to repay its debts; (iii) significant deterioration in businesses or financial status, (iv) risk in damaging the benefits of depositors, or (v) losses exceeding one third its capital and failure to improve within a prescribed timeline and being determined by the competent authority and the Management Committee of the Fund to be incapable of continuing operations.[9]

These efforts were commendable. A commentator suggests that, according to the Ministry of Finance (MOF) statistics, Taiwan wrote off US$ 4.52 billion in NPL in 2000 and US$ 7.47 billion in 2001. In 2002, banks themselves wrote off US$ 11.96 billion, lowering the overall NPL ratio from 8.04 percent in March 2002 to 6.12 percent at the end of 2002[10].

Beyond an overwhelming amount of NPL, another ramification of Taiwan's overbanking problem is a lack of economic scale. In raising concerns about overbanking (likely the most serious problem now in Taiwan's financial system), a commentator, when interviewed suggested that after 10 years of financial market liberalization, the result is that there are too many banks for Taiwan's relatively small population. The serious degree of overbanking reflected on continued declines in returns on assets, equity

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[8] Paragraph 2 of Article 4 of the *Statute for the Establishment and Management of the Executive Yuan's Financial Restructuring Fund.* (Taiwan law)

[9] Paragraph 1 of Article 4 of the *Statute for the Establishment and Management of the Executive Yuan's Financial Restructuring Fund.* (Taiwan law)

[10] Francis Li, "Financial Reforms Beginning to Pay Off" [On-line information: http://taiwanjournal.nat.gov.tw/ct.asp?xItem=19916&CtNode=118]

and profitability. According to him, in the past three years (from 1998-2001), the average return on assets for domestic banks in Taiwan has fallen from 0.59% to 0.39%. 'Greater polarization' is another sign of overbanking as the stronger banks remain competitive, but the remainder are starting to fall behind[11].

Market consolidation is generally believed to be the most effective mechanism applicable to alleviate Taiwan's overbanking problem. Overbanking has reportedly cut the profit margin of financial institutions to razor-thin levels, a situation considered especially serious given the contraction of the market during the current economic slump in Taiwan[12]. The rationale underlying market consolidation is business scale enhancement; its ultimate goal is to upgrade financial institutions in Taiwan, comparable with those in the U.S. or E.U. Market consolidation is also designed to prevent Taiwan's financial institutions (relatively small by nature) from being trapped in a vicious circle of price competition. Price competition was rampant, prior to recent financial reforms. Many believed price competition was due to overbanking and it had a direct link to the Zhong Xing Bank scandal and subsequently a series of bank runs in the early 2000s. The situation has been gradually changed. A financial report in 2005 revealed that amid ongoing market reform, Taiwan's market has gone through 26 Mergers and Acquisition (M&A) cases. Further, in the second phase of market reform, the Taiwan government continued to encourage M&A among financial institutions. The government policy has witnessed certain concrete results. First, it is foreseeable that at least three financial institutions that have gone through M&A will each control a share of over 10 percent of the domestic market. Secondly, the number of government-controlled banks will be cut from 12 to 6. Thirdly, the number of FHCs will be reduced from the current number of 14 to 7 (some scholars even suggested 5). Finally, the government policy continues to

[11] (Headline) "Independent Analysis—E Sun Bank Is One of Only Two Private Banks That Have Remained Independent From the Island's Major Conglomerates. Dennis Engbarth Discusses Taiwan's Changing Financial Market With New Board Chairman And Former General Manage The Banker", Financial Times Business Limited The Banker, July 1, 2001. [Information is available in Lexis Nexus "News & Business" research database.]

[12] Global News Wire, China Economic News Service, Taiwan Economic News, *supra*, note 2.

work its way through in the hope that by the end of 2006, at least one of Taiwan's FHCs would be listed on the international stock bourses[13].

Beyond the financial restructuring fund, the establishment of FHCs is another measure taken by the Taiwan government to solve the overbanking problem. Amidst a comprehensive overhaul of Taiwan's financial system, the Legislative Yuan (Parliament) in Taiwan passed the dubbed "Six Financial Regulations" from the 26th to 27th of June, 2001. The "Six Financial Laws" comprise (i) the *Financial Holding Company Law*, (ii) *Act Governing Bills Finance Business*, (iii) Amendment to the *Insurance Act*, (iv) Amendment to the *Business Tax Law*, (v) Amendment to the *Deposit Insurance Act*, and (vi) the *Statute for the Establishment and Management of the Executive Yuan's Financial Restructuring Fund.* These six pieces of legislation, coupled with the *Trust Enterprise Act*, the *Financial Institutions Merger Act*, the Amendment to the *Banking Act*, and the *Act Governing the Establishment and Organization of the Financial Supervisory Commission of the Executive Yuan*, all intertwined with each other, are designed for overhauling Taiwan's financial system. The underlying purpose is to discourage financially troubled banking institutions and further promote institutional amalgamation by encouraging the establishment of FHCs. The implementation of "Six Financial Regulations" (plus the other four) is believed to be instrumental to increasing the global competitiveness of Taiwan's financial institutions. In order to ensure that FHCs not conspire in illicit transactions (for example insider trading *inter alia*) with their subsidiaries, as a result of mergers and acquisitions, a single umbrella supervisory committee (the Financial Supervisory Commission) has been established in July 2004 to oversee all three types of financial institutions in Taiwan: banks, securities firms, and insurance companies.

Ensuing and ongoing mergers and acquisitions force Taiwan's domestic financial institutions to grow bigger, stronger, and become more competitive, or otherwise risk being forced out from the market. As the success of FHCs also depends on foreign

[13] (Headline) "Market Consolidation Causes New Challenges to Financial Groups", Global News Wire—Asia Africa Intelligence Wire, China Post, June 20, 2005. [Information is available in Lexis Nexus "News & Business" research database.]

investment and their managerial skills, in this regard, the *Financial Holding Company Act* opens door for further competition induced by foreign investment. This is especially true after Taiwan officially joined the WTO in December 2001. Foreign financial institutions can choose to either conduct business as foreign FHCs in Taiwan; or to invest their capital in Taiwan's locally established FHCs. With the newly vested power of providing customers with a "one-stop financial shopping services", the FHC's ultimate goal is revenue enhancement. Under this premise, the FHCs in Taiwan have reflected certain key features pertaining to the new corporate structure: (i) mega-sized financial conglomerate; (ii) cross-industry mergers and acquisitions; (ii) cross selling and marketing activities; (iv) heightened requirements for capital adequacy, internal control, and good corporate governance; (v) maintaining and increasing global competitiveness footing; and (vi) drawing on international pool of funds from the international community for much needed operational or investment capital.

II. Taiwan's Banking History/System

The law regarding banking in Taiwan (the Taiwan Banking Act; the Banking Law/Act) is comprised of 9 chapters and 140 articles. The Taiwan Banking Act is the primary banking statute in Taiwan and its purpose is to (1) simplify the legal framework regarding banking transactions (2) streamline banking business (3) provide protection to depositors (4) facilitate the development of productive enterprises, and (5) coordinate the operation of bank credit with national monetary policies.[14] The Banking Act also prescribes the obligations and responsibilities of all banks situate in Taiwan. It governs both domestic banks and foreign bank branches, through different sections in the Act.

The Banking Act has been amended 19 times and has undergone extensive review over the years, ostensibly in the interests of modernization and maintaining a secure and sound banking system within a world of change. From 1945 when Taiwan threw off the shackles of fifty years of Japanese colonization, until 1949, when the Chiang-led government set up on the island away from Mao's mainland insurrection, banks in

[14] Article 1, the Banking Act of Taiwan, whose official title is "*Banking Act of the Republic of China.*

Taiwan were gradually transformed. Even so, the Japanese influence continued to affect the development of Taiwan's banking system. Taiwan's first legal banking footprint was the 1931 Banking Act enacted in Mainland China. It was only finally replaced by the new Banking Act enacted in 1975. During this period, the Taiwanese banking sector began to moderately liberalize and internationalize its financial markets by allowing foreign banks to set up branches or representative offices in Taiwan. The 11th banking law amendment in 1989, known as Taiwan's "big-bang" banking law reform, represented a large step towards further liberalization. Taiwan repealed barriers to the licensing of private commercial banks and meanwhile strengthened banking authorities' powers.[15] By looking at the historical record of Taiwan's banking law amendments, we can better understand the development of Taiwan's banking system.

Up until December 2001, according to the statistics[16] provided by the Bureau of Monetary Affairs, Ministry of Finance, there were 53 domestic banks in Taiwan, most of which were commercial banks. Although according to more recent statistics, released by the Financial Supervisory Commission (FSC) in January 2006, the number of local commercial banks has reduced from 53 to 45. All of them together have also established 3,247 branches[17]. In parallel, 34 foreign banks maintain their presence in Taiwan, with 66 branches in total[18]. Even though the Banking Act regulates both domestic and foreign banks, it is not all-inclusive in regulating financial institutions. Outside the regulatory framework of the Banking Act are other banking institutions, such as credit cooperatives and credit departments of farmers' and fishermen's associations. In addition, the post offices in Taiwan, influenced by the Japanese system, also receive deposits. These institutions that operate outside of traditional banking law are caught under various

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[15] Brain Wallace Semkow, *Taiwan's Financial Markets and Institutions: The Legal and Financial Issues of Deregulation and Internationalization* (Westport, Connecticut, London: Quorum Books, 1992). In this book, the author describes that Taiwan's establishment of private banks were based on the substantive amendments to the Taiwan Banking Act on July 19, 1989.

[16] See on-line statistics from the website of the Bureau of Monetary Affairs (BOMA), Ministry of Finance, a branch of Taiwanese government. [http://www.boma.gov.tw/index_dirsta.htm].

[17] Original source: "Financial Statistics Monthly, Taiwan District, R.O.C.", compiled by Economic Research Department, the Central Bank of China. [Available also on FSC's official website: [http://www.banking.gov.tw/ct.asp?xItem=32339&CtNode=704] (Under "Overview of Banking Sector—Number of Financial Institutions.)

[18] *Ibid.*

statutes such as the *Act Governing Cooperatives* and the appropriately named *Act Governing Farmers' Associations* and its sister statute, the *Act Governing Fishermen's Associations.* These latter acts in some sections refer to the Banking Act, specifically deferring to the Banking Act authority with respect to their credit departments.[19] The same principle also applies to post offices where the *Act Governing Post Offices* supervises the deposit taking business within Taiwanese post offices.[20] Trust and investment companies submit in their entirety to the Banking Act.[21] Article 20 of the Banking Act provides that trust and investment companies are considered a "bank" under statute[22].

1. Vestiges of Japanese Colonial Power in Taiwan's Banking System: "Fringe Banking Industry"

Colonization has had an adverse influence on the Taiwanese government's efforts to liberalize Taiwan's financial institutions. The Japanese government created a banking system in Taiwan that was multi-functional and stringently controlled by its colonial power. It is fair to say that the Japanese legacy of the multi-agency banking supervisory system, the establishment of a complex financial system, and stringent limitations on founding private banks has taken a toll on Taiwan's financial development towards liberalization. Japanese colonial control in Taiwan lasted for 50 years, from 1895 until the end of World War II in 1945. Even though the colonial power left in 1945, its influence on Taiwan's banking system continues until today. The Japanese colonial government established multiple types of financial institutions in Taiwan, including banks, credit cooperatives, postal offices, and mutual loans and savings companies. These multiple types of financial institutions in Taiwan have also formed an excessively complex financial system, leading to many challenges for Taiwanese banking

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[19] See Article 5 of the *Act Governing Farmers' Association.* See also Article 5 of the *Act Governing Fishermen's Association.* (Taiwan law)
[20] See Articles 1 and 5 of the *Act Governing Post Offices.* (Taiwan law)
[21] See Articles 20 and 100-115 of the Banking Act of Taiwan.
[22] "Banks for a Special Business Purpose" is another type of bank, as defined in Article 20 of Taiwan's Banking Act, along with the other twos, being commercial banks and investment and trust companies.

authorities[23]. Integrating banking standards observed by different financial institutions has been one of the main issues. From a legal perspective, integration is hindered because the Banking Law is only one of many statutes that apply in the case of, for example, credit departments of farmers' associations and those of fishermen's associations.[24] Often other laws such as the *Act Governing Credit Cooperatives*, the *Act Governing Farmers' Associations* and the *Act Governing Fishermen's Associations* may apply. Cultural, social and historical reasons underlie the cause of the existence of the diverse array of lending institutions.

There are three types of cooperative financial institutions in Taiwan: credit cooperatives in general, credit cooperatives for farmers' associations and credit cooperatives for fishermen's associations.[25] What prompted the establishment of these cooperatives was explained by different theories. It is generally believed that cooperatives arose for two fundamental reasons: (i) to provide lending services to residents in rural areas; and (ii) to promote land reform. The Japanese colonial government asserted a stringent policy in curtailing the number of traditionally-defined banks; those very few chartered banks unanimously established their presence in major cities, where most of people's banking needs came from, leaving residents in the rural areas (most of them are farmers and/or fishermen) with scarce and remote access to those banks. A satellite and fringe financial system developed outside the major banking infrastructure. This would develop into a credit cooperative—credit departments attached to agriculture or fishing associations, and mutual loans and savings associations[26]. These financial institutions grew up outside of the urban centers because the Osaka Zhong Li Bank, a Japanese commercial bank, representing the introduction of western banking methods to Taiwan, was unable to extend their banking service to rural areas. Accordingly, the main purpose of existence for the "fringe banking industry" was to meet the banking needs of residents in the rural areas by providing credit and loans, along with advice on farming/fishing techniques. Secondly, as one commentator

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[23] Lawrence L.C. Lee, "Integration of International Banking Supervisory Standards: A Blueprint for the Taiwanese Banking System" (2000) 19 Annual Review of Banking Law 455 at 464.
[24] See Article 139 of the Banking Act of Taiwan.
[25] Semkow, *supra*, note 15, at 41.
[26] *Ibid* at 466.

suggested, the Japanese colonial authorities used such a complex banking system to promote land reform, encourage agricultural development, and establish more modern and specialized banks[27], such as the Land Bank and the Farmers Bank. Details of each will be provided as follows.

(1.1) Credit Cooperatives

Credit cooperatives emerged in Taiwan in 1909 under Japanese occupation. The cooperative movement had already taken root in Japan before its first establishment in Taiwan, when there were very few financial institutions in Taiwan that could meet the public need for credit.[28] Credit cooperatives are the most important cooperative financial institutions. Up until December 1991, while the credit cooperatives still maintained significant market share among financial institutions, there were 74 credit cooperatives, with 425 branches; these institutions accounted for about 10 per cent of all loans and had assets of NT$1,030 billion as compared to NT$5.881 trillion for Taiwan's domestic banks.[29] Anyone wishing to gain access to a credit cooperative's financing services has to apply for membership. Consequently, the financial services provided by credit cooperatives are exclusive to its members only. Individuals who are gainfully employed residents in the cooperative's region may purchase cooperative membership. In order to limit cooperative membership, members of one cooperative may not be members of another.[30] The primary function of credit cooperatives is to accept deposits from and extend loans to members. In some cases, credit cooperatives may handle checking deposits of members, as well as accept deposits and make loans to non-members.[31] In this light, credit cooperatives were organized to provide financing services and give guidance to its members in their financing and economic activities. Once a few

[27] Lee, *supra*, note 23, at 467.
[28] The Central Bank of China, *Financial Institutions in Taiwan The Republic of China* (Taipei: The Central Bank of China, 1969) at 18. (In Chinese)
[29] Semkow, *supra*, note 15, at 41-42.
[30] *Ibid* at 42.
[31] *Ibid.*

cooperatives were organized to do so and gained public confidence, the number of credit cooperatives in Taiwan grew steadily.[32]

(1.2) Credit Departments of Farmers' Association (Farmers' Co-ops)

Under a decree promulgated by the Japanese authorities in 1944, cooperatives of towns and villages were reorganized as farmers' associations; and the original credit cooperatives were annexed into these associations, re-organized as the credit departments of the farmers' associations.[33] Following Japan's defeat in the Second World War, the colonial period in Taiwan came to an end in 1945. With the retrocession of Taiwan to the Chinese government, the credit cooperatives were reorganized under Chinese law, with thirty-nine credit cooperatives, one warehousing credit cooperative, and 273 rural credit cooperatives. Pursuant to a suggestion by the Joint Commission on Rural Reconstruction, all rural credit cooperatives were transferred in 1949 to the farmers' associations to become their credit departments. The organization and function of the Farmers' Co-ops were specified by provincial regulations promulgated by the Executive Yuan (Taiwan's equivalent of Parliament) in 1952.[34] The Farmers' Co-ops provided the base for agricultural credit. Farmers' Co-ops thereby receive deposits from and extend loans to member farmers, handle remittances and serve as agents for the Land Bank, the Cooperative Bank, the Farmers Bank of China and different government agencies in the supply of farm credit.[35]

(1.3) Credit Departments of Fishermen's Association (Fishermen's Co-ops)

Just as the Farmers' Co-ops provide the basis for farming credit, so the Fisherman's Co-ops provide the basis for the fishing industry's credit. Fishermen's Co-ops receive deposits from and extend loans to member fishermen. Since the *Agriculture*

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[32] The Central Bank of China, *supra*, note 28, at 18.
[33] *Ibid.*
[34] Semkow, *supra*, note 15, at 41.
[35] The Central Bank of China, *supra*, note 28, at 20.

Financial Law (*Nong Yeh Jin Rong Fa*; in Chinese) was promulgated on July 23, 2003, the credit departments of farmers' associations and those of fishermen's associations have become uniformly regulated. Before the *Agriculture Financial Law* came about, the establishment of credit departments was separately (and yet in parallel) regulated in Paragraph II, Article 5 of the *Act Governing Farmers' Associations* and the *Act Governing Fishermen's Associations*. It is declared in these two paragraphs that the activities of Farmers' Co-ops and those of Fishermen's Co-ops should be conducted and regulated as a banking business, access to which is for members only. According to the new *Agriculture Financial Law*, an agricultural financial organization by definition includes both Farmers' Co-ops and Fishermen's Co-ops.[36] The establishment of these different credit departments under one regulatory regime was to assist in stabilizing the agricultural and fishing business. Banking law is *quasi* applicable[37] to the management of Farmers' Co-ops and Fishermen's Co-ops, according to the new *Agriculture Financial Law*. The new *Agriculture Financial Law* is meant to complement the existent *Act Governing Farmers' Associations* and the *Act Governing Fishermen's Associations*. The promulgation of the *Agriculture Financial Law* is focused on regulating the financial institutions providing credit for the agricultural and the fishing businesses. Its aim is to encourage sound management of the agricultural and fishing industries, to protect the rights of depositors, and to promote the development of farm and fishing villages.[38]

In addition to the above-mentioned three types of cooperative financial institutions, the Japanese colonial government also established and included both postal offices and mutual loans and savings companies as part of the satellite banking industry and as an adjunct to traditionally defined banks.

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[36] See Articles 2 and 4 of the *Agriculture Financial Law*. (Taiwan law)
[37] See Article 33 of the *Agriculture Financial Law*. (Taiwan law)
[38] See Article 1 of the *Agriculture Financial Law*. (Taiwan law)

(1.4) Postal Offices

The postal savings system in Taiwan (with a total of 1321 branches all over Taiwan, as of January 2006[39]) has become a major competitor to Taiwan's national banks, private commercial banks, and insurance companies as it not only engages in deposit taking but also offers basic life insurance products. In order to attract savings from the general public, the postal savings system offers interest rates marginally higher than those offered by the banks. Nevertheless, the postal savings system does not compete with banks in the lending market. The bulk of the deposits it raises are re-deposited with the Central Bank of China, Taiwan's central bank, which provides long-and medium-term loans to investment projects through full-service banks at a preferential rate.[40] The postal savings system has also been re-depositing a proportion of new deposits with some specialized banks designated by the central bank for investment purposes.[41] The postal savings system has been operated by the Directorate General of Postal Remittances and Savings Bank, which was established in 1930 and began full operations in Taiwan in March 1962[42]. The Directorate General of Postal Remittances and Savings Bank is an organization under the auspices of the Ministry of Communications.[43]

(1.5) Mutual Loans and Savings Companies

In addition to the above-mentioned three types of cooperative financial institutions, mutual loans and savings companies are a fourth institutional legacy of the former colonial Japanese government in Taiwan. The concept originated in China as mutual finance pools arranged by private individuals, commonly known as "Hui"[44] (in

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[39] Economic Research Department, the Central Bank of China, *supra*, note 17.
[40] Semkow, *supra*, note 15, at 43.
[41] *Ibid.*
[42] *Ibid.*
[43] *Ibid* at 16.
[44] An organizer, usually the pool leader, arranges the mutual finance pool, also known as "Hui". How it works is that the pool leader invites 10-20 friends to form a mutual finance pool for the same number of months. Every month, each member contributes a prescribed amount of money to the pool to create a monthly loan fund to be extended to one of the members who has bid to pay the highest interest. The pool leader gets the interest free loan the first month, and then in each of the following months members take

Chinese). Mutual Loans and Savings Companies were considerably more organized. The first one was established in Japan in 1901. Later in 1914, Mutual Loans and Savings Companies were introduced to Taiwan during the Japanese occupation and were organized according to Japanese corporate law. The Mutual Loans and Savings Companies often coordinated and lead mutual finance pools, paralleling the "Hui". The Company charges a commission, but does not borrow from the pool. Any person who needs money or desires to save money may apply for membership in one or more pools sponsored by such a company. Members of the pools do not need to know each other, and the company assembles qualified applicants into numerous groups, determining by bid or by lots who is to receive the loan. Mutual Loans and Savings Companies had been very popular in Taiwan, and were subject to government supervision. As compared with an informal "Hui", as organized amongst friends and associates, Mutual Loans and Savings Companies are more reliable. Following Taiwan's retrocession to China and as a result of the end of Japanese colonization, there were four Mutual Loans and Savings Companies, three of which handled loans and savings and one of which handled housing loans. The Taiwan Mutual Loans and Savings Company Ltd., was established through the merger of these four companies, and the Provincial Government owned 93% of its shares of stock. After the Provincial Government promulgated the *Regulations Governing Mutual Loans and Savings Companies* in 1948, seven private district Mutual Loans and Savings Companies were established. Mutual Loans and Savings Companies also engaged in the following activities: (1) commodity and real estate financing, (2) deposits, (3) loans, and (4) remittances and collections[45]. Mutual Loans and Savings Companies are the forerunners of domestic Small and Medium Business Banks[46], which, following the trend of globalization and liberalization in late 1990s, have recently transformed into various commercial banks.

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turn getting a loan through bidding. The pool leader conducts the bidding for loan and collects the monthly contributions from members of the pool. Interest is deducted from the amount of monthly contributions of the members who have not yet received the loan. When every member has obtained a loan (no member is eligible for a loan twice), the pool is automatically dissolved. This practice has been and still is a very popular means of finance among the middle and lower income strata of society in Taiwan. The Central Bank of China, *supra*, note 28, at 22.

[45] *Ibid* at 23.

[46] For information about the historical development of mutual finance pools ("Hui"), Mutual Loans and Savings Companies, and Medium and Small Business Banks, see [http://www.fullon.com.tw/fullon/show/showf/showfb6.asp].

(1.6) Fringe and Satellite Financial Institutions Turned into Commercial/Private Banks (in Recent Banking Development)

Japan's influence on the multi-agency banking supervisory system in Taiwan, as described above, is said to have resulted in the inefficiency of banking supervision and thus the deferral of banking deregulation. One commentator has pointed out that colonization has left Taiwanese banking authorities unprepared to face the challenges of reorganizing banking institutions and liberalization.[47] That being said, progressive banking reform has dramatically changed Taiwan's financial landscape, especially over the past decade. For instance, today, three types of cooperative financial institutions in Taiwan, including Credit cooperatives, Farmers' Co-ops and Fishermen's Co-ops are still playing a significant role in banking. In fact, these entities remain active players in Taiwan's banking industry despite the fact that different banking standards are observed, a reflection of their distinct nature. The Taiwanese government, in order to streamline the banking system in Taiwan, promulgated rules for credit cooperatives to be reorganized into commercial banks. In compliance with government policy, by 2002, seven credit cooperatives had been reorganized into commercial banks. For example in 1997 and 1998, Macoto Bank was amalgamated from The Third Taipei Credit Cooperative, the COTA Commercial Bank and The Third Tai Zhong Credit Cooperative. As a result, Taiwanese banking authorities have slowly been able to make some progress in integrating and making consistent various banking standards observed by different banking institutions. The Taiwanese government has continued to encourage other financial institutions, such as credit cooperatives and trust companies, to reorganize into banks. It is the Taiwanese government's hope that in the foreseeable future, unified banking standards can be applied to the various financial institutions that currently exist in Taiwan. Furthermore, in order to keep up with the internationalization and liberalization of the local financial industry, the Taiwan Cooperative Bank (TCB)[48],

[47] Lee, *supra*, note 23 at 457.

[48] The evolution of Taiwan Cooperative Bank (TCB) has been interwoven with the development of the cooperative system in Taiwan, which can be traced back to the early years of the 20th century. During the

which has functioned as the central financial institution in assisting the cooperative banking movement in Taiwan, was reorganized into and incorporated as a private bank in 2001.

2. Four Major Types of Banks in Taiwan

At the present time, there are four categories of banks in Taiwan, including (1) banks established during the Japanese occupation of Taiwan from 1895 to 1945; (2) banks taken over by the Chinese government and then reorganized in Taiwan from 1945-1959; (3) banks founded in Mainland China and subsequently re-established in Taiwan; and (4) new private commercial banks chartered in 1991 and 1992. Of the four categories of banks, (1) (2) and (3) together constitute a strong state-owned banking system for Taiwan. Private banks were rare before the Taiwanese government started liberalizing its financial markets in 1989. As one commentator has pointed out, in the mid-1960s, the number of head offices and branches of private banking institutions represented only 2.7 percent of the entire banking industry in Taiwan.[49] Indeed, the state-owned banking system had dominated Taiwan for four decades (1949-1989).

The four types of banks that represented state-centric power in Taiwan are described below:

Japanese colonial period, the "Taiwan Cooperative Association" (formerly named) was first organized in 1923 as a central institution to assist the cooperative development in Taiwan. It was later reorganized and named as the "Taiwan Federation of Cooperative" in 1942, and then as "Taiwan Cooperative Treasury" in 1944, with the providing of financial and guidance services to its member cooperatives as its primary function. When the colonial period came to an end—Taiwan was resorted to Chinese Government after World War II, the "Taiwan Cooperative Treasury" was renamed "The Cooperative Bank of Taiwan". The institution had since then continued to operate under this name until the year of 2001, which was renamed as "Taiwan Cooperative Bank" as it is now. See Taiwan Cooperative Bank's introduction page at [http://www.tcb-bank.com.tw/report/ch4s1.htm].

[49] Lee, *supra*, note 23, at 477.

(2.1) Banks Established under Japanese Colonial Power from 1895 to 1945

The Taiwanese banking system started to take shape at the inception of Japanese colonial rule in 1895. In fact, Taiwan's banking system under Japanese control was the first modern banking system formed within the context of a Chinese environment. What needs to be pointed out, even though Japan encouraged the private sector to develop banking in Taiwan, very few Taiwanese actually participated in the management of private banks save those few who were close to the Japanese colonial government. By the eve of the Japanese surrender in 1945, three large private banks were established and based in Taiwan: the Zhang Hua Bank (est. 1905), the Hua Nan Bank (est. 1919), and the First Commercial Bank (est. 1928). All three of them are commercial banks. The Zhang Hua Bank was founded by the gentry (Ru-Xiang Wu) and merchant class in central Taiwan[50]. Likewise, the Hua Nan Bank was founded by the gentry (Xiong-Zheng Lin) and the overseas Chinese (Chun-Yang Guo)[51] for the purpose of channeling overseas Chinese funds to promote Taiwan's economy and encourage Taiwanese to invest in overseas enterprises[52]. The First Commercial Bank was the outgrowth of the amalgamation of the Savings Bank of Taiwan (est. 1899), the Jia-Yi Bank (est. 1904), the Commercial and Industrial Bank of Taiwan (est. 1910) and the Xin-Gao Bank (est. 1915)[53].

Taiwan was ceded to Japan by the Qing dynasty government in 1895 under the Ma Guan Treaty (Treaty of Shimonoseki), following China's defeat in the first Sino-Japanese War. The Osaka Zhong Li Bank, the forerunner of Sanwa Bank Ltd. of Japan, founded the first bank in Taiwan.[54] While Taiwan was a Japanese colony from 1895 until the end of World War II in 1945, Japan introduced the Western banking system into Taiwan. In fact, Taiwan's Western-style banking system emerged thirteen years ahead of Mainland China's. By the time the Imperial Bank of China was established in Mainland

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[50] Juan-Bao Yan, *The Banking Development of the Past 40 Years in Taiwan* (Taipei: The Zhang Hua Credit Investigation Company, 1991) at 71. [In Chinese]
[51] *Ibid* at 69.
[52] The Central Bank of Taiwan, *supra*, note 28, at 13.
[53] *Ibid* at 12.
[54] *Ibid* at 465.

China in 1908, at least seven Western-style banks had begun operations in Taiwan. As a result, Taiwan had built a Western-style banking infrastructure before it reverted to China in 1945.[55]

When Taiwan was handed back to the Chinese government in 1945 as a result of Japan's defeat in the Second World War, the financial departments of agricultural and fishing associations evolved into Agricultural Co-ops and Fishing Co-ops.[56]. The Cooperative Bank of Taiwan, renamed and reorganized from the *Taiwan Chan Ye Jin Ku* (also known as "Taiwan Cooperative Treasury"[57] or "Taiwan Production Bank"[58]) under the then Japanese ruling elite, still continues to supervise and to act as a central bank for these satellite banking institutions. Until now, all Co-ops are still authorized to take deposits and to extend loans and thus still form part of Taiwanese banking system.[59]

During the Japanese ruling period, Japan-based banks and Taiwan banks were concurrently established. In December 1896, the Bank of Japan (the central bank of the Japanese government) established a branch in Taipei to act as the agent of the Japanese national treasury in Taiwan. In 1897, the Japanese Parliament established the Bank of Taiwan under the authority of Taiwanese banking law[60]. In June 1899, Japan authorized the Bank of Taiwan to issue bank notes for local circulation and to act as a central bank in Taiwan. In addition to issuing currency and handling funds for the Japanese government, the Bank of Taiwan also began providing commercial banking services in September 1899.[61]

After the establishment of the Bank of Taiwan, Japan encouraged the private banking sector to develop banking businesses in Taiwan through additional branches or subsidiaries. By the time Japan surrendered in 1945, five Taiwan-based banks were

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[55] *Ibid.*
[56] *Ibid* at 470.
[57] See Brief History of Taiwan Cooperative Bank at the bank's website at [http://www.tcb-bank.com.tw/report/ch4s1.htm].
[58] Lee, *supra*, note 23, at 469.
[59] *Ibid* at 466.
[60] See Article 3 of the Taiwan Banking Law, passed by the Japanese Parliament in April 1897.
[61] Lee, *supra*, note 23, at 467.

established: the Bank of Taiwan (est. 1897)[62], the Savings Bank of Taiwan (est. 1899), the Zhang Hua Bank (est. 1905), the Taiwan Commercial and Industrial Bank (est. 1910), and the Hua Nan Bank (est. 1919).[63] The Japanese authorities also organized the First Commercial Bank, Hua Nan (Commercial) Bank, and Zhang Hua (Commercial) Bank, all before 1919. The purpose in so doing was to carry out Japanese government policies and to support Japanese militarization. Since Japan also wanted to extend its national and financial power from south of Mainland China to Southeast Asia, the Hua Nan Commercial Bank established branches in Malaysia, Singapore, and Shanghai.[64]

(2.2) Banks Taken Over by the Chinese Government and Then Reorganized in Taiwan from 1945-1959

Following the Japanese government's unconditional surrender in 1945, the Chinese government took control of Japanese banking institutions.[65] For the purpose of

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[62] The Bank of Taiwan, which was operated by the Japanese government as the central bank of the Taiwan colony, was reorganized on May 20, 1946, as a provincial bank wholly owned by the Chinese government. *Ibid* at 472. After the retreat from Mainland China in 1949, the Bank of Taiwan had been acting as a central bank in Taiwan until the Central Bank of China resumed its operation in Taiwan on July 1st, 1961. Since then, the Bank of Taiwan had changed its role and become a commercial bank. Despite the fact, the bank had until now kept a close relationship with the Central Bank of China. For example, even though the right to issue New Taiwan Dollars had been taken back by the Central Bank of China, the allocation, arrangement, and disposition of the New Taiwan Dollars is still dealt with by the Bank of Taiwan now. See Yan, *supra*, note 50, at 21.

[63] Lee, *supra*, note 23, at 468. See also The Central Bank of Taiwan, *supra*, note 28, at 12.

[64] *Ibid* at 467.

[65] Even though the Chinese government took control over the Japanese banking institutions, the Japanese influence on the Taiwanese banking sector continued to affect the development of Taiwan's banking system. The Chinese government was also at that time following the Japanese model in restructuring Taiwan's financial sector. For example, the Bank of Taiwan, which was operated by the Japanese government as the central bank of the Taiwan colony, was reorganized on May 20, 1946, as a provincial bank wholly owned by the Chinese government. Similar to the undertaking designated by the Japanese colonial power, the Bank of Taiwan was again authorized to issue the Taiwan Dollar to circulate in the Taiwan area in accordance with the *Regulation Governing the Issuance of the Taiwan Dollar by the Bank of Taiwan under the Supervision of the Officials Dispatched by the Ministry of Finance* promulgated on August 17, 1946 by the Ministry of Finance. The Regulation is known as the "Old Taiwan Dollar Regulation". The Old Taiwan Dollar was over issued resulting from the pressure faced by the Bank of Taiwan to meet its increasing expenditures. In addition to that, the adoption of the Gold Yuan Note and the military setbacks in Mainland China had created a huge influx of Gold Yuan Notes into Taiwan. The two factors together resulted in a significant devaluation of the Old Taiwan Dollar. In order not to repeat the same failure of the Gold Yuan Note, the Chinese government appropriated 800,000 ounces of gold, as well as ten million U.S. dollars and authorized the Taiwan Provincial Government to initiate the monetary reform on June 15, 1949. The Taiwan Provincial Government issued the New Taiwan Dollar to replace the Old Taiwan Dollar at the

publishing guidelines for reorganizing Taiwan's financial system, the Chinese Ministry of Finance promulgated *Regulations Governing the Disposition of the Bank Notes and the Financial Institutions in the Taiwan Province* on October 31, 1945.[66] During the first fifteen years of post colonialism, the banking reorganization in Taiwan consisted of two stages. The first stage started from 1945-1949, and the second from 1950-1959.

In the first stage because Taiwan had just been ceded back to China, the major task of the government was to take over and reorganize Japanese banks which were set up during Japanese occupation. In 1949 Chiang's national government ("Kuomingtang"; KMT regime; Nationalist Party) retreated to Taiwan and claimed the authority of the Chinese government.[67] Taiwan's population had increased to 7.9 million and a lack of material supplies, inflation, and financial deficits in the government resulted in bleak social and economic conditions. In addition, foreign reserves had been drained and the economy was on the brink of breaking down. Under these circumstances, in the early years following the recovery of Taiwan, the government's only focus was to reorganize those financial institutions, which were established during Japanese colonial occupation. Also, no new banks were established during the ten years following the KMT government's retreat.[68] In fact, during the so-called "period of maintaining stability" from 1950 to 1958, the banks relocated from Mainland China were not even allowed to resume operations in Taiwan.[69]

During the second stage of reconstruction from 1950-1959, financial institutions originally domiciled in Taiwan dominated the financial business in Taiwan, because most financial institutions transferred from Mainland China had not started operations except

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conversion rate of one New Taiwan Dollar to 40,000 Old Taiwan Dollars. As the Chinese government moved to Taipei in December 1949, along with the currency reserves, the position of the New Taiwan Dollar was strengthened. See Lee, *supra*, note 23, at 472.

[66] See Central Bank of China, *Jin Rong Fa Gui Da Quan (Compilation of the Financial Laws and Regulations)* (1947) at 231.

[67] The KMT government represented the Chinese government in Taiwan until 2000 when Chen Shui-Bian of the Democratic Progressive Party took the presidency. Chen has since then become the President of the Republic of China (Taiwan), ending the Nationalist Party's ruling in Taiwan (the KMT regime) of five decades.

[68] Yan, *supra*, note 50, (Foreword).

[69] *Ibid* at 17.

for Central Trust of China.[70] The "Big Six" provincial-owned banks (Bank of Taiwan, Land Bank of Taiwan, Taiwan Cooperative Bank, First Commercial Bank, Hua Nan Commercial Bank and Zhang Hua Commercial Bank) dominated the banking sector in Taiwan and became the engine of Taiwan's financial markets development.[71]

(2.3) Banks Founded in Mainland China and Subsequently Re-established in Taiwan

For a more comprehensive review of the banking industry's development in Taiwan after 1949, we must first understand Taiwan's social and economic circumstances at the time because these factors not only had a huge impact on Taiwan's banking industry but also they stimulated it toward modernization. Chiang's KMT government retreated to Taiwan and became the Taiwanese government in 1949. Confronted with material shortages, it contrived to overcome economic obstacles through a series of central planning economic strategies. The government started off the first four-year economic plan in 1953 by taking advantage of aid provided by the U.S. Its goal was to strengthen the agricultural and industrial framework of Taiwan and to help it achieve self-sustenance within the next four years. By the time the second four-year economic plan started in 1957, the total population of Taiwan exceeded 10 million and the rural population 4.9 million.[72] To meet the growing basic needs of the population, the Taiwanese government managed to increase agricultural and industrial production and begin opening its local markets to foreign trade. By 1958, Taiwan had built a relatively strong economic foundation.[73] However, restricted by its limited natural resources and access to foreign markets, the growth of Taiwan's agriculture and industry seemed limited. Under pressure to overcome dire economic conditions and rising unemployment rates, the Taiwanese government began developing from an inward looking economy to an outward looking economy. Amid the second four-year economic

[70] Bureau of Monetary Affairs, Ministry of Finance, the R.O.C., *The Modernization of the R.O.C. Financial System*. (Chapter two)
[71] *Ibid.* (Foreword)
[72] Yan, *supra*, note 50, at 96.
[73] *Ibid* at 16.

plan, the government notified the International Monetary Fund (IMF) that Taiwan had unified a multiple exchange rates system and instead adopted a single foreign exchange rate system as pegged against U.S. dollars.[74] The government's purpose was to provide a more foreign-friendly financial environment for international capital. The government also relaxed restrictions on imports and promulgated rules to encourage exports. During the third four-year economic plan (1961-1964), the government endeavored to develop its export industries, energy industries and heavy industries and to build up new industries that required more skills and less capital.[75] In the fourth four-year economic plan (1965-1968), long-term economic development was encouraged. As a result the government promoted economic modernization, the maintenance and stabilization of its rapid economic growth, and the upgrading of living standards.[76] The fifth four-year economic plan (1969-1972) basically extended the goals of the previous (the fourth) economic plan, with special emphasis on the development of the electronics industry and the modernization of the agricultural industry.[77] The ongoing four-year economic plans continued to take place until the ninth and final four-year economic plan ended in 1989.

The changes in Taiwan's economic environment also brought about changes in its banking sector. In order to cope with the growing demand for banking services within individual developing industries, the government not only approved banks previously established in Mainland China, but also several newly-approved government-owned banks and one development bank.

After the government retreated to Taiwan in 1949, it was not anxious to reestablish banks originally set up in Mainland China, let alone establish new banks, given that the Japanese colonists had left Taiwan with a complicated existing banking infrastructure. However, the barely-settled banking structure of the time was almost immediately outdated, no longer able to meet Taiwan's banking needs after its economy started to improve in 1960. In order to further stimulate the local economy through the

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[74] *Ibid* at 96.
[75] *Ibid* at 140.
[76] *Ibid.*
[77] *Ibid.*

efficient allocation of financial resources made available for Taiwan's developing industries, the Taiwanese government not only adopted a policy of government control over the banking sector[78], but also provided some criteria to reestablish the government banks originally set up in Mainland China, based on an earlier *Program of the Adjustment of the National Government-owned Enterprises (PANGE)*[79], promulgated by the Executive Yuan of the national government on June 9, 1940. The principles underlying the re-establishment of Mainland China-based banks were as follows: (1) enlarging the financial resources available to developing industries in Taiwan, (2) supervising the overseas branches of Mainland China-based banks, and (3) protecting the interests of these banks' private shareholders.

Normally a diversity of banks in the marketplace brings with it more of an opportunity for developing industries to obtain credit for their businesses. Therefore, (1) appears to be a more general principle, compared with (2) and (3), which seem to be more specific guidelines, for the reestablishment of Mainland China-based banks in Taiwan. For example, even though the Bank of Communications had moved its head office to Taipei in January 1950, it was not until February 2, 1960 that the bank finally resumed its banking business in Taiwan. The PANGE approved to have the Bank of Communications relocate in Taiwan in order to allow for continued supervision over its overseas branches[80]. Likewise, the PANGE also allowed the Bank of China to maintain its legal entity because at that time The Bank of China had branches in New York, Tokyo, Osaka, Saigon, and Bangkok. The Bank of China was allowed by the PANGE to resume its business in Taiwan in October 1960. Furthermore, in order to protect its private shareholders, the Bank of China was privatized in December 1971 by selling its shares to the ruling Nationalist Party ("Kuomingtang"). It was subsequently renamed the

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[78] Bureau of Monetary Affairs, *supra*, note 70.

[79] Yu-Zuo Tan, *Zhong Guo Zhong Yao Yin Hang Fa Zhan Shi (Development History of the Important Banks in China)* (1961) at 264. (In Chinese)

[80] The PANGE allowed the Bank of Communications to maintain supervision over its overseas branches in Hong Kong, Rangoon, Calcutta, Saigon, Haiphong, Hanoi, and a subsidiary in the Philippines. Later, in the spring of 1950, its branches in Hong Kong, Rangoon, and Calcutta were taken over by the Chinese Communists following the diplomatic recognition of the People's Republic of China by the United Kingdom and India. As a result, after the bank resumed its operation in Taiwan in 1960, in order to differentiate itself from the Bank of Communication in Mainland China, the Bank of Communications in Taiwan changed its English Name to the Jiao Tong Bank in 1992. *Ibid* at 265.

International Commercial Bank of China.[81] Prior to this development and for similar reasons, the Farmers' Bank of China had obtained approval to relocate in Taiwan. The bank had moved its head office to Taipei on December 15, 1949[82]. With a view to protecting private shareholders' interests in the Bank, which had previously invested in Taiwan, the Farmers' Bank of China resumed its business operations in Taiwan in 1967.

(2.3.1) Newly-Approved Banks (1959-1982)
(After Mainland China-Founded Banks Were Relocated in Taiwan)

After the Chinese banks were relocated in Taiwan, the government further permitted the establishment of one development bank and several other banks in order to further grow Taiwan's economy. In order to finance privatized enterprises and strengthen the economy, the China Development Corporation was incorporated in May 1959[83]. This development bank was regarded as the most efficient tool to stimulate economic growth after the Second World War. For example, before the China Development Corporation was founded in Taiwan in 1959, France, Chili, Turkey, India, England, and Indonesia had already established similar financial institutions.[84] In Taiwan, the China Development Corporation was treated as a trust company, which fell into one of the four categories of banks subject to the jurisdiction of its banking laws. In addition to the China Development Corporation, in order to further subsidize economic growth, the

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[81] Lee, *supra*, note 23, at 476.
[82] Tan, *supra*, note 79 at 309.
[83] The China Development Corporation had gone through a series of reorganization from being a trust company, to industrial bank, and then to a holding company. Having mentioned in the text, the China Development Corporation was incorporated in May 1959. About forty years later, in August 1998, the China Development Corporation was permitted to reorganize as the first specialized bank providing loans and other services for the industries in Taiwan. Consequently, the China Development Corporation was renamed as the China Development Industrial Bank, which officially started its operation in January 1999. In order to increase its competitiveness among the local financial institutions by following the global trend of mergers and acquisition, the China Development Financial Holding Company Ltd. was permitted to establish on December 28, 2001. Up to the time the thesis is written in 2002, under this structure, the China Development Financial Holding Company Ltd. consists of the China Development Industrial Bank and other subsidiaries, which include commercial banks, life insurance companies, stock companies and so on. For related information regarding the China Development Industrial Bank, see its web site at [http://www.cdibank.com/cdib01/cdib0100.htm]. For other information about the China Development Financial Holding Company Ltd., see the government web site of the Bureau of Monetary Affairs, the Ministry of Finance at [http://www.boma.gov.tw]
[84] Yan, *supra*, note 50, at 101.

government also permitted several banks to establish themselves in the 1970's.

In 1971, at the beginning of what would be a politically volatile period of time for Taiwan, the island was forced to drop out of the United Nations. In 1973, it suffered a large trade deficit due to the global energy crisis. Petroleum prices increased dramatically four times within three months, increasing production and transportation costs. An international recession occurred among major trading countries.[85] These obstacles forced Taiwan to rethink its economy. In doing so, the government had, on the one hand, endeavored to launch the "Great 10 Construction Plans", and on the other hand, continued to develop its banking industry. For example, with a view to supporting Taiwan's economic development, the United World Chinese Commercial Bank was established in 1975 and the Export-Import Bank in 1979[86].

In addition, the Taipei Bank was established in 1969[87], after Taipei was upgraded to a state city in 1967. Its purpose was to streamline the municipal banking business, assist in municipal construction, assist as a municipal treasury, and coordinate the operations of bank credit with national financial policy.[88] For the same purposes, the Bank of Kaohsiung (Gao-Xiong) was established in 1982 after it became a state city in 1979.

With Chinese banks being reintroduced in Taiwan, along with the banks originally domiciled on the island, Taiwan's financial institutions could be classified into six categories, namely: (1) government banks, (2) provincial banks, (3) city banks, (4) commercial banks, (5) a development bank, and (6) foreign banks.[89] Up until 1969, according to a Taiwanese government publication, government banks included the Bank of China, the Bank of Communications, the Farmers Bank of China, and the Central

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[85] *Ibid* at 236-237.
[86] *Ibid.*
[87] Upon its establishment, the Taipei Bank was regarded as a municipal-owned financial institution. Consequently, it did not enjoy independent status of a legal person. After the banking law amendment of 1975, there were proposals to reorganize the Taipei Bank; and it was not until 1984 that the bank continued to operate within such corporate structure. See Yan, *supra*, note 50, at 193.
[88] *Ibid.*
[89] The Central Bank of Taiwan, *supra*, note 28, at 6.

Trust of China. The provincial banks included the Bank of Taiwan, the Land Bank of Taiwan, and the Cooperative Bank of Taiwan. The sole municipal bank was referred then only as the Taipei Bank, before the establishment of the Bank of Kaohsiung in 1982. Commercial banks consisted of the First Commercial Bank of Taiwan, Hua Nan Commercial Bank, the Zhang Hua Commercial Bank, the Overseas Chinese Commercial Banking Corporation, and the Shanghai Commercial and Savings Bank. The development bank referred to the China Development Corporation.[90]

(2.3.2) Starting Gradual Privatization of Banks in Taiwan (Including Those That Were Relocated from Mainland China)

From 1969 to the present date, Taiwan has gone through a series of financial changes and banking law reforms. In compliance with its government policy for the privatization of banking industry and the promotion of international trade, except for the Central Trust of China, the original government banks have been privatized. For instance, the Bank of China was privatized on December 17, 1971 under the name, the International Commercial Bank of China. In addition, the Bank of Communications was reorganized and assumed its present form as a publicly listed bank on September 13, 1999; and in order to distinguish itself from the Bank of Communications in China, the bank was also renamed the Jiao Tong Bank.[91] Moreover, The Farmers Bank of China went public on November 28, 1994.[92]

In contrast, following the phasing out of the Taiwan Provincial Government on December 21, 1998, some original provincial banks (for example, the Bank of Taiwan

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[90] *Ibid* at 6-17.

[91] Before the Jiao Tong Bank was eventually privatized in 1999, the bank had long been operated as government banks. In July 1975, the bank was designated by the banking law amendment of 1975 to be a specialized industrial bank. Later in January 1979, with the aims of upgrading Taiwan's industrial infrastructure and fostering the growth of technology-intense industries, the government amended the *Bank of Communications Act*, whereby the bank was reorganized into a development bank and was given the task of developing Taiwan's industrial, mining, transportation, and public utility enterprises. For the history of the Jiao Tong Bank, see its related web sites at [http://www.ctnbank.com.tw/about.htm]; and [http://www.ctnbank.com.tw/year/23.htm].

[92] For other information about the Farmers Bank of China, see its web site at [http://ecommerce.taipeitimes.com/Finance/Fbc].

and the Land Bank of Taiwan) were taken over by the central government of Taiwan, the Republic of China. Even so, the established "Three Provincially Owned Banks" were otherwise privatized. The First Commercial Bank, the Hua Nan Bank, and the Zhang Hua Bank had all been privatized in 1998 through the release of a large portion of government-owned shares.[93] As a consequence of privatization, an organizational restructuring was implemented in each of the three banks to ensure sound and efficient management. These banks now not only have more autonomy to make investment decisions but in order to provide multiple services to meet a customer's needs, the Hua Nan Bank and the First Commercial Bank also have made efforts to develop themselves into large financial holding companies. The Hua Nan Financial Holding Co. Ltd was approved by the Ministry of Finance in Taiwan on December 19, 2001, and the First Financial Holding Co. Ltd, on December 31 of the same year.[94] Finally, the Cooperative Bank of Taiwan, in order to increase its competitiveness among local banks, recently privatized in January 2001. Before the Cooperative Bank of Taiwan went public, it was also a provincially owned bank.[95]

(2.4) Fifteen New Private Commercial Banks Chartered in June 1991 and the Sixteenth in May 1992

Based on the statistics provided above, it can be seen that the number of government and provincial banks has decreased over the years while the number of commercial banks has multiplied. This has been a conscious effort on behalf of the Taiwan government to increase the global competitiveness of Taiwan's financial institutions. Before the establishment of 15 new private commercial banks in 1991,

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[93] For information about the privatization of these three banks, go to their individual web site. For the First Commercial Bank, go to [http://www.firstbank.com.tw/fcb_internet/eindex.htm], the Hua Nan Bank, [http://www.hncb.com.tw/content5.htm], and the Zhang Hua Bank, [http://www.chb.com.tw/english/html/chb_history.html].

[94] For information about the establishments of Financial Holding Companies, see the web site of the Bureau of Monetary Affairs of the Ministry of Finance in Taiwan, [http://www.boma.gov.tw] For further information about the establishment of the First Financial Holding Co. Ltd., go to [http://www.firstbank.com.tw/fcb_internet/new91098.htm].

[95] For the history of the Cooperative Bank of Taiwan, see its web site at [http://www.tcb-bank.com.tw/intro/intro.htm].

government-owned banks dominated the Taiwanese banking sector. As a result of increasing competition worldwide and Taiwanese government's privatization policy, which brought about the Banking Act Amendment of 1989, 1991 was a watershed in the shift of market dominance from government-owned banks to private banks.

Prior to 1991, the three provincial government-owned commercial banks, namely, Zhang Hua Bank, First Commercial Bank, and Hua Nan Bank, had dominated Taiwan's banking industry.[96] In 1991, the three banks altogether controlled 80% of Taiwan's national market.[97] With a view to modernizing and liberalizing Taiwan's banking system, the Taiwanese government not only committed itself to privatizing the three banks through the release of a large portion of government-owned shares,[98] but also amended the banking law in 1989 to allow the formation of new private commercial banks. The new law authorized the Ministry of Finance (MOF; an organ of the Taiwanese government) to promulgate regulations for the licensing of these new banks and in the meantime set forth certain requirements. On April 10, 1990, the MOF promulgated the *Criteria Governing the Establishment of Commercial Banks*, through which the MOF aimed to govern the establishment of these new private commercial banks.

The Banking Act Amendment of 1989 and the *Criteria Governing the Establishment of Commercial Banks* imposed strict requirements for the establishment of private banks. Under the criteria, each new bank must have a minimum paid-in capital of NT$10 billion (about US$380 million). Of this amount, 80 per cent must be subscribed

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[96] Michael S. Bennett, "Unleashing a Tiger: Financial Deregulation in Taiwan" (1992) 11 UCLA Pac. Basin L. J. 1 (original note 136). See also Jonathan Friedland, "Customers Come First", Far E. Econ. Rev., May 7, 1992, at 72.

[97] "Taiwan Bank Reform Drives Deposit Interest Rates Up, Loan Rates Down", Global Fin. Markets, July 18, 1991, available in Westlaw, BUS-INTL database. See also Bennett, *supra*, note 96, (original note 137).

[98] While the Ministry of Finance (MOF), an organ of Taiwanese government and a minority owner of the "big three", reduced its holdings in them in 1991, the Provincial Assembly, the banks' majority owner, had thus far declined to privatize its stake. The Provincial Assembly's continuing refusal to sell its share of the banks for the purpose of implementing the privatization of Taiwanese banking industry arose from its disinclination to give up the revenue and patronage that it gained from its stake in the "big three". The failure to privatize the three banks had delayed the government's desired pace of reform. Nevertheless, Zhang Hua Bank's privatization program was completed on January 1, 1998, followed by First Commercial Bank (January 22, 1998) and Hua Nan Bank (January 22, 1998). See on-line bank introductions: [http://www.chb.com.tw/html/ccb_cintro1_1.html; http://www.firstbank.com.tw/fcb_internet/in02.htm]; and [http://www.hncb.com.tw/history.htm] See also Bennett, *supra*, note 96, at 19.

to by the promoters of the bank and the remaining 20 per cent must be offered to the public, pursuant to a public underwriting where all shares must be issued at the same price and under the same terms and conditions and where no individual shareholder may hold more than 10,000 shares. Due to such a large amount of required paid-up capital, all sixteen of the new private banks (fifteen approved out of nineteen applicants in June 1991 and an additional one approved later in May 1992[99]) are among the world's top five hundred banks[100], in terms of bank assets. This initial capital requirement for new banks in Taiwan is significantly higher than the average capitalization of banks in the United States (about US$2 million) and Europe (about US$6 million), which are the major supporters of the Basle Committee.[101] As a result, these new private commercial banks should have no difficulty meeting the capital adequacy standards of the Basle Supervisor's Committee.[102] In order to ensure stable bank operations, the Banking Act Amendment of 1989 also required capital to be equal to at least 8 percent of a bank's total assets after applying risk-weighting coefficients to the assets, thus conforming to the Basle Committee Standards.[103] Due to the high paid-up capital requirements, the backing for these 15 new banks came principally from the largest and most aggressive industrial groups in Taiwan. The fifteen new banks (and their major investors), which received operation licenses, are Da An[104] Commercial Bank (Pacific Wire & Cable, USI Far East), Wan Tai [Cosmos] Bank (Prince Motors, San Fu Motors), Far Eastern International Bank (Far Eastern Textiles, Asia Cement), Da Zhong Bank (Formosa Plastics), Asia-Pacific

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[99] See the statistics provided by the Bureau of Monetary Affairs, Ministry of Finance in Taiwan. [http://www.boma.gov.tw/english/p4-1.htm].

[100] In fact, five of the fifteen new banks have paid-in capital of more than the minimum NT$10 billion. These are: Zhong Xing Bank at NT$13.5 billion, Grand Commercial Bank at NT$12.6 billion, Wan-Tai and Union Banks at NT$12 billion each, and Da Zhong Bank at NT$10.5 billion. See Julian Baum, "Bankers Abound", FAR E. ECON. REV., July 11, 1991, at 36.

[101] The minimum capital for the establishment of new banks, in the European Union, requires ECU$5 million (about US$6 million); and in the United States, US$2 million. See Lawrence L.C. Lee, "The Basle Accords as Soft Law: Strengthening International Banking Supervision" (1998) 39 Virginia Journal of International Law 1 at 29. See also Lawrence S. Liu, "Financial Developments and Foreign Investment Strategies in Taiwan—a Legal and Policy Perspective" (1991) 25 INT'L LAW 69 at 75.

[102] Jane K. Winn, "Banking and Finance in Taiwan: The Prospects for Internationalization in the 1990s" (1991) 25 INT'L LAW at 907.

[103] Article 44 of the Banking Act of Taiwan.

[104] Da An Commercial Bank was approved (by the Bureau of Monetary Affairs, Ministry of Finance in Taiwan,) to merge with Tai Xin International Bank on December 31, 2001. After the merger of the two banks, the amalgamation further obtained the government approval to establish a financial company (Tai Xin Financial Holding Co. Ltd.) on February 18, 2002. A letter to the public released by Tai Xin Bank confirmed the news, [http://www.Tai Xinbank.com.tw/merge/mletter.htm].

Bank (Tai Zhong city businesses, ADI Corp.), Zhong Xing Bank (Hua Ying Copper & Iron), Grand Commercial Bank (President Enterprises), Yu Shan [E. Sun] Commercial Bank (Taiwan Match, Eagle Food), Union Bank of Taiwan (Union Enterprise Construction), Hua Xin Bank [Bank Sinopac] (Central Investment and Holding, Tuntex), Bao Dao[105] Commercial Bank (Yakult), Fubon Commercial Bank (Foremost, Evergreen Marine Corp.), Zhong Hua Bank (China Rebar), Pan Asia Bank (Chang Yi Group), and Tai Xin International Bank (Xin Guang Synthetic Fiber, Wei Quan Food Corp., Teco Electric).[106]

As mentioned above, for fear of corruption and insider lending, the Banking Act Amendment of 1989 places strict limits on the extent to which individuals or companies can control these new private commercial banks. No individual entity may hold more than 10,000 shares. Examples listed in the last paragraph have also shown that the backing for these new private banks came principally from the largest private companies in Taiwan, and consequently, these entities are likely to dominate their affiliated banks. As one commentator has pointed out, in the event where these groups intend to use their affiliated banks as capital lenders at below-market rates, it is likely that the ability of the new banks to supply capital to the general market on competitive terms will be impaired.[107] In spite of this concern, the establishment of sixteen new private banks in 1991 and 1992 respectively has profoundly changed the banking environment of Taiwan. Most importantly, price banking has begun to replace relationship banking; and competition from the new banks is also beginning to pressure the previously lethargic state-run banks to provide a better level of service.[108]

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[105] Bao Dao Commercial Bank has been renamed on December 1, 2001 as Ri Sheng International Bank.
[106] Baum, *supra*, note 100, at 36. The English names of the fifteen private banks are in accordance with the "List of Financial Institutions (End of April 2002) published by the Bureau of Monetary Affairs.
[107] Bennett, *supra*, note 96, at 20-21.
[108] *Ibid* at 9-10.

3. Two Other Types of Banks in Taiwan: "Banks for a Special Business Purpose" and "Trust and Investment Companies"

What needs to be emphasized, according to Article 20 of the banking law, banks in Taiwan are defined to include not only traditionally defined banks but also "banks for a special business purpose" and "trust and investment companies".

Banks for a Special Business Purpose ("Specialized Banks") refers to those government-controlled banks that are set up for advancing the public interest. For example, China Development Industrial Bank (CDIB) is Taiwan's leading industrial bank and the Taiwanese government is one of its biggest shareholders. The CDIC's mandate is to offer a broad range of financial services to help Taiwan domestic industries. What needs to be pointed out is, faced with the pressure of increasing corporate competitiveness, CDIC is now a subsidy of its parent company, the China Development Financial Holding Corporation.

Trust and Investment Companies in Taiwan are also faced with the requirement to be reorganized into commercial banks, like Credit Cooperatives. According to a report issued by the Financial Supervisory Commission in December 2004, "in accordance with [Taiwan's] *Trust Enterprise Act*, three trust and investment companies—Taiwan Land Development and Trust Corp., China United Trust and Investment Corp., and Asia Trust and Investment Corp.—will be required to reorganize into banks or trust enterprises before July 2005"[109]. However, judging by the recently released "Financial Statistics Monthly" in 2006, there are still two trust and investment companies in Taiwan, which obviously indicates that the remaining trust and investment companies in Taiwan have not been reorganized into banks or trust enterprises.

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[109] See Financial Supervisory Commission's official government website at [http://www.banking.gov.tw/fp.asp?xItem=31506&ctNode-698] (under the title: Banking in Taiwan) (Last Updated: December 3, 2004).

4. Over-Banking in Taiwan

Overbanking in Taiwan is one of the main reasons that prompted the promulgation of Taiwan's *Financial Holding Company Act* (hereafter "FHCA") in July 2001. Official Statistics, released by Financial Supervisory Commission (FSC) in January 2006, indicates that the total number of banking institutions in Taiwan is *4875*[110], exceeding even the number of 7-Eleven convenience stores in Taiwan (which can be seen almost everywhere).

A study by the Economist also suggests that there is overbanking in this tiny-island nation of Taiwan. "In all, the island nation of 23 million people has about 45 commercial banks, 14 financial holding companies (each of them typically owns at least one bank plus insurance and brokerage subsidiaries) and over 300 rural credit cooperatives. Most are tiny".[111]

Further, recent statistics released by Financial Supervisory Commission in January 2006, continue to show that the number of local commercial banks is 45; among them they have established 3,247 branches[112]. In parallel, 34 foreign banks maintain their presence in Taiwan, with 66 branches. Even though the number of credit cooperatives is now reduced to only 28, there are still altogether 289 branches. Worth noting, the number of credit cooperatives has dwindled tremendously following Taiwan's financial reform in the 1990s. To streamline the banking business, financial reform has

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[110] The breakdown of this total number is described as follows: (1) Domestic Banks (Head: 45, Branches: 3247); (2) Local Branches of Foreign Banks (Head: 34, Branches: 66); (3) Credit Cooperatives (Head: 28, Branches: 289); (4) Credit Departments of Farmers' Association (Head: 253, Branches: 827); (5) Credit Department of Fishermen's Association (Head: 25, Branches: 39); (6) Trust and Investment Companies (Head: 2, Branches: 20). The original source is derived from "Financial Statistics Monthly, Taiwan District, R.O.C.", compiled by the Economic Research Department, the Central Bank of China", See Financial Supervisory Commission (FSC)'s on-line information: [http://www.banking.gov.tw/ct.asp?xItem=32339&CtNode=704] (Regarding "Overview of Banking Sector—Number of Financial Institutions.)

[111] "Folly by Numbers: The Government of Taiwan is Getting Too Much in the Way" in *Economist*; 11/26/2005, Vol. 377 Issue 8454, pp. 90-91.

[112] Original source: "Financial Statistics Monthly, Taiwan District, R.O.C.", compiled by Economic Research Department, the Central Bank of China. Available also on FSC's official website: [http://www.banking.gov.tw/ct.asp?xItem=32339&CtNode=704] (Under "Overview of Banking Sector—Number of Financial Institutions.)

required fringe and satellite financial institutions to gradually transform themselves into commercial banks. The various Farmer's Co-ops have 253 head offices (with 827 branches); and the Fishermen's Co-ops have 25 head offices (with 39 branches). Furthermore, as part of the banking structure, there are 2 Trust and Investment Companies in Taiwan (with 20 branches).[113]. These numbers in total bring the number of banking institutions in Taiwan to *4875*[114], exceeding even the number of ubiquitous convenience stores on the island. As a matter of interest Taiwan is said to have the world's third largest collection of 7-Eleven convenience store, totaling a number of *4037* as of 2006, behind Japan and the United States.[115] Even this figure is an understatement as to the popularity of the 7-11 chain, considering that Taiwan's total population (23 million) is much smaller than either that of Japan (128 million) or the U.S. (298 million)[116]. With a high per capita ratio like this, just as it is not unusual to see several convenience stores within a couple of blocks, it is also not unusual to see two or even three banks located within the same distance in Taipei city (Taiwan's financial capital).

The problem of overbanking can be viewed at two different levels, both international and national.

(4.1) Overbanking Problem in Taiwan (Internationally)

Internationally speaking, despite the large number of financial institutions in Taiwan (4875), their individual capitalization is small compared to the world's largest financial group, Citigroup. It is predictable that Taiwan's financial institutions would face further changes before they are to become globally competitive. To this end, the Taiwanese government has encouraged the establishment of FHCs in Taiwan. Following the promulgation of Taiwan's FHCA in July 2001 and up until December 2002, relevant

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[113] *Ibid.*
[114] Financial Supervisory Commission, *supra*, note 110 (regarding "Overview of Banking Sector—Number of Financial Institutions).
[115] See on-line encyclopedia [http://en.wikipedia.org/wiki/7-Eleven#Taiwan].
[116] *Ibid.* See also other relevant information provided by Wikipedia: [http://en.wikipedia.org/wiki/Japan] & [http://en.wikipedia.org/wiki/The_United_States], in regards to the population of respective countries.

statistics, posted by the Bureau of Monetary Affairs (subordinate to the Ministry of Finance), indicated that after the first wave of mergers and acquisitions, the number of FHCs stood at 14. For Taiwan's FHCs to gain a global competitive advantage, the government has encouraged further mergers among financial conglomerates that currently exist in Taiwan. In fact, the second wave of mergers is starting to take shape. For example, there were signs indicating that the China Trust Financial Holding Company was attempting to buy out the Mega Financial Holding Company.

A study by the *Economist*, as mentioned above, further pinpoints a critical problem existing in Taiwan's banking industry – Taiwan's lack of global competitiveness within the banking sector. The top five lenders in Taiwan have just 35% of the market, versus 60-80% in most developed countries.[117] Put in a macro context, Taiwanese banks possess only a relatively small market share, compared to other more vibrant international banks, such as HSBC and Citibank. The Taiwanese government has long identified this issue and in an announcement made by the President on October 20th 2004, it clearly indicated that one of the four goals for financial institutions' consolidation (which constitutes part of the overall financial reform) was to "develop at least three financial institutions with over 10% of market share by the end of 2005."[118] To this end, measures for providing incentives include "financial institutions with over 10% market shares will get prior approval to establish branches overseas and acquire foreign financial institutions"[119]. As most banks in Taiwan have aspired to grow overseas, this incentive is clearly pointing in the right direction. In retrospect, the study in 2005 and the President's proclamation in 2004 does seem to provide support for why Taiwan has attained a 35% share of the world market. Despite this watershed success, the study in 2005 also suggests that "a lack of scale and fierce competition have left revenues flat and profits anemic. In the first half of 2005 the banks' average return on equity was around 8%, the

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[117] Economist, *supra*, note 111.
[118] See "Pushing Forward the Four Goals for Financial Institutions Consolidation: Strategies & Measures", presented in Power Point format by the Financial Supervisory Commission, Executive Yuan, on December 4, 2004; accessible on-line: [http://www.banking.gov.tw/ct.asp?xItem=224619&ctNode=1991&mp=10] (Last Updated on March 16, 2005)
[119] *Ibid.*

lowest in Asia, says Fitch, a rating agency."[120] With respect to market value, Taiwan official statistics[121] further indicated that in the 2nd quarter of 2005, the financial service sector produced 12.05% of Taiwan's total GDP[122], a record high over the past decade, compared to 8.90% in 1996. Translating this ratio into an actual monetary amount, in the 2nd quarter of 2005, the financial sector in Taiwan contributed NT$ 25, 981 billion (US$ 787 billion) to Taiwan's economy. This, in juxtaposition with the official statistics provided by U.S. Department of Commerce, Bureau of Economic Analysis, its financial service sector produced a gross output of US$ 1541.8 billion dollars in the year of 2004[123], or approximately 14% of U.S. total GDP[124]. In sharp contrast, the financial services sector in Taiwan, its market value accounts for only 51% (that is about a half) of its U.S. counterpart. This again demonstrates a lack of scale in Taiwan's financial service sector. As Taiwan's financial institutions strive to elevate its scale, mergers and acquisitions among which in order to become FHCs have witnessed an unprecedented growth throughout Taiwan's financial history.

(4.2) Overbanking in Taiwan (Nationally): Zhong Xing Bank Scandal

Nationally, within Taiwan, the problem of overbanking reached its apex when overbanking allegedly led to the 'banking storm' in Taiwan in 2000, shaking almost the entire banking system to its core. Incidents of this sort suggested that some less-competitive banks, aiming to increase their revenue from a fiercely competitive banking market, lent out an unacceptable amount of bad credit. The banking storm in Taiwan

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[120] Economist, *supra*, note 111.

[121] Statistics provided by the Executive Yuan (the cabinet) of Taiwan. Statistics data available from the official website of Taiwan's Banking Bureau, Financial Supervision Commission (FSC). [On-line: http://www.banking.gov.tw]

[122] GDP (Gross Domestic Product) of a country is defined as the market value of all final goods and services produced within a country in a given period of time. [On-line encyclopedia: http://en.wikipedia.org/wiki/GDP]

[123] Statistics released by U.S. Department of Commerce, Bureau of Economic Analysis regarding "Gross Output by Industry"—Item No. 51 Finance and Insurance (inclusive of banking, securities, and insurance industries). [On-line: http://www.bea.gov/bea/industry/gpotables/gpo_action.cfm?anon=290&table_id=14101&format_type=0] (Released Date: April 27, 2006)

[124] According to Countryfacts, the GDP in the U.S. was US$ 10.99 trillion (2003 est.). [On-line: http://www.countryfacts.com/unitedstates/]

started out as an apparent after-effect of the Zhong Xing Bank scandal—the bank illegally lent to an individual (the chairman of Taiwan Pineapple Corp.; Zong-Hong Huang) and his related entities (the Taiwan Pineapple Group) far exceeding their permitted loan/value ratios.[125] This peculiar case not only spooked the private banking sector in Taiwan and its investors but also resulted in numerous judicial investigations into the business practices of the management of the Taiwan Pineapple Corp. and those of the Zhong Xing Bank. Furthermore as a result of the Zhong Xing Bank crisis the Legislative Committee launched a review of all Taiwanese banks. The results indicated that, apart from Zhong Xing Bank, there were also other banks in Taiwan, such as the Qing Feng Commercial Bank, the Bank of Overseas Chinese, Development & Trust (Tai Kai), and Zhang Hua Bank, which were allegedly involved with illegally extended loans. All of them had also experienced bank runs due to concerns that their lending practices had left them unstable.[126]

Specifically, the Taiwan Pineapple Group has huge business holdings ranging from food product manufacturing to construction companies and investment firms. By the very nature of the parties involved, this scandal involved numerous investors and shareholders. According to the indictment, the scandal involved a substantial number of illegal loans—the total amount of loans to the Chairman of the Taiwan Pineapple Corp. exceeded NT$ 5.4 billion (approx. US$ 257 million), nearly the limit that the Zhong Xing Bank in its entirety is authorized to lend to both Huang and his corporation[127]. Furthermore, aside from the credit line that Zhong Xing Bank illegally extended to Huang as an individual, the bank also loaned indirectly to Huang through dummy accounts he had set up to continue borrowing money. According to the prosecutor, Huang had set up numerous dummy accounts either in the names of related individuals, for example, his wife and his mother, or through his Taiwan Pineapple Group's

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[125] According to the Banking Act of Taiwan and its related regulations, a bank is not allowed to lend more than 40 per cent of its net worth of the previous fiscal year to a single client.

[126] See "Agency May Investigate Bank Leaders", *Taipei Times* (July 13, 2000). *The Taipei Times* is an English-language newspaper published and released in Taiwan. This story is obtained from their on-line news. In that news report, The Ministry of Finance asked the Investigation Bureau in Taiwan to file charges against Zhang Hua Bank's former chairman and current president, who were allegedly involved in lending irregularities.

[127] That is 40 per cent of the bank's net worth of the previous fiscal year.

employees and/or subsidiaries, or even through unrelated third parties. The prosecutor found that the Taiwan Pineapple Group had used over 100 fake names to set up accounts into which the bank loans were funneled.

At that time, the press in Taiwan observed that in 1998 the Taiwan Pineapple stock surged to NT$256 per share, but by December of that same year it had dropped as low as NT$39.4 per share. The indictment read that as Taiwan Pineapple's share price continued to slump and the amount of money loaned to the company grew larger, Yu-Yun Wang, the President of Zhong Xing Bank at the time, feared the company would go bankrupt, thereby endangering its debt to the bank. Instead of discontinuing the loans he felt he had no choice but to continue to support Huang, regardless of the legal limits on lending. This inevitably created a vicious cycle of lending good money after bad. The indictment alleges that every time Huang was in need of funds he would inform Zhong Xing Bank's bank officials and the general manager of the bank (Xuan-Zhen Wang) would order Bi-Yun Wu—then manager of the bank's Tian Mu branch—and Dong-Xing Li of the Lu Zhou branch, to offer loans to Huang the same day he applied for them. In this way, "The Zhong Xing Bank seemed to have become a Taiwan Pineapple Corporation-owned treasury," according to the prosecutor. After the scandal was revealed, the press in Taiwan observed that the total amount of illegal credit exceeded NT$7.03 billion. Due to the singularly large amount of money involved, and the numerous investors and shareholders, the scandal had a large impact on Taiwan society. The Zhong Xing Bank crisis later perpetuated itself in ripple effect as a series of related bank crises involving other companies. As mentioned above, spurred by the widely-publicized misconduct of the Zhong Xing Bank, a few other banks (Qing Feng Commercial Bank, the Bank of Overseas Chinese, Development & Trust (Tai Kai), and Zhang Hua Bank) also underwent investigation because of allegedly illegal lending practices. Not only did the Zhong Xing Bank scandal become a catalyst for an overhaul of Taiwan's banking law regime, the banking storm in Taiwan in 2000 also precipitated a series of banking law reforms. The government called for a halt to corrupt banking practices. The Taiwanese legislature therefore implemented a series of regulations that enabled closer monitoring of the bank's loan-to-deposit ratios by passing amendments to

Taiwan's Banking Act earlier in 2001. New regulations, announced on March 7, 2001, (to be effective within the subsequent 15 days), by the Ministry of Finance, are part of an ongoing banking reform designed to prevent Taiwan from bogging down in a widespread financial catastrophe, as did Thailand, during the Asian Financial Crisis.[128] Under the new regulations, banks are forbidden from lending more than 40 per cent of their net worth from the previous fiscal year to (any individual,) any domestic group, its affiliates or subsidiaries. Compared with the old regulation, previously, the limit had been set at 40 per cent for any bank's client; therefore, "domestic group, its affiliates or subsidiaries" were not encoded and thus not regulated under the Banking Act of Taiwan at the time.[129] The new regulation is viewed as a response to the Zhong Xing Bank scandal, in which bank officials are alleged to have allowed the Chairman of the Taiwan Pineapple Group to use dummy accounts to circumvent loan limits. In addition, the new regulations also limit uncollateralized loans to a single commercial entity to a maximum 15 per cent of the bank's net worth. If total loans have already exceeded the ceiling, then the bank is forbidden from extending any further loans.[130]

What needs to be emphasized is that due to the redefinition of "a single bank client", the "domestic group" here also includes its affiliates or subsidiaries. After the new regulations were passed and became effective, the officials from the Ministry of Finance in Taiwan confirmed that the purpose of the new regulations was to improve the risk control of the banking sector and to prevent concentrated financial risks in the banking sector. Likewise, economic analysts in Taiwan approved of the judicial process and commented that the measure would significantly affect credit lines of large industry groups and conglomerates and thus reduce the increasing number of overdue or non-performing loans. Obviously, economic analyses at the time were applied to articulate the problem under judicial review, and also contribute to the legal analysis. In the case of the Taiwan banking crisis, economic analysis had not only been included in the process of judicial reasoning but had also been reflected in the banking law reform of

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[128] See "New Banking Rules Set Up", *Taipei Times* (March 8, 2001).
[129] See Article 33-3 of the Banking Act of Taiwan. See also: Order issued by the Taiwan Ministry of Finance (No. tai-cai-rong-zi 86633243), dated Oct. 17th, 1997.
[130] Taipei Times (daily news), *supra*, note 128.

Taiwan. In particular, economic analysis was embodied in the enunciation of the underlying banking theories for prohibiting banks extending a credit line to a single bank client and in the declaration of the government policies in regulating the banking sector in Taiwan. This coincidentally conforms to Richard Posner's philosophy of law where he recognizes the economic analysis of law as a theory of law[131].

III. Conclusion

It has been reported that the Taiwanese government, in an effort to solve the NPL problem at the macro level, expanded the financial restructuring fund to NT$ 1.05 trillion, an amount equal to 10% of Taiwan's GDP[132]. In a similar vein, a report by analysts at Goldman Sachs estimated the clean-up cost would roughly amount to 11 percent of GDP (or NT$ 1.1 trillion), though it also emphasized that Taiwan's NPL ratio is still well-below that in other Asian crisis countries[133]. Goldman Sachs's report further acknowledged that the Taiwanese government was on the right track to clean up the NPLs caused by the overbanking problem in Taiwan.

Notwithstanding this silver lining, financial experts warned that disposal of NPLs alone will not serve as a fundamental solution to Taiwan's overbanking problem, since the NPL is only a symptom and not a cause of those problems[134]. For a fundamental solution, experts suggested that the government will have to step up its efforts to encourage financial institution mergers so as to alleviate the overbanking problem[135]. While further M&As are a step in the right direction, the importance of achieving optimal performance is otherwise underestimated. It should be noted that "market consolidation" in Taiwan through FHC establishments has not yet reached comparable success in other Asian countries. A recent financial report found that the total reduction

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[131] Richard Posner, *Economic Analysis of Law*, 3rd ed. (Boston and Toronto: Little, Brown & Company Ltd., 1986) at 24.
[132] Global News Wire, China Economic News Service, Taiwan Economic News, *supra*, note 2.
[133] (Headline) "Goldman Sees Opportunities for Taiwan Banks Despite NPL Problem", Financial Times Information, Global News Wire—Asia Africa Intelligence Wire, Taiwan News, September 4, 2002. [Information is available in Lexis Nexus "News & Business" research database.]
[134] Global News Wire, China Economic News Service, Taiwan Economic News, *supra*, note 2.
[135] *Ibid.*

in the number of financial institutions in Taiwan from 1997 to 2002 was only 14%, from 378 to 324, which is far less than South Korea's 30% cut, from 1,897 to 1,390[136]. Commentators thus suspected whether enough had been done by the government to solve the overbanking problem in Taiwan[137]. On top of the 26 M&A cases, involving 61 banks and financial institutions as of June 2005, the government continued to encourage M&A among existing financial institutions to have at least three of them each control a share of over 10 percent of the domestic market.[138] Improved as it may sound, it however would only mean that such financial institutions would collectively account for merely 30 percent of the total market share. In juxtaposition with the financial groups in most developed countries where they would typically occupy 60-80% of its domestic market, Taiwan FHCs still lack sustainable scale in the context of global competitiveness. That being said, all these reform objectives are part of Taiwan government's policy to develop internationally competitive financial groups, and as long as they are moving in the right direction, such effort should not be belittled.

The government's action of using a substantial amount of the financial restructuring fund to clean up NPLs, while commendable, did not go through without criticism. A lack of 'market-withdrawal mechanism', referring to some ailing financial institutions still receiving government subsidies (the financial restructuring fund), has resulted in 'unfair competition', as suggested by some commentators[139]. The commentators' view is well taken. According to a recent financial report, the reforms do not place enough value in the failing financial institution's credit rating, before the restructuring fund was distributed for its rescue. Specifically, the financial report indicated that:

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[136] *Ibid.*
[137] (Headline) "Goals Set For 2nd Finance Reform to be Reevaluated: Analysts", Global News Wire—Asia Africa Intelligence Wire, China Post, October 13, 2005. [Information is available in Lexis Nexus "News & Business" research database.]
[138] Global News Wire—Asia Africa Intelligence Wire, China Post, *supra*, note 13.
[139] Li, *supra*, note 10.

> The government has now decided to seek a fundamental solution to the problem of non-performing loans at a macro level by expanding the Resolution Trust Fund to NT$ 1.05 trillion (from the original set fund for NT$ 140 billion)...NT$ 180 billion (US$ 5.3 billion) of the extra NT$ 910 billion (US$ 26.7 billion) needed for the fund will come from an extension of the business tax on financial institutions for six more years, and this money will be used to liquidate more problem institutions. The remaining NT$ 730 billion (US$ 21.5 billion) needed will come from the issuance of financial bonds by the Central Deposit Insurance Corp. over the next two years. This money will be used, first, for the selective purchase of non-performing loans from financial institutions having an NPL ratio above 5%. The NPLs will be packaged, classified, and sold in batches at opportune times. The proceeds from the issuance of financial bonds will also be used to buy into financial institutions with a low capital-adequacy ratio (the ratio of self-owned capital to risk-based assets), with the aim of boosting their ratios above the minimum requirement of 8% set by the Bank of International Settlements (BIS). The shares bought by the government will have a special status that allows the authorities to reorganize the management of the financial institutions and oversee their merger with or acquisition by other institutions. Within five years, the government shares will be sold to private parties and revert to common shares. The government's goal is to cut the island's overall NPL ratio, as defined by the strict international norm, to below 5% within two years, while boosting the capital-adequacy ratio to above 8%. To reach the 5% goal, domestic financial institutions will have to write off NT$ 800 billion (US$ 23.5 billion) more in bad assets. Financial-industry insiders hail the government's NPL-reduction efforts, saying that its purchase and orderly sale of bad assets will avoid the dumping of bad assets by AMCs, which could deal a debilitating blow to the island's already weak real-estate market[140].

In this regard, a credit rating by a reputable credit ratings company can provide the benchmark needed in enabling government to more fairly distribute the financial restructuring fund. After all the fund is supported by tax dollars and thus considered a matter of public interest, fairness is paramount. The good news is that Taiwan's Ratings Corporation (TRC) is Taiwan's first credit rating organization, established on May 29, 1997 under the auspices of Taiwan's Ministry of Finance. As will be introduced later in Chapter 2 of this dissertation, the TRC proclaims its mission to be the introduction of an independent credit rating organization to Taiwan's financial markets. TRC has attempted to establish itself as a reputable credit rating agency in Taiwan, not only by allying itself with Standard & Poor's (S&P) but also by obtaining favorable nation-wide media

[140] Global News Wire, China Economic News Service, Taiwan Economic News, *supra*, note 2.

coverage. As a matter of fact, S&P is TRC's largest shareholder, holding a 51% majority shareholding. Under these circumstances, TRC's ratings should be able to boost public confidence in financial markets if it can play a more significant role in the government's distribution of the limited resource of financial restructuring fund.

In Taiwan, the total output of the financial services industry has increased to 15% of Taiwan's GDP (GDP was reported to be NT$386 billion in 2003). Commentators credit the success of the financial restructuring fund, citing that "after restructuring through reducing the mountain of bad debt and assets, and the reduction of overbanking through mechanisms such as financial holding companies, Taiwan banks will be better prepared to form strategic alliances with overseas banks and gradually build international competitiveness. In this way, Taipei may be able to evolve into a finance or capital market center."[141] That being said, they also emphasize that "the driving force will be from the market, not from the government."[142] This is consistent with my view that by the nature of a capitalist market (such as the U.S. and Taiwan, despite its variance in company size and business scale), financial markets in both countries will most likely conform to market rule, and only when the market is leading in the wrong direction, will government interfere. Government interference should come into place only as an exception and only under certain circumstances. That is because government interference implies the application of government subsidy, which is in large part funded by tax payers' money; therefore, unless the situation is justifiable (both legally and economically) there is no reason to use public money to subsidize one business rather than another.

Relevant to the government's efforts in restructuring the financial system is its aspirations to establish Taiwan as a "Regional Financial Center" in Asia, where its fast growing economy has gained much political clout. Despite the propaganda often heard in public venues, the general manager of one foreign bank branch in Taipei reportedly

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[141] (Headline) "Taiwan—Financial Reform Takes Priority Over Expansion—Taiwan Has Put Its Ambitions As A Regional Financial Centre On Hold For Now, In Order To Shore Up The Foundations Of Its Own Monetary System", Financial Times Business Limited, The Banker, March 1, 2003. [Information is available in Lexis Nexus "News & Business" research database.]
[142] *Ibid.*

said that "the phrase 'regional financial center' still 'pops out every so often but no one really pays much attention anymore. (He even expressed doubt that) such ambitions could ever be realized. Taipei does not have the qualifications with respect to language, accounting systems or legal systems or a truly free currency, given its very interventionist central bank..."[143] He thus suggested that "instead of trying to become a regional center, Taipei's role should be to become a local financial center as part of the 'greater China' sphere—especially in relation to the coastal industrial zones opposite Taiwan in Fujian Province. (That is because) despite their problems, the legal, accounting and other regulatory systems are far better than in China, and the greater China area is a big enough market for Taipei to find its own niche"[144]. As a matter of fact, under the current banking law regime, Taiwan banks are still barred from establishing branch offices in Mainland China. Furthermore, government policy has shown little signs that it will change. However, after the NPL problem has been sufficiently resolved, Taiwan's local bankers maintained that "Taipei still has considerable opportunity to emerge as a regional financial center. (Their confidence is based on the observation that) Taiwan's edge over most of its regional rivals lies in software. (Taiwan has) relatively better educational, telecommunications, information technology and legal and accounting systems, and, in the final analysis, lower risk. The main competitive factors are the amount of capital, the state of the legal system and how democratic and open the political system is. Everything else is relative."[145]

This optimism is somewhat premature as commentators may have difficulty finding any significant evidence to support the views above. Although many bankers acknowledge that the DPP-led government's top priority is to revamp and streamline the entire financial system, in light of its designation of 2001 as "Year One of Financial Reform"[146], it should be noted that there is still some time before Taiwan can achieve absolute market consolidation. As aforesaid, the majority of financial groups in Taiwan only account for 30% of the domestic market, way below the ratio for major financial

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[143] *Ibid.*
[144] *Ibid.*
[145] *Ibid.*
[146] *Ibid.*

groups in the U.S. It is fair to say that Taiwan FHCs' financial strength has not been well manifested. To make a more comparable analysis, the market consolidation in Taiwan is also less satisfying than neighboring South Korea. Many attempts to become a regional financial center have been taken up and explored by other Asian countries, including Japan, Singapore, and even Thailand before the Asian financial crisis weighed it down in 1997. The competition is elevated with China being the world's fastest growing economy. The Chinese government is putting every effort into building Shanghai into a new financial center on top of Hong Kong. Hong Kong has long established itself as a financial center in Asia with good standing (even back when it was still a British colony), known for its maturity and sophistication in international banking. Hong Kong's leading role in Asia's financial sector, coupled with China's success in attracting foreign investment, will unquestionably make Taiwan's candidacy for becoming a regional financial center less promising. Suffice it to say that with expedited financial reforms currently taking place in Taiwan, Taiwan FHCs will become more globally competitive.

Chapter Two

Financial Holding Companies in Taiwan

I. Introduction

Taiwan's *Financial Holding Company Act* ("Taiwan's FHCA"; "the Act") was promulgated in July 2001. Since then the law has spurred the trend towards mergers and acquisitions across the traditionally demarcated banking, securities, and insurance sectors. Financial holding companies (FHCs) are the result. As of 2002, fourteen FHC groups have been formed, accounting for 39-45% of system-wide assets, net worth, and profits at the end of 2003[1]. Studies also found that in 2003, only seven government-controlled entities (including three FHC groups and four banks) ranked among Taiwan's top fifteen financial institutions, having lost ground to the private sector FHC groups, with nine of them ranked among the largest fifteen financial institutions in terms of net worth[2]. The fourteen FHCs in Taiwan have emerged as dominant forces in Taiwan's financial services industry, and as a result Taiwan's financial landscape has been significantly altered.

Under the Act, an FHC may invest in and own 100 per cent of all banks, securities firms, and insurance companies. That is to say the law allows FHCs to place all their financial resources in one entity, inclusive of banking, securities, non-life insurance, and life insurance subsidiaries[3]. Worth noting is that FHCs in Taiwan do not have to concurrently hold shares or capital from all three financial industries—banks, securities firms, and insurance companies—but only any two of the three. Nonetheless,

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[1] Chun Huang, "FHC Groups Fostering Change in Taiwan but Challenges Remain", analyst report under the auspice of Taiwan Ratings Corp, online: [http://tred.taiwanratings.com.tw/ratings/en/newsD.asp].
[2] *Ibid.*
[3] Cai-Qing Lai & Ming-De Yu, "Capital Requirement for Financial Holding Companies in Taiwan", Google Scholar, on-line: [http://www.iisonline.org/hongkongsem2005/Lai%20&%20Yu%20-%20Article.pdf].

in actual practice, current records show that consolidation has taken place at a faster pace in the banking industry, compared to others. An analyst pointed out that this is largely because FHC groups view banks as the most important distribution channel for their diverse financial products. Further indications are that insurance companies like Fubon FHC, Cathay FHC, and Xin Guang FHC that were already quite strong in their respective lines of business, have expanded their financial services and focused on the banking industry, after each of them formed a financial conglomerate[4].

The ultimate goal of synergy is to increase the FHC's revenue, and ultimately, profits. Although major integration problems have not been witnessed, the integration of the acquired companies with FHC group members has often proved difficult, largely due to different corporate cultures. This challenge further resulted in less-than-expected synergistic benefits. A recent interview with the Assistant Vice President[5] at the Fubon Financial Holding Company suggests that the banking, insurance and securities arms do not usually collaborate except for "joint-effort projects". This means that on a daily basis, individual banking, insurance, and securities arms, operate as an independent company, thus having its own business culture, operational system, as well as having their own separate accounting books. Assuming that Fubon's experience is representative of the current practice in all 14 FHCs in Taiwan, the benefits of synergy, as in the design of FHC establishment, cannot be guaranteed. In fact, Fubon's experience resembles the results of two pieces of empirical research that were covered in the 'Introduction' chapter. The aforesaid research results provided a few important findings. First, operational efficiency changes were positive as a result of the FHC establishment. Secondly, both the profit and liquidity indices were obviously better after than before the FHC establishment. Thirdly, even though the FHC banks' operational efficiency had been adversely affected at the initial stages, due to structural changes, nonetheless, after FHC banks successfully integrated their financial subsidiary's resources, their operational efficiency levels rose to surpass the original levels prior to Taiwan's FHCA. However, the research results also revealed a dismal fact that the FHC banks' average operational

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[4] Huang, *supra*, note 1 "FHC Groups Fostering Change in Taiwan but Challenges Remain".
[5] May 26, 2006 Interview with J.S. Lin, Assistant Vice President at Safety & Loss Control Department, the Fubon Financial Holding Company, Taiwan.

efficiency is not that much higher than that of non-FHC banks. Researchers suggested that there is a certain amount of *resource waste*. One can assume that once the problem has been properly identified and solved, it can be reasonably predicted that FHC banks' operational efficiency can increase significantly. Given that competition among Taiwan's financial holding companies is getting fiercer than ever before, it remains to be seen whether collective joint forces will be marshaled for achieving optimal performance. On the theory that cross-selling and cross-marketing are more likely to be achieved within the FHC structure, this gives another incentive (on top of 'tax incentive') for the establishment of FHCs, as it brings forth a positive prospect in elevating operational efficiency levels[6]. Deepened cross-selling and marketing are foreseeable and will surely play a significant role in revenue enhancement by achieving broader synergies.

In order to streamline the operation of financial holding companies, Taiwan's *Financial Holding Company Act* adopts the U.S. model requiring a parent FHC to be a "pure" holding company. Article 36 of Taiwan's *Financial Holding Company Act* stipulates that "the business of a financial holding company shall be limited to investment in, and management of, its invested enterprises." That is to say, an FHC, being a parent company, can only manage its holdings in financial groups, or a regulated financial institution, and is prohibited from running the FHC's actual business[7]. This regulatory restraint is verified by the Assistant Vice President of Fubon, who indicated that "wherever Fubon Insurance enjoys a business surplus and thus has excess capital or cash on hand, the parent FHC immediately reallocates the insurance subsidiary's assets through re-investment ("*zhuan tou zi*", in Chinese). This strategy closely mirrors the assumption behind the legislation (for example, Article 36 of Taiwan's *Financial Holding Company Act*) that the parent FHC's functionary role is to make sure at all times the assets belonging to each subsidiary are well-managed. Since the FHC in Taiwan is a pure holding company (also known as an investment-holding company), its entire

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[6] See the 'Introduction' Chapter of this dissertation, under the subhead: I. 4. (2) Research Subject: FHC Banks and Non-FHC Banks in Taiwan. See also Guo-Geng Gao & Jing-Kai Xiao, "Comparative Analysis of Operational Efficiency for Financial Holding and Non-Financial Holding Banks in Taiwan" (2006) Financial Law Review (*Cai Jin Lun Wen Cong Kan*, in Chinese) Vol. 5, at pp. 42-57.

[7] Lai & Yu, *supra*, note 3 "Capital Requirement for Financial Holding Companies in Taiwan".

function works very distinctly from universal banking in the German model, where the parent company can be both the managing and operating company.

Despite the fact that Taiwan adopts the U.S. model by restricting their FHCs to being only pure holding companies, there is still a profound difference in their capital/assets base. Unlike the U.S. FHCs that are backed-up by large capital, the capital base of Taiwan's FHCs is relatively small.[8] The Cathay FHC, for example, is deemed the largest FHC in Taiwan (in total company assets), boasting assets valued in 2003 at NT$ 2.1 trillion (equivalent to US$ 60.9 billion)[9]; it is however still dwarfed by Citigroup, the largest FHC in the world. At the time when Citicorp and Travelers first publicly announced their merger to become Citigroup in 1998, its joint assets were valued at about US$ 700 billion. By comparison, even the largest FHC in Taiwan, the Cathay FHC, accounted for less than 10% of Citigroup—that was only when the latter first started to merge and realize financial synergies. Recently, the gap has been widened and the disparity is even more transparent—on the 2006 Fortune 500 list, the recent business review suggests that Citigroup currently has total assets of over US$ 1.4 trillion and a market capitalization (value) of approximately US$ 236 billion as of March 17th, 2006. That is to say, Citigroup's total assets are valued at approximately 23 times the size of the Cathay FHC, or, put another way, the Cathay FHC holds only about 4.35% of Citigroup's total company assets. Worth noting, on the 2006 Fortune 500 list, Citigroup is still ranked No. 1 in the categories of company assets and stockholders' equity. Furthermore, Citigroup boasts relationships with 100 million customers in 100 countries and has 3,200 offices around the globe.[10] Cathay FHC on the other hand, as reported in their 2005 annual report, has now over 10 million clients. Evidently, with respect to

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[8] That being said, according to a report by Taiwan's Financial Supervision Commission (FSC), Executive Yuan, the largest 19 Taiwanese banks still rank among the top 500 banks in the world in terms of tier-one capital, according to the *Banker*, July 2003 Issue. See government website of FSC at http://www.banking.gov.tw/ct.asp?xItem=31506&CtNode=698

[9] See *Taiwan Yearbook of 2004*. *Taiwan Yearbook* is a government paper published annually to give updates on major political and social events, as well as to provide measures and statistics in summarizing financial development over the past year and economic status quo. This specific information is accessible on-line [http://english.www.gov.tw/Yearbook/index.jsp?categid=158&recordid=83310] (Taiwan Yearbook—Finance and Banking—Money and Banking, last updated on June 27, 2005)

[10] Jennifer Saboley, "Mergers & Acquisitions in the Financial Services Industry; 1st Quarter 1998" Research Review (1998) Journal of the Society of Insurance Research. Available at Lexis Nexus Company News search.

market share, the Cathay FHC accounts for merely 10% (approximately) of the size of the client base developed by Citigroup.

In this chapter, I will first give details as to the status quo of the FHCs in Taiwan; many of them are either 'family-owned' or 'government-controlled'. The role of Taiwan's first credit rating organization (Taiwan Ratings Corporation) and other international ratings services in Taiwan (such as Standard and Poor's, Fitch, and Moody's), in particular their impact or influence on FHCs' financial strength, will also be included for a more comprehensive review of Taiwan's FHCs. I will then explain the Taiwanese government's lowering of the minimum capital requirement threshold so as to induce the creation of the first wave of FHCs in Taiwan. In order to examine an FHC's actual practice and the prospect for further synergy, I will look into the reported controversy that arose from the China Trust Financial Holding Company's aggressive attempt to eventually take over the Mega Financial Holding Company. A recent interview with another noticeable FHC in Taiwan, the Fubon Financial Holding Company, will also be included as it helps to bolster our knowledge of the actual operation of FHCs in Taiwan. Deregulation, amid the streamlining of Taiwan's financial regulatory system, through Taiwan's FHCA, and how it models its U.S. counterpart (GLBA), will also be spelled out in the latter part of this chapter.

II. FHCs in Taiwan

1. An Overview

Following the promulgation of Taiwan's FHCA in July 2001 and up until December 2002, relevant statistics, posted by the Bureau of Monetary Affairs (subordinate to the Ministry of Finance), indicated that after the first wave of mergers and acquisitions, the number of FHCs stood at 14. In chronological order, sorted by establishment date, they were (1) Hua Nan Financial Holding Co. Ltd. (December 19, 2001), (2) Fubon Financial Holding Co. Ltd. (December 19, 2001), (3) China

Development Financial Holding Corporation (December 28, 2001), (4) Cathay Financial Holding Co. Ltd. (December 31, 2001), (5) E. Sun Financial Holding Co., Ltd. (January 28, 2002), (6) Mega Financial Holding Co. Ltd. (originally named CTB Financial Holding Co. Ltd.; established on February 4, 2002; name changed on January 2, 2003), (7) Fuh-Hwa Financial Holding Co. Ltd. (February 4, 2002), (8) Ri Sheng Financial Holding Co. Ltd. (February 5, 2002), (9) Tai Xin Financial Holding Co. Ltd. (February 18, 2002), (10) Shin Kong Financial Holding Co. Ltd. (February 19, 2002), (11) Waterland Financial Holdings (March 26, 2002), (12) SinoPac Holdings (May 9, 2002), (13) China Trust Financial Holding Co. Ltd. (May 17, 2002), and (14) First Financial Holding Co. Ltd. (January 2, 2003).

Despite the fact that Taiwan adopted the U.S. model with respect to FHCs, unlike the U.S. where FHCs are supported by a large capital base, the capital base of Taiwan's FHCs is relatively small.[11] The above-mentioned comparative study on Citigroup and Cathay FHC, citing facts that the latter accounted for less than 10% of the former's company assets, has proven the case. Despite being overshadowed by the size of Citigroup, it is generally believed that further synergies among Taiwan's existing FHCs is the only way to substantially increase their capital base. The Taiwanese government anticipates that through further synergies among current FHCs in Taiwan, the remaining FHCs will grow substantially in capital assets and thus be able to bring themselves closer in line with global standards.

Before further synergy took place, Taiwanese government strategically and systematically drew on legal incentives to encourage the formation of FHCs in Taiwan, lowering the threshold for both 'controlling interest' and 'minimum capital' requirements. For example, according to Article 4 (Paragraph 1) of Taiwan's *Financial Holding Company Act*, for an FHC to gain 'controlling interest', the FHC must hold "voting-right-shares or capital stock of a Bank, Insurance Company or Securities House more

[11] That being said, according to a report by Taiwan's Financial Supervision Commission (FSC), Executive Yuan, the largest 19 Taiwanese banks still rank among the top 500 banks in the world in terms of tier-one capital, according to the *Banker*, July 2003 Issue. See FSC's government website online: [http://www.banking.gov.tw/ct.asp?xItem=31506&CtNode=698]

than twenty-five percent (25%), or otherwise having the direct or indirect ability to designate the majority of the directors of a Bank, Insurance Company or Securities House". Here, there is a 25% threshold, compared to the "50% stipulated shareholding standard" as mandated by a similar law (i.e. *Standards on Approval of the Application by the Investment Holding Company for Public-Listing of Company Shares*) that qualifies for a normal type of holding company. The ceiling for minimum shareholding is set much lower (only ½) for companies seeking to become FHCs in Taiwan (rather than a normal type of holding company). The formation of Taiwan's FHCs mirrors the joint efforts by industry and government to aggregate capital into the hands of larger more consequential banks, big enough to attain global competitiveness.

As already discussed in Chapter One of this dissertation, one main factor that contributes to the overbanking problem in Taiwan was its government's lift of the ban on establishing new banks in the early 1990s. The government tried to *reverse this trend* by first encouraging the establishment of FHCs, following the promulgation of Taiwan's FHCA in 2001; secondly they encouraged further synergies among existing FHCs in Taiwan. Market analysts have foreseen the call for "further synergy" which in turn would foster even more market competition, dubbed a "bloody war"[12]. Major market players are reportedly in agreement with this analysis, citing that this war could be "far more distressing than the one they experienced during the 1990s"[13]. Thereby FHCs in Taiwan keep expanding their financial empires to cope with the government's goal of cultivating internationally competitive financial groups in Taiwan[14]. Amid the second phase of market reform in 2004, a decree was issued to reduce the current number of FHCs in Taiwan from 14 to 7, by the end of 2006. To provide incentives to achieve this goal, the government promised to authorize a pre-approval to open new overseas branches for existing conforming FHCs. With this guideline in place, the second and even third wave of mergers among Taiwan's existing FHCs is starting to take shape. To this end, though differing people might weigh the pros and cons differently, the

[12] (Headline) "Market Consolidation Causes New Challenges to Financial Groups", Global News Wire—Asia Africa Intelligence Wire, China Post, June 20, 2005. [Information is obtained from Lexis Nexus "News & Business" research database.]
[13] *Ibid.*
[14] *Ibid.*

inescapable conclusion is that further mergers are instrumental for broadening the capital base of Taiwan's FHCs. The downside, however, raises concerns that creating a monster FHC might produce a cartel situation, which itself is detrimental to competitiveness. For example, the board reshuffle at Mega Financial Holding Company ("Mega FHC") in June 2006 fueled speculation that Mega's main rival, the China Trust Financial Holding Company ("China Trust FHC"), aggressively sought to control Mega FHC by colliding with Mega FHC's chairman Shen-chi Zheng.

Relevant to this concern of creating a cartel situation is "fierce criticism from labor unions and criticism that the government unfairly favored Taiwan's powerful, family-oriented conglomerates." In this regard, the Taiwan government has reportedly modified its full-speed reforming tactic and instead "adopted a more cautious approach and *missed* its targets"[15]. As of this writing in 2007 and judging by the current number of FHCs in Taiwan which still remains at 14; the pre-determined goal of "further synergy" clearly has not materialized.

Setting all controversies aside, on the whole, Taiwan's FHCs are in good shape. The outlook is at least stable or better, according to the world's leading ratings companies. First, Standard & Poor's Ratings Services ("Standard & Poor's") reportedly gave positive ratings for Xin Guang FHC, reflecting the company's good market position in Taiwan's competitive financial services industry, its average profitability, adequate capitalization and liquidity, and satisfactory financial flexibility[16]. At the end of 2006, Xin Guang FHC's total equity (of NT$ 88.3 billion) and consolidated assets (of NT$ 1,492 billion) ranked ninth and eighth, respectively, among Taiwan's FHCs. A mid-sized financial group, Xin Guang FHC has over the past years enjoyed moderate performance with a good franchise, especially in its life insurance business. Xin Guang Life Insurance is the financial group's flagship and core subsidiary, with a 15% market

[15] Kathrin Hille, "Taiwan's Banks Feel the Heat", Financial Times, July 11, 2007. [Information is obtained from Lexis Nexus "News & Business" research database.]
[16] (Headline) "Xin Guang Financial Holding Co. Ltd. 'BBB' Rating Affirmed On", Market News Publishing, May 23, 2007.

share in terms of assets at the end of 2006[17]. Secondly, compared to Xin Guang FHC's average ("BBB" in long term counterparty credit rating) and above-average ("A3" in short term rating), Cathay FHC, the largest FHC in Taiwan by company assets, enjoyed a higher rating (beyond "stable") assessed by Moody's Investment Services ("Moody's") in early 2007. Like Standard & Poor's, Moody's also credits the Cathay FHC's competitive edge with very similar rating criteria: the strength of its key operating subsidiaries ("A1"), long-term issuer rating ("A3"), and others such as financial flexibility, improved capitalization, strong liquidity, (though no exact number ratings were being quoted)[18]. Thirdly, First FHC has also recently received an improved rating from Moody's, for its flagship bank subsidiary's ability to diversify income resources by expanding their business ventures into 'wealth management' and 'offshore markets'[19]. More details about the improved ratings for Cathay FHC and First FHC, respectively, are to follow in Part III "Conclusion".

2. Recent Scandals Involving 'Further Synergy'- Attempts by China Trust FHC to Take Over Mega FHC

(2.1) Letting the Cat out of the Bag—How did the Scandal Start?

Mega Financial Holding Company ("Mega FHC"), Taiwan's third-largest financial service company, was formed by the state-owned Jiao Tong Bank and International Commercial Bank of China (two major subsidiaries), plus a securities firm, an insurance company and a venture capital company. According to a recent news report, Mega FHC is a very valuable company. In 2005 alone, it reported NT$ 96.8 billion (US$ 2.9 billion) in gross revenue and NT$ 22 billion (US$ 700 million) in net income, with NT$ 2.13 trillion (US$ 65 billion) in total assets.[20] All factors considered together, it is generally believed that retaining government control of Mega FHC would be a positive

[17] *Ibid.*
[18] *Infra* note 67 "Taiwan: Moody's Upgrades Cathay Financial Group's Companies".
[19] *Infra* note 86 "Moody's Assigns Baa1 and Aa3.tw Ratings to First Financial Holding".
[20] "Mega Case Delineates the Options", in Taipei Times, June 26, 2006 issue, page 8.

result as it enables the government to protect important state assets and safeguard the interests of the public. Nonetheless, the government was alleged to harbor a disproportionate share of the managerial pie. The unjustifiable outcome, as pointed out by lawmakers in Taiwan, is that the government, which owns 22.78 percent of Mega FHC, retains managerial control of the financial conglomerate with 7 of the 15 board seats and 3 out of the 5 supervisory seats. Compared to China Trust Financial Holding Company ("China Trust FHC"), a stakeholder and main rival to the Mega FHC, which holds a 15.63 percent stake in Mega FHC and holds only 4 board seats and 1 supervisory seat, Mega FHC Chairman Shen-chi Zheng, a private shareholder with only 0.01 percent share in the company, retains his seat and was re-elected as chairman for another three years.[21] This disproportionate share of seats intensified speculation that Cheng, Mega FHC's Chairman, has been backed by the China Trust FHC in his bid for re-election. The motivation underlying this hypothesis is China Trust FHC's (owned and controlled by the Gu family) attempt to take three years' time to successfully merge with Mega FHC.[22]

Reportedly, China Trust FHC's aggressive attempt has concerned lawmakers in Taiwan who expressing the fear that "the government might no longer have a majority eight seats representing government shares on the 15 member board despite its strong position as the single largest shareholder controlling (about) 22 percent of the shares in the company."[23] A whip of the legislative caucus of the main opposition Kuomintang (KMT), even asserted that "if the government fails to secure its board majority, thus losing operational control over Mega FHC's NT$ 2.13 trillion (US$ 65 billion) assets, the premier and the finance minister should step down to take responsibility."[24] The political fallout further led to the conclusion that "the saga of Mega FHC's boardroom election has tainted the nation's process of financial reform as well as the company's

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[21] *Ibid.*
[22] Next Magazine, p. 39 in no. 265 issue, published in Taiwan on June 22nd, 2006. [On-line: http://twnext.atnext.com/]
[23] "Lawmakers Warn on Loss of Control over Mega Financial", in Chinapost, June 23rd 2006 business news. [On-line: http://www.chinapost.com.tw/p_detail.asp?id=84594&GRP=A&onNews=]
[24] *Ibid.*

corporate governance"[25]. When the controversy waned following the government's narrow election victory—referring to the public shareholder's retention of managerial control of Mega (with 7 of the 15 board seats and 3 out of the 5 supervisory seats)—against Mega's private shareholders, including the government's main rival, China Trust FHC (a prominent private shareholder which wins 4 board seats and 1 supervisory seat); politically, the final result helped take some of the steam out of the opposition parties' call for the resignation of both Premier Zhen-chang Su and Finance Minister Ji-cheng Liu. It nevertheless raises an interesting question of whether such political interference is appropriate in the course of the government's commitment to a privatization program purportedly in order to eventually sell off its stake in Mega FHC. With regard to this issue, commentators have noted that "the government must review its shareholding management systems for state-controlled financial institutions. As long as the financial enterprises are under the state's control, the government should be as active as private shareholders in soliciting votes to secure controlling power. But the government should be as transparent as possible if its privatization policy is to prevail."[26] As ambiguous as it sounds, even the toughest critics cannot deny the fact that China Trust FHC has acquired its 15 percent share in Mega FHC on the open market and is legally entitled to increase its holdings in the future[27]. Notwithstanding the rumor that China Trust FHC will eventually take over the very profitable Mega, the legality of its act was not seriously questioned. Even if it proves to be true that such an attempt will be consummated by way of an "infusion of influence", (either through sudden increase of investment capital or allying with Mega's Chairman, Cheng), as inimical as it seems to its competitors, unless China Trust FHC's take-over constitutes a monopoly and becomes a threat to the public economic order, and consequently is in violation of the fair trade laws, there is no way to stop this potential course of action. As well, Mega FHC's foreign investors, who hold jointly a 23.15 percent stake, were originally motivated in holding the company's shares in expectation that China Trust FHC's takeover attempt would lead to further consolidation[28]. These factors, jointly considered together, provoke

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[25] Taipei Times (daily news), *supra*, note 20, "Mega Case Delineates the Options".
[26] *Ibid.*
[27] *Ibid.*
[28] *Ibid.*

another concern—a concern that is to strike a delicate balance between "market rule" and "lawmakers' rightful exertion of examination power", for the sake of better corporate governance. Timely and sensitive, this issue remains of how to find a resolution especially during the privatization transition. Too much emphasis on the role of political supervision, though useful in curbing government corruption, might otherwise compromise the continuous efforts toward ultimate financial liberalization, as projected by ongoing financial reforms.

(2.2) An Update on this Scandal

Citing Taiwan's report, on November 23, 2006, the Taipei District Prosecutor's Office issued a warrant for the arrest of China Trust FHC's vice chairman Jeffrey Gu Jr. ("Gu") for his failure to appear at a questioning session on his alleged role in an illegal acquisition of stakes in Mega FHC by a China Trust branch in Hong Kong[29]. Gu failed to make his appearance within the prescribed period marked by the prosecutor on the warrant, the result was that Gu could be placed on a wanted list, and the list would remain valid for as long as 25 years. As of this writing, the most recent news item indicated that following an arrest warrant being issued on November 23, 2006 for Gu, he was further placed on the police most-wanted list on December 4, 2006, meaning he can be arrested anytime within 25 years[30].

Gu's allegation involves an order from the Financial Supervisory Commission ("FSC") for the parent company (China Trust FHC) to cut its stake in Mega FHC to 6.1 percent from 9.6 percent within one year; the company was also banned from raising capital. A penalty was further laid down by the FSC, which imposed a NT$ 10 million fine on China Trust FHC[31]. The penalty was for the purchase by China Trust Commercial's Hong Kong unit of US$ 390 million worth of notes convertible into Mega

[29] (Headline) "Prosecutors Issue Arrest Warrant for Jeffrey Gu Jr.", China Post, November 24, 2006. [Information is obtained from Lexis Nexus "News & Business" research database.]
[30] (Headline) "3 China Trust Execs Indicted", China Post, February 16, 2007.
[31] (Headline) "Gu Jr. Quits China Trust Post", China Post, November 25, 2006. [Information is obtained from Lexis Nexus "News & Business" research database.]

shares using money earmarked for loans[32]. China Trust Commercial is a key operational banking subsidiary of its parent company, China Trust FHC.

Financial regulators explained that the alleged irregularities involved a misuse of funds by China Trust FHC for the illegal procurement of structured notes issued by Mega FHC. According to them, in July 2006, Gu failed to consult with the financial regulators before letting the bank use funds earmarked for loans to buy structured bonds issued by Mega FHC. Financial regulators further stressed the magnitude of the aggressive takeover—"[a]cquiring Mega would make China Trust Taiwan's second-largest financial group by market value"[33].

Gu had since resigned from his post as vice chairman of the China Trust FHC in July 2006, following the FSC's order. Gu is now said to be overseas, hiding himself from the prosecution and the ensuing legal consequences in Taiwan. Whereas, the FHC continued to stress its role to "maintain a dynamic watch on every financial holding firm, and [its determination to] bring to justice whoever commit financial irregularities."[34]

In addition to Gu, the aforesaid news search found that three key executives of China Trust FHC were indicted on February 15, 2007, following a four-month investigation into the financial group's illegal purchase of a stake in Mega FHC. The three key executives, namely (i) former Chief Financial Officer (Perry Zhang), (ii) former Head of China Trust FHC's Compliance Department (Y.D. Deng), and (iii) former Senior Vice President (Sean Lin) were charged with violations of Securities and Banking laws[35]. One of them, Zhang (as former CFO), reportedly may be facing 22 years of jail time and NT$ 250 million in fine. As for the other two, prosecutors requested an 18 year-jail term and a fine of NT$ 130 million against the former Head of Compliance Department (Deng), and sought a 20-year sentence and a fine of NT$ 190 million against

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[32] *Supra* note 29 "Prosecutors Issue Arrest Warrant for Jeffrey Gu Jr.".
[33] *Ibid.*
[34] *Supra* note 31 "Gu Jr. Quits China Trust Post".
[35] *Supra* note 30 "3 China Trust Execs Indicted".

the former Senior Vice President (Lin)[36]. They have all been accused of using NT$ 27.5 billion to buy 9.9 percent of Mega FHC's shares without China Trust FHC board's approval. 'Insider trading'[37] was another charge they were accused of—reportedly, they have made profits on the above-mentioned illicit transaction that involved the purchase of US$ 390 million worth of notes convertible into Mega shares by using money earmarked for loans.

3. A Closer Look

Out of the fourteen FHC s in Taiwan, five of them were formed by the consolidation of two banks—Cathay united with United World Chinese Commercial, China Trust with Grand Commercial, Fubon with Taipei Bank, Tai Xin with Dah An, and Jiao Tong with the International Commercial Bank of China to form Mega[38]. This activity reduced the number of Taiwan's domestic commercial banks to 45 from 50 at the end of 2003, as shown by statistics published by the Financial Supervisory Commission ("FSC") of the Executive Yuan (Taiwan's top-tiered administrative cabinet) in Taiwan[39].

A potential threat to the soundness of FHCs in Taiwan is that among these 14 FHCs, the more competitive ones are either backed by wealthy families or the government. It is fair to say that the largest FHCs in Taiwan are either family-owned or government-controlled; this has caused concerns by experts in corporate governance, especially on behalf of minority shareholders. For example, the No.1 FHC in Taiwan (in terms of its total assets), the Cathay Financial Holding Company, is owned/controlled by the "Tsai" family; and the No.2 (in terms of its market share), the China Trust Financial Holding Company, by the "Gu" family. As for the No. 3 FHC, the Mega Financial Holding Company, the government is the largest shareholder. The No. 4 FHC, arguably

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[36] *Ibid.*
[37] *Ibid.*
[38] Brian Asmus, "Financial Holding Companies Spur Consolidation Drive", in Vol. 33, No. 10 of AmCham's Local Circulation in Taiwan.
[39] On-line information provided by Financial Supervisory Commission (FSC): [http://www.banking.gov.tw/lp.asp?ctNode=2418&CtUnit=661&BaseDSD=41] (Last updated on April 14, 2006)

the Shin Kong Financial Holding Company, is owned/controlled by the "Wu" family. In fact, "Tsai", "Gu", and "Wu" are among the wealthiest families in Taiwan. In addition, both the Hua Nan Financial Holding Company and the China Development Financial Holding Company are largely controlled by the government.

Concentration of ownership has created many concerns, especially in the area of corporate governance. In a legal sense, the Board of Directors has a fiduciary duty to maintain standards of corporate governance—they have both the responsibility and right to ensure that they are monitoring in the best interests of their company's shareholders. Accordingly, the Board of Directors should assume their responsibilities and honor these obligations. Even so, commentary has suggested that boards do otherwise in the actual practice of corporate governance in Asia. The Board of Directors, supposedly charged with the responsibility of protecting the interests of all shareholders, is more often than not stacked with insiders, friends, and relatives[40]. Consequently, directors do not always adequately monitor the corporation's decisions and their controlling shareholders. Research results also suggest that "it is richest family control, rather than family control per se, that is associated with particularly aggressive insider trading"[41]. This problem runs especially rampant in Southeast Asia, where wealthy families are particularly aggressive in trading on their proprietary knowledge concerning the information in annual earnings before these earnings are reported to outsiders.

4. Recent Interview with Fubon Financial Holding Company

A recent interview in May 2006 with the management at Fubon Financial Holding Company reveals some of the practical fallout pertaining to Taiwan's *Financial Holding Company Act*. I chose Fubon as the subject for an interview because among all 14 FHCs in Taiwan, Fubon Financial Holding Company was the first Taiwanese FHC to be rated by the Taiwan Ratings Corporation ("TRC"). It should be noted that Standard &

[40] Stijin Claessens & Joseph P. H. Fan, "Corporate Governance in Asia: A Survey" (2002) 3:2 International Review of Finance 71 at 78.
[41] Julian Roche, *Corporate Governance in Asia* (London and New York: Routledge, 2005) at 231.

Poor's (S&P) is TRC's largest shareholder, holding a 51% majority shareholding. S&P enjoys a world-wide reputation for its leading credit rating system, generally known as the Corporate Governance Score ("CGS").

Fubon's management laid out several prominent features concerning an FHC's actual practice in Taiwan. First, in normal circumstances, each subsidiary (the banking, insurance, or security arm) of the FHC not only works independently but keeps separate accounting books. This, in juxtaposition with cross-selling and cross-marketing, collaboration among the three subsidiaries would often be seen where joint efforts is sought for devising new financial service products. A case in point is the issuance of credit cards combined with travel insurance, which grants new class credit card holders with complimentary travel insurance. The FHC's umbrella trade name is identified prominently on the new hybrid product. Through collaboration, the FHC's banking and insurance subsidiaries enjoy mutual benefits, and simultaneously enhance the overall revenue of the financial holding company. Asked about the parent FHC's functionary role, Fubon Insurance's Assistant Vice President indicates that wherever Fubon Insurance has excess capital or cash on hand, the parent FHC immediately reallocates the insurance company's assets through re-investment. Re-investment measures include purchasing government bonds or subscribing to shares in an open market, such as the Taiwan Stock Market Exchange[42]. He goes on to say that wherever the accumulated assets of the insurance arm are greater than its required operational capital, the parent FHC will redistribute its surplus (this is a practice known in Taiwan as "slimming down") and reinvest it with a view to further generating profits for the FHC. This strategy closely mirrors the assumption that behind the legislation the parent FHC's functionary role is to make sure at all times the assets belonging to each subsidiary are well-managed. It also corresponds to Article 36 of Taiwan's *Financial Holding Company Act* which emulates the U.S. model (GLBA) by strictly limiting its FHCs to the role of a pure holding company. That means, an FHC (as parent company) can only manage its

[42] Interview with J.S. Lin, Assistant Vice President at Safety & Loss Control Department, the Fubon Financial Holding Company, Taiwan. The interview took place on May 26, 2006.

holdings in financial groups and is prevented from running the actual day-to-day business affairs of the individual units.

The Ministry of Finance in Taiwan stipulates that an FHC in Taiwan must meet a minimum capital requirement of NT $*20 billion* (equivalent to approximately US$*670 million*).[43] Asked if the minimum capital requirement is a sound measurement in gauging the economic strength of an FHC, Fubon's representative pointed out that a strict threshold cannot accurately measure an FHC's well-being. Suffice it to say, setting minimum capital requirements is not an ideal way to prevent operational risks. For example, the minimum capital requirement for an insurance company is only NT$ 2 billion. Clearly, this relatively low capital requirement cannot provide enough guarantees for many types of insureds—for example a venture capital company that operates with a capital base of NT$ 20 to 40 billion. He disagreed on the basis that "How can an insurance company 'insure' another company that has 10 to 20 times of its own capital?" On the other hand, if the ceiling for minimum capital requirements is set too high, in all likelihood some capital will sit idle, whereas it could be employed for reinvestment and thus have the potential of generating more revenue. Last but not the least, the minimum capital requirement does not take human capital into account. Human capital, referring to the ability of each management team (at all levels, up from the parent company and down to each subsidiary) in the FHC to create revenue, is as crucial as the minimum capital requirement that can guarantee the FHC's operational stability.

[43] Order of the Ministry of Finance, No. 0901000116. [*Cai Zheng Bu Tai Cai Rong Yi Zi Di 0901000116 Hao Ling*, in Chinese]

5. The Role of the Taiwan Ratings Corporation with respect to FHCs in Taiwan

(5.1) TRC's Partnership with Standard & Poor's Boosts Taiwan FHCs' Corporate Governance

The Taiwan Ratings Corporation ("TRC") is Taiwan's first credit rating organization, established on May 29 1997 under the auspices of Taiwan's Ministry of Finance. TRC proclaims its purpose is to introduce an independent credit ratings organization to Taiwan's financial markets. TRC has rooted itself as a reputable credit rating agency in Taiwan, not only by allying itself with Standard & Poor's (S&P) but also through nation-wide media coverage. As a matter of fact, S &P is TRC's largest shareholder, holding a 51% majority shareholding. In October 2005, on top of its already 50% shareholding, Standard & Poor's purchased an additional 1% share of TRC from TRC's local shareholders, of which, their respective names and shareholdings are: (i) Taiwan Stock Exchange Corp. (19.99%), (ii) Taiwan Depository & Clearing Corporation (19%), (iii) Joint Credit Information Center (5%), (iv) China Credit Information Service Ltd. (5%), (v) Taiwan Futures Exchange (0.005%), and (vi) Taiwan Certificate Authority Corp. (0.005%).[44] TRC's local shareholders play a very significant role in facilitating and improving transparency in corporate governance in Taiwan. Indeed TRC has built a reputation for credibility; henceforth, its ratings involve the public interest.

For FHC's investors/shareholders, the rating given by a credit ratings agency not only provides transparency but also accountability—it affects the perceived risk that further translates into interest rates to be applied to loans or other similar types of financial services.

TRC's partnership with Standard & Poor's is without a doubt a key factor that leads to its success in the first place. S&P enjoys a world-wide reputation for its leading

[44] TRC's Company information can be found through its website. [On-line: http://www.taiwanratings.com/en/]

credit rating services. Historically, S&P, together with Moody's and Fitch Ratings, were the only three Nationally Recognized Statistical Rating Organizations (NRSRO) designated by the U.S. Securities and Exchange Commission in 1975[45]. S&P is well known for its US-based S&P 500 stock market index, which is a list of 500 US corporations, ordered by market capitalization. The list is owned and maintained by S&P, but S&P is also credited with one of the most respected corporate and credit ratings systems in the world, generally known as the Corporate Governance Score ("CGS"). Standard & Poor's took four years to develop its CGS system, which reflects S&P's assessment of a company's corporate governance practices, policies, and the extent to which they serve the interests of the company's financial stakeholders. The CGS system is the result of S&P's desire to create analytical baselines and objective assessments of corporations, derived from a carefully-calculated scoring methodology. The CGS measure is formed based on a combination of international codes, governance best practices and guidelines of good corporate governance, with an emphasis on shareholders' interests[46]. Therefore, CGS is considered a program used to inform outside investors about their invested companies' governance practice, compared to that of their competitors. On the other hand, companies can also use the CGS service by retaining or voluntarily providing S&P with the required information to garner an evaluation of how their governance and financial practices are perceived by the general public.[47] As suggested, S&P scores companies in four different categories: (i) ownership structure, (ii) financial stakeholder relations, (iii) financial transparency/information disclosure, and (iv) board and management structure. Under these categories are subordinated categories that provide evaluation on more detailed criteria, such as concentration and influence of ownership, voting and shareholder meeting schedules, independence of the company's auditor, anti-takeover provisions, and the like.[48] S&P has won international recognition due to its relatively complete ratings system that is useful in protecting shareholder interests, the first and utmost concern of outside investors. It is generally believed that with a CGS system in place, a companies' ability to provide transparency in its corporate

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[45] Information provided by Wikipedia (on-line Encyclopedia) [http://en.wikipedia.org/wiki/Fitch_Ratings]
[46] Roche, *supra*, note 41 at 232.
[47] *Ibid* at p. 231.
[48] *Ibid* at p. 232.

governance practices is improved and at the same time outside investors can make informed decisions based on public information.

TRC prizes itself in its independence and professionalism—"because of its close cooperation with Standard & Poor's, TRC implemented a rating system which is based on the methods and criteria used by Standard & Poor's, while adjustments are made for domestic conditions."[49] In fact, TRC uses a different rating scale from Standard & Poor's, although TRC proclaims that the application and consequences are the same. In this regard, TRC very much aspired to attain local acceptance by partnering with Standard & Poor's, a world-renowned credit rating agency, while at the same time cultivating a domestic image. Such a "selective-adaptation"[50] seems inevitable and necessary in reflecting assessed companies' risk taking sustainability and other abilities such as paying back loans. With Taiwan FHC's relatively small capitalization and revenues, compared with Citigroup's size and scale, unless localized-standards can be well adjusted against Standard & Poor's measures, it is very likely that none of the FHCs would qualify for even a satisfactory rating, even if they are actually well managed.

(5.2) Pragmatism Prevails—Finding and Developing Meaningful and Measurable Good Corporate Governance Standards is Key

Each country uses different market indicators and various rating measures are applied to assorted equations, too. Clearly, because of the proliferation of methodologies as applied to corporate governance, there is no internationally unified or universally-accepted standard yet, despite the underscored importance of good corporate governance and independent ratings agencies. The providence of an objective measure is technically difficult if not impossible, stressed by KPMG, S&P's another competitor in connection

[49] TRC's Company information, *supra*, note 44.
[50] "Selective Adaptation" is a phrase first coined and introduced by Professor Pitman Potter, in his article entitled "Globalization and Economic Regulation in China: Selective Adaptation of Globalized Norms and Practices" (published in winter 2003, vol. 2 no. 1 Washington University Global Studies Law Review, pp. 119-150) and has since then been widely accepted and quoted by other scholars and commentators in general focusing on Asian legal studies.

with corporate governance ratings. "KPMG China observed in 2003 that good corporate governance is still hard to gauge, stressing that complying with all the rules does not necessarily mean a firm is being well run. KPMG argues that it follows that organizations that rate governance need to develop more meaningful and measurable yardsticks and (assessed) firms need to communicate their governance processes even more effectively. Managers themselves are finding it hard to gauge exactly what the reforms mean precisely for their companies. Asked whether companies are better governed now than they were before Enron became a household name, the largest group of respondents—45 per cent of the executives—said there was no way of telling."[51] However, emphasis needs to be made that as long as a local measure is applied for governance ratings, its analytical basis needs to be sound, consistent and sufficient enough to reflect the well-being of assessed companies. So far, the TRC in Taiwan seems to have fulfilled this requirement.

Another reason that has lead to TRC's success is the media attention it has gathered so far. In its corporate profile, TRC describes itself as having "played a very important role in providing information to the media. In 1999, the company, on average, provided the media with between 10 and 15 news releases per month. Benefiting from the extensive media exposure, these credit ratings have become widely disseminated in (Taiwan's) local market."[52] TRC has announced its credit ratings frequently every month and obtained media coverage. Thus TRC seems to have rooted itself in Taiwan as the preeminent credit rating agency.

Theoretically, independent and unbiased credit ratings can contribute to the improvement of transparency in corporate governance as well as provide investors with professional credit information in this age of "Buyer Beware". This function of credit ratings is characterized as its "social benefit", nonetheless, such an expectation does not run without caveats. For example, in the midst of the Enron scandal, the credit agencies were also blamed for failing to detect and disclose Enron's some 30 billion dollars worth

[51] Roche, *supra*, note 41, at 218-219.
[52] TRC's company information, *supra*, note 44.

of loans hidden within its balance sheet. Enron needed to raise billions of dollars to meet its costs (for instance, purchasing steel) but, rather than resorting to traditional means, such as additional stock offerings or loans, Enron traded in the derivatives markets with "price risk management liability—a derivative trading liability"[53]. To avoid the outcome of lowering Enron's credit rating and thus alarming investors, Enron would offer to sell to major financial institutions energy futures for, say, $1 billion. In the meantime, Enron would also offer to buy back the same energy futures in one year, for, say, $1.2 billion. Typically, the bank would accept this business proposal as, for all intents and purposes, the proposed transaction could be treated as a loan. From the bank's perspective, it would provide Enron $1 billion and in return would receive the principal back plus $200 million in interest, when the loan is due[54]. Enron miraculously and repeatedly pulled this trick off, quietly borrowing over $30 billion to meet its costs without a significant impact on its credit rating. Enron knew well that only companies with solid credit ratings and a reputation for reliability could play in the derivatives market in any substantial way, and nothing drives one's credit rating faster than large scale borrowing. As one commentator correctly pointed out, if one's credit rating declines, counterparties demand more collateral before entering into trades, making extensive trading prohibitively expensive. Fatefully, Enron opted to raise billions of dollars in a manner that would not spook capital markets and jeopardize its trading business[55]. Enron finally achieved infamy prior to its bankruptcy in late 2001, when it was revealed that its reported financial condition was sustained mostly by institutionalized, systematic, and creatively planned accounting fraud[56]. Despite its staggering into bankruptcy and being mired with huge debts, Fortune magazine (in its February 19, 2001 issue) still credited Enron as one of "America's Most Admired Companies"[57]. This misleading public information unfortunately only left Enron's investors (at a very large scale) even more bewildered with the energy giant's bankruptcy. As dramatic and mysterious as Enron's dirty tricks may sound, in the midst of controversy pertaining to the credit rating agencies'

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[53] J. B. Kroger, "Enron, Fraud, and Securities Reform: An Enron Prosecutor's Perspective" (2005) 76 U. Colo. L. Rev. 57 at 72-73.
[54] *Ibid* at 73.
[55] *Ibid* at 68.
[56] Information obtained through on-line encyclopedia. [On-line: http://en.wikipedia.org/wiki/Enron]
[57] "America's Most Admired Companies", Fortune, Feb. 19, 2001, at 64, 104. See also Kroger, *supra*, note 53, (original note# 8).

assessment on Enron, commentary points out that "Enron's earnings statements were, as one expert on Wall Street equity research later testified, 'inscrutable", not just to laypersons, but to sophisticated analysts as well."[58] To this end, it can be inferred that credit rating agencies are susceptible to market pressure and other biases which impugn their claim to objectivity.

6. Deregulation amid Streamlining of Taiwan's Financial Regulatory System

The enactment of Taiwan's *Financial Holding Company Act* in July 2001 was prompted, in part, by relatively contemporaneous events in the U.S., namely the passing of the *Gramm-Leach-Bliley Act 1999*. In parallel, recently success in the European Union following the adoption of the *Second Banking Directive* and ongoing pressure for financial services sector liberation under the WTO/GATS also confirmed the fruits of financial liberalization.[59] Heavily influenced by this global trend, Taiwan has followed many other countries by calling for financial reform that has resulted in synergy across financial institutions and their products. This turnover is predictable as Taiwan has been striving to develop itself as Asia's financial operations center. This goal was encouraged by Taiwan's position as an island highly dependant on foreign trade. Consequently, it is critical for Taiwan to ensure its access to international markets is not blocked by unnecessary regulatory restraints. Almost unequivocally, the best way to achieve that goal is to make sure Taiwan's financial regulatory regime conforms to international standards.

Taiwan's recent financial regulatory reforms feature some key elements: deregulation, desegmentation, liberalization and internationalization. Over the past 15 years, the highlights of Taiwan's reinvigorated financial regime include the following landmark achievements: the "big bang" banking law reform in 1989, the banking law amendment in March 2001, and the recent passage of the *Financial Holding Company*

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[58] Kroger, *supra*, note 53, at 101.
[59] Raymond B. Walker III, "The U.S. Financial Services Modernization Act of 1999: New Financial Order, or Financial Chaos?" (2000-2001) 16 Banking & Finance Law Review 47 at 49.

Act in July 2001. Induced by increasing global competition, the resulting clamor of Taiwan's business community for liberalization, combined with the Taiwanese government's privatization policy, these events worked together and eventually brought about the banking law amendment of 1989, dubbed the "big bang". The Big Bang was a watershed in the shift to a market driven banking sector from a government managed sector. This liberal banking law change led to the establishment of 16 new commercial banks (15 of them were chartered in June 1991, and the 16th in May 1992). However, the over-competitiveness ("overbanking") among these banks finally erupted in a series of banking crises, as an apparent after-effect of the Zhong Xing Bank scandal. Thus the Zhong Xing crisis brought about further banking law reforms in March 2001. In four months' time, the new *Financial Holding Company Act* in Taiwan, promulgated in July 2001, has reduced or eliminated the distinctions between classes of financial institutions. With more diversified financial conglomerates in place that compete in all financial services, rather than a highly segmented set of financial institutions with each one limited in the services it can offer, suffice it to say "desegmentation" is also accurately dubbed to depict recent changes in the law. The regulators now allow the synergy of full financial services to be operated under one roof, in anticipation of increasing respective financial subsidiary's operational efficiencies. Under this new corporate structure, group resources can be used in an integrated fashion so as to achieve economies of scale and scope[60], furthermore, the independence of respective subsidiaries would not be compromised, if each subordinated company still maintains its freedom and flexibility to decide on matters in connection to its daily operations. Thus, the *Financial Holding Company Act*, which came about as a result of financial law reform, stands to manifest the law's subordination of distributive considerations to efficiency considerations[61]. Efficiency considerations prevail over distributive concerns because efficiency is considered by industry to be one of the keys to creating wealth.

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[60] Lee and Li Bulletin, September 2001 Issue, at 5. (Lee and Li is a law firm based in Taipei, Taiwan.)
[61] Richard Posner, *Economic Analysis of Law*, 3rd. ed. (Boston and Toronto: Little, Brown & Company Ltd, 1986) at 494.

Following the banking law reform in March 2001 (as an institutional response to the Zhong Xing Bank scandal and a series of related crises following that[62]), later in the same year, the *Financial Holding Company Act* was promulgated in July 2001. Accordingly, it may have created an interesting connection for people who see the *Financial Holding Company Act* as a necessary tool to reestablish the financial order offset by a series of earlier financial disasters in Taiwan. It is suggested that overbanking and bad loans are two fundamental reasons why the Taiwanese government promulgated the *Financial Holding Company Act*. "Overbanking" results from over-competitiveness among Taiwan's privately owned commercial banks while "bad loans" refer to the setbacks in improving Taiwan banks' overall global competitiveness. In June 2001, legislators in Taiwan approved the establishment of an NT$140 billion (US$ 4 billion) government-run clean-up fund[63]. Various efforts taken by the Taiwanese government were targeted to disclose non-performing-loan (NPL, bad loans) levels, and to redefine NPL according to international standards and to set a schedule for NPL reduction[64]. However, it is suggested that the bank clean-up fund in its current form is not large enough even to sort out the problems in the grassroots sector—let alone does it have the capacity to support any other banks that may need help. Studies showed that immediate action was taken to clean up the cooperative financial institutions—according to government records, the average NPL ratio in this sector reached 17.2 per cent at the end of March 2001, with at least 30% having a negative net worth. In addition, official statistics also indicated that the non-performing loan ratio in the domestic banking sector reached 6 per cent at the same time[65]. In the first quarter of 2002, non-performing loans

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[62] As a result of the Zhong Xing Bank crisis the Legislative Committee in Taiwan launched a review of all Taiwanese banks. The results indicated that, apart from Zhong Xing Bank, there were also other banks in Taiwan, such as Chin Fong Commercial Bank, the Bank of Overseas Chinese, Development & Trust (Tai-Kai), and Chang Hwa Bank, which were allegedly involved with illegally extended loans. All of which had also experienced bank runs due to concerns that their lending practices had left them unstable. See "Agency May Investigate Bank Leaders" *Taipei Times* (July 13, 2000). *The Taipei Times* is an English-language newspaper published and released in Taiwan. This story is obtained from their on-line news. In that news report, The Ministry of Finance asked the Investigation Bureau in Taiwan to file charges against Chang Hwa Bank's former chairman and current president, who were allegedly involved in lending irregularities.

[63] See "Will Taiwan Experience a Big Bang?" *Taipei Times* (July 19, 2001).

[64] See report from the European Chamber of Commerce, Taipei. Available at [http://www.ecct.com.tw/committees/banking/2003banking.php].

[65] *Supra* note 63 "Will Taiwan Experience a Big Bang?" *Taipei Times* (July 19, 2001).

(NPLs) reached 8.78 per cent, the highest ever[66]. Thus, the banks' poor management of their portfolios has become one of the main concerns of the Taiwanese government.

Another problem, due to comparatively low minimum capital requirements in Taiwan for setting up an FHC (NT$ 20 billion, equivalent to approximately *US$ 670 million*), is that Taiwan's FHCs do not actually have a natural competitive global advantage. The low threshold, though it has successfully created a handful of FHCs, as anticipated by Taiwanese government, has not grown the size of Taiwan FHCs relative to the rest of the world. They are still dwarfed by world class financial conglomerates, such as the Citigroup in the U.S., boasting assets of approximately *US$ 70 billion* (at the time of their merger in 1998). That basically means, legally speaking, Taiwan's FHCs are entitled to exist in the global market with less than one percent of the world's largest FHC, Citigroup's total assets. Taiwan's low threshold is not a competitive threshold.

III. New Developments and Challenges Facing Taiwan's FHCs

Of all 14 FHCs in Taiwan, Cathay is the largest FHC by assets; its total assets amounted to NT$ 3.1 trillion (US$ 100 billion) as of end of December 2005, according to a recent banking report[67]. The report revealed both good and bad news pertaining to the biggest FHC in Taiwan. The good news is that Moody's Investors Service (hereafter "Moody's") has upgraded the long-term issuer rating of Cathay Financial Holding Company ("Cathay FHC") from Baa1 to A3. However the bad news is that Moody's rating also signaled that "the upgrade of [Cathay FHC] was prompted by the rating upgrades of its key operating subsidiaries, Cathay Life Insurance (from A2 to A1) and Cathay Century Insurance (from A3 to A2)". That is because, as Moody's pointed out, "given [Cathay FHC]'s reliance on its subsidiaries for cash flow, an aggressive use of financial leverage would reduce its financial flexibility, and hence pressure its financial

[66] Lawrence Lee, "Time for Taiwan to Act on NPLs", Aug. 23, 2002, Taipei Times.
[67] (Headline) "Taiwan: Moody's Upgrades Cathay Financial Group's Companies", The Asian Banker Journal, February 15, 2007. [Information is obtained from Lexis Nexus "News & Business" research database.]

strength."[68] Being an FHC, it basically means that Cathay FHC is designed to be a 'pure holding company', as commanded by Taiwan's FHCA, which adopts the U.S. model GLBA. Consequently, the Cathay FHC, like any other FHC in Taiwan, cannot engage in the day-to-day operations of actual business because its sole purpose as a holding company is to manage/invest for the benefit of the entire FHC. In this regard, the "bad news", which refers to Cathay FHC's heavy reliance on its subsidiaries for cash flow and aggressive use of leverage funds, is in my view not necessarily a risky business unless Cathay FHC has problem maintaining strong liquidity to offset the risks of any unexpected cash flow difficulties.

What can be better appreciated from the Cathay FHC's "moderate success" is reflected in the reasons that underlie Moody's upgrade of Cathay FHC's key operating subsidiaries. The aforesaid financial report cited:

> "Moody's upgrade of Cathay Life incorporates its improved capitalization, backed by its consistently healthy profitability, solid market franchise position and sustainable business portfolio. The upgrade is also supported by its sizeable agency distribution channels, which have relatively high productivity levels when compared to those of its major peers. At the same time, Cathay Life's increasing business interactions with various banking institutions—including its sister company, Cathay United Bank—provide it with further cross-selling opportunities for widening its customer base."[69]

The criteria used by Moody's for evaluating the soundness of Cathay FHC clearly demonstrated that a *widened* 'customer base' and 'agency distribution channel' are as conducive to the FHC's success (revenue enhancement) as are 'improved capitalization' and 'manageable business portfolio', the latter being more traditionally venerated. The former, referring to a superior ability to widen the customer base and agency distribution channels, is how international financial institutions (such as 'Citigroup' and 'Standard Chartered') distinguish themselves from Taiwan FHCs. As the largest player in global

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[68] *Ibid.*
[69] *Ibid.*

banking services, Citigroup (the world's largest FHC) is savvy about taking part of their sizeable capital assets to buy out less competitive banks in a less competitive country at a very competitive price. Citigroup has reportedly agreed to buy Bank of Overseas Chinese in Taiwan in April 2007. After the changeover, Citigroup will soon take over the local banks' established business and clientele and quickly turn them into part of their ongoing portfolio. In fact, aggressive takeovers have become a financial leverage strategy typically used by Citigroup to expand, at an exponential rate, its capital assets and economic power. Prior to Citigroup's buyout of the Taiwan bank, the London-based Standard Chartered announced a NT$ 40.5 billion (US$ 1.2 billion) purchase of Xin-Zhu International Bank in September 2006. The buyout raised the number of Standard Chartered Bank's branches in Taiwan from merely 4 to 86[70]. A few months later, in April 2006, Citigroup agreed to buy the Bank of Oversees Chinese (in Taiwan) for NT$ 14.1 billion (US$ 426 million), increasing Citigroup's branches six-fold to 66[71]. In fact, Citigroup has become the most profitable international bank in Taiwan. What is important is that almost instantly, the foreign banks' takeover of local banks help them (foreign banks) build a customer base at a much faster pace and in a much larger way than they would if they grew organically. More significantly, as commentators have pointed out, foreign banks in Taiwan can combine their operations in China, Hong Kong and Taiwan. That of course is going to put more pressure on Taiwan banks[72], as the government policy in Taiwan actually barred banks from doing so.

The Taiwan government has issued a decree that bars the country's banks from opening any new branches in Taiwan in order to foster mergers within this industry and as part of its concrete plan to solve the overbanking problem. More restrictions are in order for Taiwan banks in the future. Due to current government policy, Taiwan banks are also barred from opening new branches in Mainland China, reflecting a political reality that separates Mainland China from Taiwan, following (Taiwan's) Chiang Kai-shek government being forced into exile on Taiwan by Mao Zedong-led government,

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[70] Cathy Chan, "Taiwan Banks Face Regulatory Bind; Domestic Rules Bar Following Customers to Mainland China", The International Herald Tribune, May 11, 2007. [Information is obtained from Lexis Nexus "News & Business" research database.]
[71] *Ibid.*
[72] *Ibid.*

when the civil war ended in 1949. In this regard, compared to Taiwan banks, foreign banks will have an advantage in Mainland China. A recent report indicated that "foreign banks are increasingly targeting corporate customers wanting banking services to support their factories in China, and individuals looking for higher-yielding offshore investments."[73] As it is not easy for any bank to expand their branch network in Taiwan, buying existing banks is the quickest way to achieve that, said Eddy Yang, chief executive of Taiwan Ratings Corporation ("TRC"), cited another report[74]. Legally speaking, Citigroup's investment venture is employed to circumvent the legal ban, as a result of Taiwan government's decree, in barring banking institutions (including both local and foreign banks) from opening new branches in Taiwan. By acquiring local banks in Taiwan, Citigroup (as a foreign financial institution) successfully circumvented the restriction set by the Taiwan government. In actual effect, by taking over the number of outlets previously-owned by a Taiwan bank, Citigroup's number of branches (i.e. distribution channels), as well as its customer base, has been substantially increased. Citigroup's success in financial leverage has gained itself considerable competitive advantage in the Asian market. According to a recent report, Citigroup generates about 20 percent of its profit from Asia though its clout is less than London-based HSBC Holdings whose profit from the Asian region forms a whopping 41 percent of its entire revenue[75].

The wholesale buyout of local Taiwan banks by 'Citigroup' and 'Standard Chartered' is evidence of Taiwan FHCA's attitude towards foreign ownership of the shares of domestic banks in Taiwan. Citing the aforesaid report, after Citigroup agreed to buy the Bank of Overseas Chinese (in Taiwan) for NT$ 14.1 billion (US$ 426 million) it was ready to pay NT$11.80 dollars per share, 4.9 percent higher than the stock's last closing price[76]. Article 1 of Taiwan's FHCA stipulates that "[t]his Act is enacted in order to increase the 'synergy' of financial institutions, to consolidate the supervision of

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[73] *Ibid.*
[74] Cathy Chan & James Peng, "Citigroup to Buy Bank of Overseas Chinese", The International Herald Tribune, April 10, 2007. [Information is obtained from Lexis Nexus "News & Business" research database.]
[75] *Ibid.*
[76] *Ibid.*

'cross-financial industry'..." To this end, technically speaking, an FHC in Taiwan (referring to both domestic FHCs and foreign FHCs in Taiwan) must own or have a controlling interest in "cross-industry" financial institutions. In actual fact, it is equivalent to saying that FHCs in Taiwan must own or have controlling interest in cross-industry 'subsidiaries', rather than mere 'branches'. This is especially the case for domestic FHCs in Taiwan although they do not have to concurrently hold shares or capital from all three financial industries; banks, securities firms, and insurance companies, but only any two of the three. This is however not the case for most foreign FHCs (including E.U.'s Universal Banks) in Taiwan where they often only keep "branches" in Taiwan. To ameliorate the differences while applying the law, Taiwan's FHCA otherwise takes a very 'practical approach' by treating foreign FHCs' 'branches' as 'subsidiaries'. That means, as a usual banking practice, many foreign FHCs use their banking 'branch' in Taiwan to buy out Taiwan's local banks—a practice that is acceptable and legal. To apply the theory in the example stated above, if Citigroup had used their banking 'branch' in Taiwan to buy out Bank of Overseas Chinese in Taiwan, it would be treated the same way under Taiwan's FHCA if the Taiwan bank (Bank of Overseas Chinese) was acquired by any of Citigroup's banking 'subsidiary'. Such a 'subsidiary', practically speaking, could be located either in New York (home to the Citigroup), Taiwan, or elsewhere in the world; as long as it was a subsidiary of Citigroup.

Lauding the successful business scheme employed by Citigroup, particularly its buyout of local banks in other countries to increase its distribution channels and client base, does not imply that Taiwan FHCs are less innovative in engaging similar business ventures. In fact, Taiwan's Fubon FHC has reportedly planned to invest in a Mainland China bank through its Hong Kong unit when the 'ban' is lifted. The 'ban' refers to Taiwan's current banking policy that disallows local banks to open branches in Mainland China[77]. Fubon FHC is credited as "Taiwan's most comprehensive financial service

[77] By extension, Taiwan banks currently with 'representative offices' in Mainland China can not upgrade them to 'branches' because Taiwan government insists on first setting up a regulatory mechanism to monitor them there. See James Peng & Stephen Engle, "Regulator Seeks to Better Taiwan Banking", The International Herald Tribune, March 15, 2007. [Information is obtained from Lexis Nexus "News & Business" research database.]

group".[78] With a history of over 40 years in good standing, Fubon FHC provides comprehensive financial services from commercial banking to insurance, securities brokerage, assets management, and investment banking. However, it still feels pressured to increase its capitalization and hence its profit levels. That is because, "[e]ven Taiwan's strongest banks are weaker than their regional peers in terms of capital strength, and that reflects their weaker profitability"[79], as indicated by the director of financial institutions at Fitch Ratings in Taipei. Looking beyond the competitive domestic market for investment opportunities, many banking executives in Taiwan hold that investing in Mainland China is one viable solution. Under these circumstances, "[Fubon FHC] signed a memorandum of understanding in September (2006) to buy an undisclosed stake in Xiamen Bank for 2 billion dollars...with the China factor, you can leapfrog and make yourself stand out from other competitors...."[80] However, restricted by Taiwan's currently applicable laws and government policy, Fubon FHC cannot buy out the Xiamen Bank directly. Therefore, in a more circuitous fashion, Fubon FHC has taken the initiative to have reportedly "paid 3.24 billion Hong Kong dollars, or US$ 414 million, for about 75 percent of International Bank in 2004 to become the first Taiwan lender to operate a branch network in Hong Kong. Fubon has yet to make full use of the bank as a bridgehead into Mainland China because of regulatory issues."[81]

There are reportedly more than 1 million Taiwan business people who, with their families, live on the mainland, and there they have invested at least RMB$ 150 billion[82]. In this light, Taiwan FHCs are put on a less equal footing because of its own government's banking policy. Although the political reasons underlying this policy restriction are too complex to be discussed here, there is no doubt that internationally competitive financial groups like Citigroup, Standard Chartered, and HSBC are all

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[78] (Headline) "Taiwan Investor Intends to Control Mainland Bank", SinoCast China Financial Watch, July 25, 2007. [Information is obtained from Lexis Nexus "News & Business" research database.]
[79] Hille, *supra*, note 15, "Taiwan's Banks Feel the Heat".
[80] *Supra* note 70 Cathy Chan, "Taiwan Banks Face Regulatory Bind; Domestic Rules Bar Following Customers to Mainland China".
[81] *Ibid.* Although Taiwan Fubon FHC has put much effort in seeking to successfully buy the mainland bank, according to the report, the plan to buy the bank in the South-eastern province may fail because of the Taiwan government's restriction.
[82] *Supra* note 74 Cathy Chan & James Peng, "Citigroup to Buy Bank of Overseas Chinese".

capitalizing on the 'ban' to serve Taiwanese business people (residing in Mainland China) who could have been better served by their home country banks. Top international players such as Citigroup have already been aggressively buying out mainland banks; they in turn will continue to take advantage of the Taiwanese ban. For example, it has been reported that "New York-based Citigroup led a group in December (2006) that bought 86 percent of Guangdong Development bank. The firm also plans to increase its stack in Shanghai Pudong Development Bank to 19.9 percent from 3.78 percent."[83] As a matter of fact, Shanghai is the new home for most of the reportedly 1 million Taiwanese business people (and their families) who having moved from Taiwan to Mainland China. So the potential revenue loss for Taiwan FHCs is significant. Taiwan bankers are nevertheless thinking positive thoughts—"China is not a solution for everything. Management quality is still the most important factor", stated the president of Da Zhong Bank, Taiwan's fifth largest by market value[84].

Mainland China is Taiwan's biggest trading partner. It has also been reported that Taiwan companies and individuals are the biggest investors in Mainland China, with RMB$150 billion at stake. Under these circumstances, it is anticipated that market forces will pressure for the cancellation of the ban. There are already signs of relief—as the 2008 presidential election is fast approaching, many lobbying groups have campaigned vehemently for future banking reform to lift the ban. And candidates from Taiwan's two major political parties (Ma from "KMT" and Xie from "DPP") have both agreed to change the status quo by allowing Taiwan banks to expand their branch network in Mainland China. If this political promise is honored, it would effectively remove the long-standing competitive disadvantage suffered by Taiwan banks. In sharp contrast to Citigroup and its peers (Standard Chartered and HSBC), all three have reported revenue increases in Taiwan's financial markets. "The return on equity for Taiwan's financial services industry plunged to a negative 0.43 percent at the end of 2006, from a 4.8 percent gain a year earlier, according to the Taiwanese financial

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[83] *Supra* note 70 Cathy Chan, "Taiwan Banks Face Regulatory Bind; Domestic Rules Bar Following Customers to Mainland China".
[84] *Ibid.*

regulator"[85]. Taiwan banks have in recent years just recovered from heavy write-offs of large NPLs, as part of their joint efforts in collaboration with the Taiwan government to solve the overbanking problem in Taiwan. Faced with increasing competitive pressures, as the foreign financial institutions are entrenching their niches in Taiwan, the current government policy will need to be reevaluated to increase Taiwan banks' global competitiveness. Since the problem of overbanking has been substantially resolved, with the government's set aside of the financial restructuring fund and the encouragement of FHC establishment, one would think there should be more adaptive measures than merely banning the opening of branches. On one hand, from a government policy perspective, improving Taiwan's overall investment climate appears to be the right direction. In terms of actual implementation, regulatory supervision and other requirements for Taiwan FHCs should conform to international standards. The latter requirements generally include capitalization requirements, minimum assets requirements, disclosure requirements, internal control and auditing requirements etc. On the other hand, from a corporate development perspective, diversifying income resources is a key improvement factor for Taiwan FHCs. A case in point, First FHC (a domestic FHC in Taiwan) and its flagship bank subsidiary, First Commercial Bank, have sought to diversify income resources by expanding their business ventures into 'wealth management' and 'offshore markets'[86]. This endeavor has earned First FHC an improved rating by Moody's. "Moody's believes that the company's diversifying of its revenue sources—with regard to both product lines and geographical presence—is a positive development"[87]. This is no small feat for First FHC, given that First FHC has always been a bank-centric financial group (with more than 95% of its assets or earnings from First Commercial Bank)[88].

Last but not least, recent developments in Taiwan's financial markets have also witnessed a type of joint venture arrangement between a Taiwan FHC and a foreign financial institution. In June 2007, the Hague-based AEGON Life Insurance Company

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[85] *Ibid.*
[86] (Headline) "Moody's Assigns Baa1 and Aa3.tw Ratings to First Financial Holding", The Asian Banker Journal, May 31, 2007. [Information is obtained from Lexis Nexus "News & Business" research database.]
[87] *Ibid.*
[88] *Ibid.*

("AEGON") has reportedly signed a memorandum of understanding with Tai Xin FHC (a domestic FHC in Taiwan) to establish a joint venture (JV) in Taiwan to develop life insurance and pension products[89]. According to the report, Tai Xin FHC will hold 51% of the JV and AEGON the remaining 49%[90]. The advantage for AEGON of entering the JV is to distribute its wide-ranging insurance products through the extensive Tai Xin network, a highly regarded brand. The Tai Xin network, cited the report, includes "Tai Xin Bank, Taiwan Securities, Tai Xin Insurance Agency and Tai Xin Insurance Brokers", (which in total account for) a customer base of 4 million and a nation-wide distribution network of 200 locations... As part of its growth strategy, AEGON aims to further enhance its global distribution network, which includes partnership with banks."[91] From Tai Xin FHC's perspective, the new JV will enable it to provide life insurance and pension products for its own customers. The report says that "[s]ince its establishment in 2002, Tai Xin has offered the widest and most diverse range of products and services in Taiwan's financial services sector. However, until now, Tai Xin has *lacked* (emphasis added) life insurance and pension products of its own to offer its customers. Today's agreement with AEGON enables Tai Xin to offer these products for the first time, considerably strengthening the company's already diverse range of financial products and services. With demand for pensions and other long-term savings products set to grow, Tai Xin believes its joint venture with AEGON marks a significant step in its efforts to become the leading brand in Taiwan's financial services."[92] The same enthusiasm is shared by AEGON—"[i]ncreasingly in Asia, banks (Tai Xin being one of them) are playing an essential role as customers seek innovative protection and retirement products to provide for their long-term financial goals. Supported by AEGON's successful history of working through banks in the United States and in Europe, we look forward to working closely with Tai Xin to deliver quality financial solutions to their extensive customer base."[93] This mutual appreciation foretells a win-win situation. Tai Xin FHC's JV with AEGON is commendable especially amid the

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[89] (Headline) "AEGON and Tai Xin to Establish Life Insurance and Pension JV in Taiwan", The Asian Banker Journal, June 15, 2007. [Information is obtained from Lexis Nexus "News & Business" research database.]
[90] *Ibid.*
[91] *Ibid.*
[92] *Ibid.*
[93] *Ibid.*

Taiwan banking industry's struggle with negative profitability. As mentioned earlier, the return on equity for Taiwan's financial services industry plunged to negative 0.43 percent at the end of 2006, from a 4.8 percent gain a year earlier, according to the Taiwanese financial regulator[94]. In light of this, Tai Xin FHC's entering into a JV agreement with AEGON is a very positive move towards diversifying its revenue sources. Despite the fact that the banking industry has not fully recovered yet (most banks in Taiwan have in recent years been spending billions of dollars writing off large NPLs), the insurance industry has nonetheless recorded an unprecedented gain due to the aging population in Taiwan. Statistically speaking, "[b]etween 2003 and 2006, the Taiwanese insurance market grew at an annual rate of 15%. Over the last several years, bank assurance has expanded rapidly. In 2006, banks ranked as Taiwan's second largest distribution channel, behind the traditional agency channel. Banks sold a total of US$ 2.3 billion in insurance products in 2003. In 2006, the total increased to more than US$ 5.6 billion, an average annual growth rate of 35%."[95] Such a statistical record is undeniably a confidence-booster for Tai-Xin FHC's innovative approach in diversifying its revenue sources. Tai-Xin FHC's JV model hence can provide some inspiration for other FHCs in Taiwan that are poised to find solutions to increase their profit level.

IV. Conclusion

For each and every FHC in Taiwan, the ultimate goal of synergy is to increase revenue, and ultimately, to raise profit level. Judging by the recent moves by a couple of prominent FHCs in Taiwan, it is evident that they are heavily influenced by the Citigroup's strategic behavior in maximizing its self interest. Aggressive takeovers are already shaping up in Taiwan. A case in point is China Trust FHC's alleged role in acquiring the controlling interest in Mega FHC in 2006. In a similar vein, the Fubon FHC has reportedly signed a memorandum of understanding in September 2006 to buy out the Xiamen bank in China when the ban is lifted. The 'ban' refers to Taiwan's current banking policy that disallows local banks to open branches in Mainland China.

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[94] *Supra* note 70 Cathy Chan, "Taiwan Banks Face Regulatory Bind; Domestic Rules Bar Following Customers to Mainland China".
[95] *Supra* note 89 "AEGON and Tai Xin to Establish Life Insurance and Pension JV in Taiwan".

On the other hand, earlier this year (in June 2007), a third FHC in Taiwan, Tai Xin FHC, reportedly signed a joint venture agreement with the Hague-based AEGON Life Insurance Company in order to develop life insurance and pension products. All these efforts (regardless of whether they are acceptable to Taiwan's current banking law regime) speak to the fact that Taiwan FHCs are no less innovative than Citigroup in transacting business ventures in order to maximize their profit level. Indeed Taiwan FHCs have a heightened awareness when utilizing strategic behavior to increase their distribution channels and client base. This is not only spurred by the success of Citigroup but perhaps more importantly by the fact that all FHCs in Taiwan are now forced to compete with other foreign FHCs (or universal banks) entering into Taiwan's financial market. As a result of Taiwan's joining the WTO in 2002, the country is supposed to open its market to its foreign counterparts; this of course, includes Taiwan's financial market.

The interview with Fubon's management revealed the actual operation of Taiwan's FHCs on a daily basis. Fubon's management pointed out that collaboration among the FHC's three subsidiaries (the banking, insurance, and security arms) are rare, and then only when joint effort is required for devising new financial service products. He further stressed that in normal circumstances, each subsidiary not only works independently but keeps separate accounting books[96]. The observation by Fubon's management is consistent with the conclusion drawn by researchers (as shown in Table 1 in the 'Introduction' chapter)[97] that "in Taiwan, the FHC banks' average operational efficiency is not that much higher than that of non-FHC banks. 'Resource waste' is the culprit in this problem."[98] This dismal observation was made when the research was conducted between December 2001 to June 2004, only two and a half years following the promulgation of Taiwan's FHCA in July 2001. One can reasonably expect that once the FHCs in Taiwan are more mature and have successfully resolved the problems of

[96] A detailed account of the interview with Fubon's management can be found in Section II of this chapter, under the subhead of "4. Recent Interview with Fubon Financial Holding Company".
[97] See the "Introduction" chapter of this dissertation (under the subhead of "(4.2) Research Subject: FHC Banks and Non-FHC Banks in Taiwan").
[98] *Ibid.*

clashing corporate cultures (among all subsidiaries) and found a better way to collaborate, the operational efficiency for Taiwan's FHCs will increase in due course.

The success of Citigroup inspired me to conduct a case study on the Citicorp-Travelers merger—a merger which resulted in the first and largest FHC in the world. The Citigroup merger marked a journey in U.S. financial legal history from 'regulation' to 'de-regulation' and further to 're-regulation'. Details of these accounts will follow in Chapter Three of this dissertation.

Chapter Three

Regulation, Deregulation, Reregulation: Pre-GLBA (Gramm-Leach-Bliley Act) Era Regulatory Restraints

I. Introduction

The *Gramm-Leach-Bliley Financial Modernization Act* (hereafter "the *Gramm-Leach Bliley Act*, or "the GLBA") marks a watershed change from previous legislation characterized by Depression-era limitations on financial services conglomerates. It differs from prior regulatory and statutory schemes in the manner in which it addresses potential risks to a depository institution associated with securities and other activities conducted by affiliates. The GLBA blurs previous legal distinctions between banking and non-banking sectors—distinctions which traditionally characterized the U.S. financial services industry. It also relaxes most of the activity restrictions on U.S. commercial banks under the *Glass-Steagall* provisions of the *Banking Act of 1933* ("the *Glass-Steagall Act 1933*") and *Bank Holding Company Act of 1956* ("the BHCA"). The *Glass-Steagall Act* (which refers to only four sections of the *Banking Act of 1933*, they are Sections 16, 20, 21, 32) was passed in the wake of a rash of bank failures following the stock market crash in 1929; it imposed a barrier between commercial banking (taking deposits and making commercial loans) and investment banking (underwriting, issuing, and distributing stocks, bonds, and other securities). Specifically, Sections 16 and 21 of the *Glass-Steagall Act* limited the ability of banks and securities firms to engage directly in each other's business activities, while Sections 20 and 32 limited the ability of banks and securities firms to engage indirectly in such activities through separately established affiliates. Sections 16 and 21 of the Act, therefore, prohibit depository institutions from underwriting securities directly, and section 20 prohibits banks that are members

of the Federal Reserve System (member banks) from underwriting securities through affiliates[1]. The BHCA, on the other hand, placed severe restrictions on bank holding companies forming separately capitalized insurance affiliates and on insurance companies acquiring banks[2]. These restrictions, effectively meant that any permissible activities by a bank holding company had to be carried out through subsidiaries regulated under Section 20 of the *Glass-Steagall Act* ("Section 20 Subsidiaries"), which was initially authorized by the Federal Reserve Board in 1987[3], and not by the bank holding company itself. By putting together both the *Glass-Steagall Act 1933* and the *Bank Holding Company Act 1956*, it is clear that for banks that intend to cross into 'limited permissible securities activities', they must do so by first, setting up a bank holding company, and secondly, engaging in the limited securities activities only through the bank holding company's subsidiary (Section 20 subsidiary). Section 20 standards[4] contain detailed restrictions on relationships and transactions between depository institutions and securities affiliates. The GLBA relies instead on requirements that each depository institution affiliated with securities firm be and remain well capitalized and well managed[5].

Having briefly introduced the new GLBA, it makes sense to subsequently analyze deregulation through various aspects. In this chapter, Part One describes in general deregulation from an historical perspective. Methodologically speaking, an overall review of previous legislation as well as court decisions will be conducted, in order to identify what triggered deregulation. Part Two stresses the evolutional development of the GLBA, from regulation to deregulation and further to re-regulation. Part Three undertakes a case study of the Citigroup Merger. I will outline the issues and controversies pertaining to this first mega-sized merger, which

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[1] D.A. Howard, "Ownership of Member Banks by Mutual Fund Advisors under the Glass-Steagall Act" (1984) 52 Fordham L. Rev. 691 at 692.
[2] Lei Yu, "On the Wealth and Risk Effects of the Glass-Steagall Overhaul: Evidence from the Stock Market", at p. 5. Full text of the article is available at http://courses.freeman.tulane.edu/rhansen925/yu.pdf
[3] M. C. Collins, S. A. Kwag, & H. S. Yildirim, "An Examination of the Equity Market Response to the Gramm-Leach-Bliley Act—Across Commercial Banking, Investment Banking, and Insurance Firms", published in September 2002, available at [http://bus.utk.edu/finance/WP/Gramm-Leach-Bliley%20Paper%202002.]
[4] The operating standards would continue to apply to Section 20 subsidiaries controlled by bank holding companies that do not qualify as financial holding companies or do not elect to become one. See "Bank Holding Companies and Change in Bank Control; Securities Underwriting, Dealing, and Market-Making Activities of Financial Holding Companies", by Board of Governors of the Federal Reserve System, 12 CFR Part 225, [Regulation Y; Docket No. R-1063].
[5] *Ibid.*

spawned the financial conglomeration craze back in 1998 and openly challenged the legal system by joining banking and insurance forces. This all took place one year prior to the much anticipated legal reform towards liberalization.

Despite most scholars referring to the origins of the GLBA as result of a trending towards deregulation, I argue that GLBA is rather a form of "re-regulation". I want to emphasize the 'evolutional development' of the GLBA, from 'Regulation' to 'Deregulation' and further to 'Re-regulation'. The *linear direction* denotes *sequential development*. 'Regulation' is represented by the *Glass-Steagall Act of 1933*, followed by 'deregulation', which is typically represented by the *Bank Holding Company Act of 1956*. In fact, the *Bank Holding Company Act of 1956* started the gradual relaxation of the *Glass-Steagall Act of 1933*. 'Re-regulation' is otherwise represented by the GLBA. I prefer the term 're-regulation' because (i) deregulation is somewhat misleading—GLBA does not mean total liberalization, but rather (ii) the scope of "permissible financial activities" has been expanded. There are still requirements to be met, for example, (iii) financial subsidiaries must be "well-capitalized", "well-managed", and their CRA (Community Reinvestment Act) rating must be satisfactory or better, and (iv) the so-called "permissible financial activities" must be financial in nature or incidental or complementary to financial activities. That also means the GLBA still *bans* banks from engaging in 'non-banking business *per se*'.

Before the Citigroup merger in 1998 that openly challenged the Pre-*Gramm-Leach-Bliley Act* ("Pre-GLBA") regulatory restraints and further forced Congress to pass the GLBA in 1999, a brief history of financial service industry regulation (as below) shows that the American financial industry has historically been heavily regulated. Increasing efficiency of financial institutions and striving to maintain global competitiveness is the backdrop against which deregulation was taking place.

The historical development, from the "pre-GLBA regulatory restraints" to the "post-GLBA financial liberalization", will be elaborated on in the following.

The pre-GLBA regulatory restraints, of particular significance, refer to first, the *Glass-Steagall Act 1933* and secondly, the *Bank Holding Company Act 1956*.

The banking regulation in *Glass-Steagall Act 1933* represents an absolute ban on banks affiliating themselves with securities firms. The idea of an "absolute ban" reflected the intention of the drafters of the *Glass-Steagall Act* to eradicate problems relating to commercial banks' excessive risk-taking by engaging in the securities business and taking on conflict of interests by utilizing depositors' money to make sometimes inappropriate loans to cover poorly underwritten deals. Following the Great-Depression era, the *Glass-Steagall Act* was enacted (i) to promote public confidence in banking institutions, (ii) to prevent investor deception and (iii) to avoid conflict of interests in the management of the banking and securities businesses. In order to fully implement these ideals, the drafters deliberated extensively over whether these three aims required complete prohibition of the relationships between banking and securities enterprises or whether these relationships should be permitted subject to elaborate regulation. Congress chose outright prohibition in the belief that the dangers arising from these relationships were so subtle and variegated that regulation could not be entirely effective[6].

Although the *Glass-Steagall Act of 1933* created a firewall that separates commercial banking from investment banking, this wall is not impenetrable. There is a loophole in the *Glass-Steagall Act of 1933*, as it only applies to banks, not bank holding companies. For those banks that intend to circumvent the *Glass-Steagall Act*, they either set up, or affiliated with, holding companies, and through the holding company structure, (commercial) banks began to engage in non-banking activities. The *Bank Holding Company Act 1956* was enacted in order to close this loophole in the *Glass-Steagall Act*. The core of the *Bank Holding Company Act* is that a bank holding company is prohibited from acquiring direct or indirect control over a company that is not a bank. (Any violation of this would necessitate bank holding companies to divest themselves of non-banking interests.) The legal rule is nonetheless subject to a few exceptions.

(i) Exception #1 is set forth in Section 4(c)(8) of the *Bank Holding Company Act* ("Section 4 (c)(8)"). Section 4(c)(8) is the most important exception to the general rule of the BHCA, which states

[6] Howard, *supra*, note 1, at 696.

that the Federal Reserve Board ("FRB") may permit a bank holding company to acquire or control a non-banking company if its activities are "so-closely related to banking or managing or controlling banks as to be a proper accident thereto".

(ii) Exception #2 is "Regulation Y", which refers to the FRB's list of a number of "permissible non-banking activities" for bank holding companies.

(iii) Exception #3 is outside the bank holding company framework, the securities activities of commercial banks also expanded due to liberal interpretations of the *Glass-Steagall Act* by the Office of the Comptroller of the Currency ("OCC"). The OCC permits commercial banks to engage in an expansive array of securities and securities-related activities, such as the underwriting of government bonds (the United States government, state, and municipal obligations.)

Even though the latter Act of 1956 was designed to further strengthen the Act of 1933, in retrospect, the *Bank Holding Company Act 1956* proved to have begun a gradual relaxation of the *Glass-Steagall Act*. Specifically, as commentators have pointed out, the *Glass-Steagall Act* 1933 separated commercial banking from securities business and the *Bank Holding Company Act* 1956 separated commercial banking from the insurance business. These prohibitions had been notably diminished by not only regulatory rulings, court decisions, but also marketplace practices[7]. For example, a legal review in 1984 indicated that "although the Supreme Court (of the United States) has stated that the *Glass-Steagall Act* separates the commercial banking and securities industries 'as completely as possible', recent changes in the economy[8], in technology[9], and in demographics[10] have prompted both

[7] Collins, Kwag, & Yildirim, *supra* note 3.

[8] Securities Activities of Depository Insts.: Hearings on S. 1720 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs, 97th Cong., 2d Sess. 1 (1982) (testimony of Sen. D'Amato) (increase in the number of mergers and acquisitions) [hereinafter cited as 1982 Hearings]; Competition and Conditions in the Financial System: Hearings Before the Senate Comm. on Banking, housing and Urban Affairs, 97th Cong., 1st Sess. 71 (1981) (statement of John G. Heimann, Comptroller of the Currency) (inflation fluctuations in interest rates, unemployment and production) [hereinafter cited as May 1981 Hearings]; see Hill, One Bank's Difficulties Can Hurt Many Others Because of Loan Links, Wall St. J., June 21, 1982, at 1, col. 6 (volatile interest rates and unruly capital markets).

commercial banks and securities firms to expand into each others' fields. In 1971, for example, the Court denied Citibank's predecessor permission to offer the equivalent of a mutual fund, but ten years later permitted Citibank's holding company to act as investment adviser to a closed-end investment company. In 1984 the Court was to decide whether Bankers Trust Co. may continue to deal in commercial paper and whether Bank-America Corp. must divest itself of Charles Schwab & Co., its discount brokerage subsidiary. Over the vehement opposition of the Board of Governors of the Federal Reserve Board, the Office of the Comptroller of the Currency ("OCC") recently permitted[11] companies that advise, sponsor and underwrite mutual funds to own member banks."[12] Starting two decades ago, the revolutionary forces had continued to grow even stronger, especially with the advent of new financial products such as securitization and derivatives, whereby liberalization of the Depression-era restrictions had taken on an unprecedented fast pace.

Of particular relevance to such regulatory rulings and court decisions is the "Source-of-Strength Doctrine". The essence of the doctrine is to force bank holding companies to bail out their failing subsidiaries. The rationale behind this doctrine is that because bank holding companies reap benefits from bank ownership, especially in times of prosperity, it also should bear some of the burdens imposed by banks in times of adversity. In view of this, the Board of Governors of the Federal Reserve System (the "Fed") did not feel this was an unfair burden on bank holding companies or their shareholders. The *Bank Holding Company Act 1956* confers broad authority

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[9] *Ibid.* (1) *1982 Hearings* at 1 (statement of Sen. D'Amato) (emergence of new technologies for the transfer of funds and innovative financial products); (2) *May 1981 Hearings* at 72 (statement of John G. Heimann, Comptroller of the Currency) (expanded competition by smaller institutions made practical and possible by technological innovation); Bennett, *Deregulation Has Freed Banks to do What They Never Could. Should They Also Be Allowed the Freedom to Fail?*, N.Y. Times, Feb. 19, 1984, ?3 (Business), at 12, col. 2 (dramatic technological advances); Wall St. J. July 18, 1983, at 1, col. 5 (high-speed computers).

[10] *Ibid. May 1981 Hearings* at 72 (population shift from North and East of the country to South and West expected to have major effect on financial products markets).

[11] Despite the approval by OCC, a commentary against such approval is noteworthy, which suggests that OCC's approval of the bank-mutual fund structure is incorrect as the structure is illegal under the *Glass-Steagall Act*. More specifically, the structure's mutual funds are "controlled" within the meaning of section 2(b)(2) by their adviser-sponsor and therefore affiliated with their adviser's member bank subsidiary is in violation of section 20. The unavoidably hazardous nature of the relationship between the bank and mutual funds supports this conclusion. A company which advises and sponsors mutual funds, therefore, should not be permitted to own a member bank under the Act. See Howard, *supra*, note 1.

[12] *Ibid* at 692-694.

on the Fed to regulate and supervise the day-to-day operations of bank holding companies, especially operations that have a significant impact on the stability and soundness of subsidiary banks and the banking system. This doctrine is of particular importance following the deregulation of previous restrictions set out by both the *Glass-Steagall Act 1933* and the *Bank Holding Company Act 1956*, both preventing banks from engaging in non-banking activities. After the amendment to the *Bank Holding Company Act* in 1970, Congress added a provision in Section 4 (c)(8) that allows bank holding companies to engage in non-banking activities that the Fed determines to be "closely related to banking". Under these circumstances, as the risk for banks increases, the Fed wished to maintain authority over bank holding companies, by applying this doctrine. The doctrine is to alleviate serious risks of loss to the Bank Insurance Fund ("BIF") and to the banking system presented by an impending bank failure[13]. Along this line of thought, another emphasis is on market practice, which is manifested by the Traveler's Insurance buyout of Citibank in 1998, one year before the *Gramm-Leach-Bliley* was actually promulgated.

The development of the U.S. financial holding company law ("the U.S. FHC Law", the GLBA) is, relatively speaking, more evolutionary than revolutionary. Even though the U.S. FHC Law did not come about until November 1999, popular discussion of financial holding companies can be traced back 20 years or even earlier. Indeed, from the 1933 *Glass-Steagall Act* until now, over seven decades of banking history, the U.S. FHC Law has come through a full cycle of regulation, deregulation, and re-regulation.

For extended discussions, in this chapter, Part II provides details as to the sequential development of "regulation—deregulation—re-regulation" followed by Part III, which is devoted to explaining the case study of Citigroup merger that in my view is a good example for illustrating the paradigm shift from deregulation to re-regulation. A brief summary will be tailgated at the end as Part IV conclusion.

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[13] J. F. Groth, "Can Regulators Force Bank Holding Companies to Bail Out Their Failing Subsidiaries?—An Analysis of the Federal Reserve Board's Source-of-Strength Doctrine" (1991) 86 Northwestern University Law Review 112.

II. Regulation, Deregulation, and Re-regulation: Evolutionary Historical Development

1. Regulation

(1.1) Regulation for Securities Dealing—the *Glass-Steagall Act 1933*

The *Glass-Steagall Act of 1933* prohibited insurance, securities brokerage and banking companies from merging[14]. A mix of commercial and investment banking and their principals was blamed for the biggest banking crisis and economic recession in American history. Historically, the Great Depression[15] began with the stock market crash in 1929, which was believed to have resulted from the poor quality of commercial banks' securities underwriting. Before 1929, a prosperous U.S. securities industry had attracted the attention of the banking industry and the two fields rapidly expanded towards the securities business. At that time, many U.S. commercial banks directly engaged in securities underwriting either through the bank's liquid assets or its client's account for trusted securities. Due to the close relationship between the bank and its affiliate, commercial banks quite often provided securities firms with necessary help, mainly to offset the balance for unsold securities or to provide direct credit, which in turn led to the 1929 Depression and the breakdown of the U.S. banking system.[16] This phenomenon exposed the problem of U.S. banks being able to manipulate the stock market. For example, banks can shift bad loans to the general public (the investors) through and in the form of corporate shares and bonds. This also raises concerns of moral hazard. The *Banking Act of 1933* (more precisely, the

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[14] S. Gunawan, E. Joo & J. Y. Kim *et al.*, "The Merger Between Citicorp and Travelers: A Closer Look at Citigroup", Professor Alan Dye, Economics of Business Organization, April 12, 2002, M&A Project. Available at Google Advanced Search—
[http://beatl.barnard.columbia.edu/dye/Citigroup+Merger+Final+Paper.pdf]

[15] Between 1929 and 1933 approximately 9,000 banks failed, roughly half the banks in the United States at the time. This was a result of liquidity problems and wide spread bank runs. This was virtually unprecedented in the U.S. history. While there were a number of banking panics throughout the nineteenth century, a general suspension of all banking businesses for a period as long as a week had never before taken place. Such a banking holiday was declared on March 6, 1933, however, and all banks, including the Federal Reserve System, closed down for a week. Tim S. Campbell, *Money and Capital Markets*, 1st ed. (Glenview, Illinois/Boston/London: Scott, Foresman & Co., 1988) at 377.

[16] Wen-yu Wang, *Holding Company and Financial Holding Company Law* (*Kong Gu Gong Si Yu Jin Rong Kong Gu Gong Si Fa*, in Chinese) (Taipei: Yuan Chao, 2001) at 200. (In Chinese).

Glass-Steagall Act) was prompted by allegations that commercial banks had engaged in stock market manipulation and insider trading prior to and following 1929 Crash/Depression. In order to ensure the stability of the U.S. banking system, the *Glass-Steagall Act* 1933 put a barrier between commercial banking and investment banking.

Traumatized by the experience of bank failure in the Great-Depression era, regulation of the banking industry via the *Glass-Steagall Act* remained largely untouched for nearly 70 years, until the recent GLBA finally came into place in 1999. Nonetheless, emphasis needs to be made that the *Glass-Steagall Act* "did not prohibit (commercial) banks from being affiliated with entities that underwrite or deal in corporate securities, so long as those entities were *not principally* engaged in those activities."[17] Banks were ultimately required to form bank holding companies, under language in Section 20 of the *Glass-Steagall Act* (known as "Section 20 Subsidiary"), in order to engage in non-permissible banking activities, such as the securities business. That also means, banks have to rely on their affiliates to do business that banks want to do but cannot be done by banks themselves. The restriction also entails that the affiliates of commercial banks cannot engage principally in non-permissible activities. Section 20 of the *Glass-Steagall Act*, requires member banks (referring to those banks participated in federal deposit insurance) wanting to conduct business in securities to observe the following restrictions:

> SEC. 20. [12 U.S.C. 377] After one year from the date of the enactment of this Act, no member bank shall be affiliated in any manner described in section 2(b) hereof with any corporation, association, business trust, or other similar organization engaged *principally* in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities....

[17] John Nelson Laski & David Hemley, "Management of Small Banks and Financial Companies Following Enactment of Gramm-Leach-Bliley": The Academy of Entrepreneurial Finance; April 2003; 14th International Conference; DePaul University; Chicago. Quotation of this paragraph appears in page 3 of the article. Full text available at [http://scholar.google.com/url?sa=U&q=http://www.aoef.org/papers/2003/laski.pdf]

(1.1.1) Definition of an "Affiliate"

An "affiliate" of a bank is a firm effectively controlling or controlled by the bank, or a firm effectively controlled by a parent entity that in turn controls a bank.[18] As far as "affiliates" are concerned, any business entities that fall into one of these four categories in Section 2(b) of the *Banking Act of 1933* is regarded as a bank's affiliates.

(i) First, during election, the term "affiliate" shall include any corporation, business trust, association, or other similar organization (jointly referred to as the "business entities") of which a (member) bank, directly or indirectly, owns or controls either a majority of the voting shares or more than 50 per centum of the number of shares voted for the election of its directors, trustees, or other persons exercising similar functions at the preceding election. Similarly, in situations where a member bank controls in any manner the election of a majority of the directors, trustees, or other persons exercising similar functions in such business entities, these business entities also constitute a banks' "affiliates".

(ii) Secondly, in regular business operations, where the control is held, directly or indirectly, through stock ownership or in any other manner, by the shareholders of a member bank who own or control either a majority of the shares of such bank or more than 50 per cent of the number of shares voted for the election of directors of such bank at the preceding election, or by trustees for the benefit of the shareholders of any such bank, then, such bank would also constitute an "affiliate" of the member bank. This scenario takes place when a member bank becomes a holding company of such bank (another bank), and the latter becomes an affiliated bank of the former.

(iii) Thirdly, where a majority of another bank's directors, trustees, or other persons exercising similar functions are directors of any one member bank,

[18] 12 U.S.C. §377 (repealed). This section (Act June 16, 1933, ch 89, § 20, 48 Stat. 188; Aug. 23, 1935, ch 614, Title III, § 302, 49 Stat. 707) was repealed by Act Nov. 12, 1999, P.L. 106-102, Title I, Subtitle A, § 101(a), 113 Stat. 1341 (effective 120 days after enactment, as provided by § 161 of such Act, which appears as 12 U.S.C.S. §24 note). It prohibited member banks from affiliating with organizations dealing in securities and penalties. See also 12 U.S. C. §221a(b).

then such overlap would subordinate the former bank to the member bank. The former bank becomes an affiliated bank to the member bank, or put another way, the member bank becomes the holding company of its subordinate.

(iv) Fourthly, a bank's affiliate also refers to a company that owns or controls, directly or indirectly, either a majority of the shares of capital stock of a member bank or more than 50 per cent of the number of shares voted for the election of directors of a member bank at the preceding election, or controls in any manner the election of a majority of the directors of a member bank, or for the benefit of whose shareholders or members all or substantially all the capital stock of a member bank is held by trustees.[19]

In either one of the above four scenarios, the member bank (as a commercial bank) becomes the holding company of its affiliates, which could be a corporation, business trust, association, or even another bank.

It should be noted that the 50 per cent requirement was reduced to 25 per cent under the *Bank Holding Company Act*. That is to say, under the *Bank Holding Company Act*[20], any corporation, partnership, business trust, or other similar organization (jointly referred to as the "business entities"), as long as they hold 25 per cent or more of any class of voting securities of another bank or company, such business entities would then be considered the holding company. Furthermore, if the holding company owns or controls a bank, then, it becomes a bank holding company.

(1.1.2) A Case Example for an "Affiliate"

A good example of an affiliate's role and its permissible activities in a bank holding company is the case of the *Securities Industry Association* v. *Board of Governors of the Federal Reserve System Et. Al.*[21] In March 1982, BankAmerica Corp. ("BAC"), a bank holding company, applied to the Federal Reserve Board

[19] 12 U. S. C. S. §221a (b)(1)-(4).
[20] 12 U.S. C. 1841 (a)(1). See also Wang, *supra*, note 16, at 209 (original footnote 156).
[21] 468 U.S. 207; 104 S. Ct. 3003. This case was argued in the United States Court of Appeals for the Second Circuit on May 23, 1983, and was decided on July 15, 1983 which mandated that order to the Federal Reserve Board affirmed. The petitioner further brought this case to the Supreme Court of the United States and this court affirmed the court of appeals' decision on June 28, 1984.

("Board") for approval under Section 4(c)(8) of the *Bank Holding Company Act* ("Section 4(c)(8)") to acquire a non-banking affiliate corporation (The Charles Schwab Corporation, "Schwab") engaged in retail securities brokerage. Section 4(c)(8) authorizes bank holding companies, with prior Board approval, to acquire stock in other companies that are engaged in non-banking activities that the Board determines "so closely related to banking...as to be a proper incident thereto." The Board authorized BAC to acquire Schwab, holding that the decision would not reduce competition, and would produce public benefits that outweighed any potential adverse effects (such as the undue concentration of resources, decreased or unfair competition, conflict of interests, or unsound banking practices[22]). Specifically, the Board upheld that a securities business, such as Schwab, that is essentially confined to the purchase and sale of securities for the account of third parties, without providing investment advice to the purchaser or seller[23], is "closely related" to banking within the meaning of Section 4(c)(8). The Board also concluded that the acquisition would not violate Section 20 of the *Glass-Steagall Act*. In this case, it is reasonable for the Federal Reserve Board to determine that Section 20 of the *Glass-Steagall Act*, which provides that no bank may be affiliated in any manner with any organization engaged principally in the issue, flotation, underwriting, public sale, or distribution of securities, permits bank holding companies to acquire firms engaged in a brokerage business that is essentially limited to the purchase and sale of securities for the account of customers, and without provision of investment advice to purchaser or seller. In this light, the Board's determination that the business of purchasing or selling securities upon the unsolicited order of, and as agent for, a particular customer does not constitute the "public sale" of securities for the purposes of Section 20 is reasonable, consistent with the plain language and policies of the statute and its legislative history, and deserves the deference normally accorded the Board's construction of banking laws.[24] The legislative history demonstrates that Congress enacted Section 20 of the *Glass-Steagall Act* to prohibit the affiliation of commercial banks with entities that are engaged principally in activities such as underwriting. In

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[22] 12 U. S. C. § 1843 (c)(8)

[23] Schwab is known as a "discount" broker because of the low commissions it charges. Schwab can afford to charge lower commissions than full-service brokerage firms because it does not provide investment advice or analysis, but merely executes the purchase and sell orders placed by its customers.

[24] 82 L. Ed. 2d 158 (Headnote #5). See also 468 U.S. 207, 104 S. Ct. 3003.

this case, however, none of the hazards of underwriting are undertaken by Schwab's brokerage activities.[25]

Of particular importance is that there is no express requirement in Section 4(c)(8) that a proposed activity must facilitate other banking operations before it may be found to be "closely related" to banking. The record substantially supports the Board's factual findings that Schwab's brokerage services (i.e. "retail securities brokerage") were very similar to the types of services that are generally provided by banks and that banks are particularly well equipped to provide such services.[26] Even so, a national trade association of securities brokers (Petitioner) opposed the application of the Board (Respondent), in the United States Court of Appeals for the Second Circuit, alleging that under the *Glass-Steagall Act* and the *Bank Holding Company Act*, 12 U.S.C.S. §1841 et seq. (1976) Respondent did not have authority to approve the petition, and that the subsidiary (more correctly "the affiliate")[27] was not "closely-related" to banking. The *Glass-Steagall Act* mandated a separation of the commercial and investment banking industries, and the *Bank Holding Company Act* generally prohibited bank holding companies from engaging in non-banking activities. In opposition, the Respondent made a determination that retail brokerage (as was engaged by Schwab) was closely related to banking activities, which was a reasonable determination. As such, neither of the Acts prohibited BankAmerica, as a bank holding company, from engaging in retail brokerage. The result was that petition for review of the Board's decision was denied and the Respondent's order affirmed in the United States Court of Appeals for the Second Circuit. The Petitioner then brought this case to the Supreme Court of the United States, and the court affirmed the Respondent's determination, holding that the Respondent's decision was entitled to great deference and was well within its discretion[28]. The court concluded that the bank holding company and retail securities brokerage businesses were similar, and the merger was well within the law.

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[25] 468 U.S. 207, at 216-221.
[26] 468 U.S. 207, at 214-216.
[27] In the court decision, "subsidiary" and "affiliate" seem to be used interchangeably.
[28] 104 S. Ct. 3003

(1.1.3) Does the Distinction between "Subsidiary" and "Affiliate" Matter? (in the Context of Section 4(c)(8) of BHCA)

One may wonder whether it matters that such Section 4(c)(8) activities are performed by either the bank's subsidiaries or affiliates. Under the *Bank Holding Company Act* ("BHCA"), a company is a "subsidiary" of a bank holding company if the bank holding company (i) owns or controls 25% or more of the company's voting shares, or (ii) controls the election of a majority of the company's directors[29]. A company is also considered a "subsidiary" of a bank holding company if the Board (of Governors of the Federal Reserve System) determines, after proper notice and an opportunity for a hearing, that the bank holding company directly or indirectly exercises a controlling influence over the management or policies of the company[30]. In contrast, for the purpose of the BHCA, the term "affiliate" means any company that controls, is controlled by, or is under common control with another company[31]. In regards to company structure, subsidiaries can only be owned by bank holding companies, whereas, in multiple bank holding companies, affiliates can control or own another bank holding company for the parent bank holding company. A multiple bank holding company indicates a bank holding company owns more than one bank or bank holding company. Despite the difference of "who is being owned by whom", as per the restrictions contained in the BHCA, both subsidiaries and affiliates can only engage in activities that are "closely related to banking" or engage in non-banking activities approved by the Board of Governors of the Federal Reserve System ("Fed" or "Board").

In Section 121 of the GLBA, with respect to "limiting the exposure of a bank to a financial *subsidiary* to the amount of permissible exposure to an *affiliate*", it is clearly stipulated that a "*financial subsidiary (is) treated as an affiliate*". Specifically "a financial subsidiary of a bank shall be deemed to be an affiliate of the bank; and shall not be deemed to be a subsidiary of the bank."[32] One might wonder, with respect to the legal effect, whether this statement is merely used for bridging the gap between the wording adopted in the old law (the *Bank Holding Company Act*) as

[29] 12 U.S.C. §1841(d)
[30] *Ibid.*
[31] 12 U.S.C. §1841(k)
[32] 12 U.S.C.A. §371c(2)(A)(B)

opposed to the new law (GLBA)? As it is so understood, "the Gramm-Leach-Bliley Act eliminates many long-standing federal and state law barriers to *affiliations* between banks and securities firms, insurance companies, mutual funds, and other financial service providers. In so doing, the GLBA paves the way for a significant restructuring of the U.S. financial service industry and a modernization of the way financial services are offered in the United States."[33] Under these circumstances, the new law allows and even encourages banks to merge or acquire insurance companies and securities firms in subsidiary or affiliate form, thus creating a financial conglomerate. Because restrictions under the old laws (including both the *Glass-Steagall Act 1933* and the *Bank Holding Company Act 1956*) basically prohibited banks from engaging in both the insurance and securities businesses, it is naturally understandable that the old laws also imposed bans on banks *affiliating* with insurance companies and securities firms. This intention is clearly expressed in Section 20 of the *Glass-Steagall Act*, and the exact wording used there is "*affiliate*", while Section 20 of the *Glass-Steagall Act* is generally known to refer to the "Section 20 *Subsidiary*". The distinction under these statutes between "affiliates" and "subsidiaries" has traditionally been blurred. Furthermore, Section 4(c)(8) of the *Bank Holding Company Act* only allowed bank holding companies to engage in insurance activities under exceptionally limited circumstances of affiliation and through Regulation Y[34], the Federal Reserve Board also continued to add to the list of permissible non-banking activities, so long as they were "closely related to banking". Regulation Y is also known as the "operating *subsidiary* rule", therefore, by then, whether the Federal Reserve Board still attempted to strictly differentiate the way they treated affiliates of a bank holding company from subsidiaries of a bank holding company becomes an unknown and interesting question.

The mix of both terms also explains for the fact that even in legislation or most literature reviews, "subsidiary" and "affiliates" are used interchangeably. A simple example would be the concept of a "Section 20 Subsidiary" which is borrowed from the definition of affiliates drawn in Section 2(b) of the *Banking Act 1933*. Court decisions also construe and conclude that a bank holding company's various

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[33] M. E. Van Der Weide & S. M. Kini, "Subordinated Debt: A Capital Markets Approach to Bank Regulation" (2000) 41 Boston College Law Review 195 at 195-196.
[34] Regulation Y, 12 C.F. R. 225 (1990). More detailed explanation for Regulation Y ensues later in this chapter.

subsidiaries are bank affiliates[35]. What needs to be pointed out, in the process of enacting the new GLBA, is that the U.S. Federal Reserve and U.S. Department of Treasury had in fact debated about what corporate structure would be most preferable for the formation of financial conglomerate. The Fed is "pro-affiliate", while the Treasury is "pro-subsidiary". The Federal Reserve suggested follow the structure of "financial holding company" and in which case the "affiliates" of the financial holding company would expand the financial conglomerate's business scope by engaging in the traditionally defined non-permissible activities. Nevertheless, the Department of Treasury advised that "the financial holding company's subsidiaries" can expand the financial conglomerate's business scope. The Federal Reserve, which supported having "affiliates" of the holding company be able to engage in non-permissible business for banks, based its argument on the "safety net" theory. The "safety net" referred to is a preventive measure designed to ensure that this was applicable to members of the Federal Depository Insurance Corporation (FDIC) system. Therefore, in order to avoid any misappropriation of FDIC funds, in the Federal Reserve's view, the funds would not be used to cover losses from "non-permissible business for banks" by banks' affiliates, which are deemed to be separate corporate entities apart from their associated banks. With the "safety net" in place, i.e. deposit insurance, the central bank's discount window and a riskless settlement of payment system guarantees[36], the safety and soundness of depository institutions could be ensured. The ideal, of course, could be achieved if complemented by further preventive measures. The elimination of moral hazards should be taken into consideration as the blanket protection of safety net can easily be taken advantage of by opportunists. In conclusion, the Federal Reserve deems it "acceptable" to assimilate the difference between subsidiary and affiliate that has been otherwise separated under the traditional classification of corporate structures in modern corporate theories.

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[35] *Securities Industry Asso.* v. *Board of Governors of Federal Reserve System* (1983, CA2) 716 F. 2d 92, affd. (1984) 468 U.S. 207, 82 L. Ed. 2d 158, 104 S. Ct. 3003, CCH Fed Secur L Rep P 91544.
[36] Wang, *supra*, note 16, at 140.

(1.1.4) "Section 20 Subsidiary"—Facilitating the Breakdown of the Strict Separation of Banking/Securities Activities by *Glass-Steagall Act 1933*

As previously mentioned, the *Glass-Steagall Act 1933* refers to only four sections of the *Banking Act of 1933*: Sections 20, 32, 16, and 21. In addition to Section 20, as elaborated above, Section 32 of the Act prohibited closely tied boards of directors, and shared officers and employees (i.e. "director, officer, and employee interlocks") between banks and their affiliates or unaffiliated securities firm which may be "principally engaged" in securities underwriting activities that are not permissible for banks to engage in directly (i.e. "bank ineligible" securities activities)[37]. The purpose of this is to prevent insider trading. Section 16, amended by the *Banking Act of 1935*, prohibited banks from purchasing securities for their own accounts. Section 21, with only a few exceptions (including federal and municipal debt, as these are reasonably safe and pose very low risk), further establishes a metaphorical wall between commercial and investment banking. The former refers to the traditional banking business of taking deposits and making loans, and the latter refers to the underwriting, selling and distribution of most other classes of securities (aside from federal and municipal debt), including but not limited to stocks, bonds, corporate debt, etc.[38]

Practically speaking, the *Glass-Steagall Act 1933* forced banking firms to divest themselves of their securities operations and limit future activities to what is now called commercial, as opposed to investment, banking[39]. Suffice it to say, the *Glass-Steagall Act* actually restricted commercial banks from doing business on Wall Street. The motivations for this separation were principally to prevent conflicts of interest between those who handled depositors' funds (commercial bank managers) and those who underwrote securities (e.g. corporate financiers of investment banks) as well as to limit the riskiness of the activities of commercial banks.[40] Through this mechanism, the *Glass-Steagall Act* not only aimed to avoid conflicts of interest but

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[37] Covington & Burling, Financial Modernization: The Gramm-Leach-Bliley Act Summary, American Bankers Association, 1999 (See Executive Summary). Covington & Burling is a Washington law firm, which is credited, by Hjalma E. Johnson, then President of American Bankers Association, to have one of the foremost banking practices in the U.S..
[38] Laski & Hemley, *supra*, note 17 at 3.
[39] Campbell, *supra*, note 15, at p. 436.
[40] *Ibid.*

also to restore economic order.

Nonetheless, the barrier between commercial and investment banking that was once sacred began to break down in 1987. After much arm-twisting and political finagling by industry agents, the Federal Reserve in 1987 accepted the notion that underwriting and dealing in corporate securities was "closely related to the business of banking", which proved very true after the popular acceptance of "securitization" and the growing use of "derivatives". From 1987 banks have been able to offer brokerage services and investment advice to clients, as long as they were done through a "Section 20 Subsidiary". This breakthrough was regarded as the first brick, in a sense, taken down from the proverbial "regulatory wall" originally set by Section 21 of the *Glass-Steagall Act 1933*.

To make sure the compromise did not go too far, as well as to ensure compliance with the intent of the *Glass-Steagall Act*, the Federal Reserve Board ("FRB") at first required that any Section 20 Subsidiary be limited to 5% of revenues from securities activities. Within a few years that 5% number grew to 10%, and by 1997, just two years prior to GLBA, the FRB significantly reduced the significance of the cap by allowing 25% of a Section 20 Subsidiary's revenues to be generated from traditional non-banking activities (i.e. non-permitted activities).[41]

(1.2) Regulation of the Insurance Business—*Bank Holding Company Act 1956* et seq.

Even though the *Glass-Steagall Act 1933* successfully created a barrier between commercial and investment banking, over time, it began to lose its charm and could not fully prevent banks from affiliating with other insurance companies. The regulatory scheme set forth by the *Glass-Steagall Act* appeared adequate until the early 1950s when banks, faced with growing competition, began to try to circumvent Section 20 of the *Glass-Steagall Act* by "forming bank holding companies, which were allowed to control both commercial banking and investment banking subsidiaries."[42] In order to eliminate the loopholes in the *Banking Act of 1933* by

[41] Laski & Hemley, *supra*, note 17, at 3.
[42] P. J. Burke, "Should Banks be Permitted to Engage in Real Estate Brokerage and Management

prohibiting banks from actual cross-state operation through the formation of holding companies, the U.S. Congress in 1956 enacted the *Bank Holding Company Act*. The *Bank Holding Company Act* of 1956 limited ownership of non-banking subsidiaries to subsidiaries that engaged in activities determined to be "so closely related to banking or managing or controlling banks as to be a proper incident thereto"[43]. That is to say, after the *Glass-Steagall Act* was promulgated in 1933, later in 1956, the U.S. Congress, by passing the *Bank Holding Company Act*, imposed further restrictions to prevent financial conglomerates from amassing too much power. The *Bank Holding Company Act 1956* prohibited commercial banks from owning insurance companies in order to reduce the risks involved with banks underwriting insurance[44]. Except on rare occasions[45], a bank holding company providing insurance as a principal, agent, or broker, is NOT regarded as an activity closely related to banking.

Such exceptions are listed in Section (4)(c)(8) of the *Bank Holding Company Act*. More specifically, Section (4) of the *Bank Holding Company Act* prohibits the acquisition by bank holding companies of the voting shares of non-banking entities unless the acquisition is specifically exempted. The principal exception to that prohibition is found in Section (4)(c)(8). That provision authorizes bank holding companies, with prior Board of Governors of the Federal Reserve System approval, to engage in non-banking activities that the Board determines are so closely related to banking as to be a proper incident thereto[46]. Application of the § 4(c)(8) exception requires the Board to make two separate determinations. First, the Board must determine whether the proposed activity is "closely related" to banking. If so, the Board may amend its regulations to include the activity as a permissible non-banking activity. Next, the Board must determine on a case-by-case basis whether allowing the applicant bank holding company to engage in the activity reasonably may be

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Services?: How the Current Debate Demonstrates the Inadequacies of the Gramm-Leach-Bliley Act", 50 Cleveland State Law Review 103 at 106.

[43] See Section 4 (c)(8)of the *Bank Holding Company 1956*, 12 U.S.C.§1843(c)(8)

[44] Gunawan, Joo & Kim *et al.*, *supra*, note 14.

[45] See Section 4 (c)(8) (A)-(G) of the *Bank Holding Company 1956*, 12 U.S.C.§1843(c)(8)(A)-(G)

[46] See LexisNexis(R) Headnotes for Banking Law and Bank Holding Companies. Available at [http://www.lexis.com/research/retrieve?_m=121e31ff8520c69aa83f489586d4dba0&_browseType=TEXTONLY&docnum=1&_fmtstr=FULL&_startdoc=1&wchp=dGLbVzb-zSkAz&_md5=7043e84b149917f0b3ec2c2d2127e462]

expected to produce public benefits that outweigh any potential adverse effects.[47] Public benefits refer to "greater convenience, increased competition, or gains in efficiency"; whereas, adverse effects include "undue concentration of resources, decreased or unfair competition, conflict of interests, or unsound banking practices".[48]

(1.3) Regulation Y

To better enhance the application of the Section 4(c)(8) exception, through "Regulation Y", the Federal Reserve Board has continuously added to the list of activities determined to be "closely related to banking". The Federal Reserve Board's determination of which activities are "closely related" to banking under Section 4(c)(8) of the *Bank Holding Company Act*[49]—which authorizes the Board to allow holding companies to acquire or retain ownership in companies whose activities are "so closely related to banking or managing or controlling banks as to be a proper incident thereto"—is entitled to the greatest deference[50]. That is to say, as a general rule, courts should give great weight to any reasonable construction of a regulatory statute adopted by the Federal Reserve Board charged with enforcement of the statute. The underlying rationale is—as the agency responsible for federal regulation of the national banking system, the Federal Reserve Board's interpretation of a federal banking statute is entitled to substantial deference[51].

There are important emphases needed to be made in regards to Regulation Y. First, the Federal Reserve Board still continues to add to the Regulation Y' list. Secondly, even though GLBA repealed the *Glass-Steagall Act* and substantially changed the *Bank Holding Company Act*, Regulation Y (as a separate bill) is still in effect, even after GLBA came into place in 1999.

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[47] 12 U. S. C. §1843 (c)(8). See also H. R. Conf. Rep. No. 91-1747, pp. 16-18 (1970) Available at 468 U. S. 207 (at 211) or 104 S. Ct. 3003 (at 3006).
[48] *Ibid.*
[49] 12 U. S. C. S. 1843 (c)(8)
[50] 322 L. Ed. Digest § 160.2 (Lawyer's Edition Headnotes 2, Statutes § 160.2)
[51] *Securities Industry Asso.* v. *Board of Governors of Federal Reserve System*, 468 U.S. 137 (Available also 104 S. Ct. 2979, or 82 L. Ed. 2d 107).

(1.3.1) Regulation Y = "Operating Subsidiary Rule"

Regulation Y[52], the so-called "operating subsidiary rule", purports to govern the activities of subsidiaries of a bank holding company. In general, such subsidiaries must limit their activities to those banking and "closely related to banking" activities permitted by the *Bank Holding Company Act*[53]. In statutory context, Section 225.4 of Regulation Y contains a list of those activities already determined by the Board to be "closely related" to banking. This section provides that a bank holding company shall serve as a source of financial and managerial strength to its subsidiary banks (I will expand upon this further below) and shall not conduct its operations in an unsafe or unsound manner. As a safeguard, whenever the Board believes an activity of a bank holding company or control of a non-bank subsidiary (other than a non-bank subsidiary of a bank) constitutes a serious risk to the financial safety, soundness, or stability of a subsidiary bank of the bank holding company and is inconsistent with sound banking principles or the purposes of the *Bank Holding Company Act* or the *Financial Institutions Supervisory Act of 1966*[54], the Board may require the bank holding company to terminate the activity or to terminate control of the subsidiary, as provided in Section 5(e) of the *Bank Holding Company Act*. Section 225.4 of Regulation Y further requires that (except as provided in paragraph (b)(6) of this section), a bank holding company shall give the Board prior written notice before purchasing or redeeming its equity securities if the gross consideration for the purchase or redemption, when aggregated with the net consideration paid by the company for all such purchases or redemptions during the preceding 12 months, is equal to 10 percent or more of the company's consolidated net worth. Obviously, the restriction imposed by this section is to ensure the bank holding company operates in a prudent and reasonable manner when it comes to large-scale securities dealings.

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[52] 12 C. F. R. 225 (1990). (The citation stands for Code of Federal Regulations, title 12, chapter II, part 225.)

[53] 12 U.S.C. 1843(a)(2).
See also LexisNexis(R) Headnotes for Banking Law and Bank Holding Companies. Available at [http://www.lexis.com/research/retrieve/frames?_m=c281d91bb64296e9806404530ab79189&csvc=fr&cform=free&_fmtstr=XCITE&docnum=1&_startdoc=1&wchp=dGLbVzz-zSkAl&_md5=700be3ad5ec6d8341e099808815ff8a9]

[54] As amended, 12 U. S. C. 1818(b) et seq.

Regulation Y is issued by the Board of Governors of the Federal Reserve System under Section 5(b) of the *Bank Holding Company Act of 1956*, as amended (12 U.S.C. 1844 (b)); Sections 8 and 13(a) of the *International Banking Act of 1978* (12 U.S.C. 3106 and 3108); Section 7(j)(13) of the *Federal Deposit Insurance Act*, as amended by the *Change in Bank Control Act of 1978* (12 U.S.C. 1817 (j)(13); Section 8(b) of the *Federal Deposit Insurance Act* (12 U.S.C. 1818(b)); Section 914 of the *Financial Institutions Reform, Recovery and Enforcement Act of 1989* (12 U.S.C.1831(i)); Section 106 of the *Bank Holding Company Act Amendments of 1970* (12 U.S.C. 1972); and the *International Lending Supervision Act of 1983* (Pub. L. 98-181, title IX)[55]. Regulation Y (regarding *Bank Holding Companies and Change in Bank Control*) governs the corporate practices of bank holding companies and certain practices of state-member banks, as a result of the dual banking system in the U.S.. Regulation Y also describes transactions for which bank holding companies must seek and receive the Federal Reserve's approval. Common transactions requiring approval include: (i) when a bank holding company acquires a bank or merges with another bank holding company; (ii) when a bank holding company engages in a non-banking activity, either directly or through a subsidiary; (iii) when an individual (or group of individuals) acquires control of a bank holding company or state-member bank; and (iv) when a bank holding company or state-member bank in troubled condition appoints a new senior officer or director[56].

(1.3.2) "Source of Strength Doctrine" in the Context of Regulation Y

An important aspect regarding Regulation Y is the "Source-of-Strength Doctrine". In the context of a failing subsidiary of a bank holding company (BHC), it is the decision of the Board of Governors of the Federal Reserve System (the "Fed" or "Board") that the parent BHC is at least partially responsible for the bailout. A bank holding company's failure to assist a troubled or failing subsidiary bank would generally be deemed as an "unsafe and unsound banking practice" or a violation of Regulation Y or both. The result is the Fed can assert authority, through its source-

[55] See Regulation Y, Sec. 225.1 (a) Authority, available at [http://www.bankersonline.com/regs/225/225-1.html]

[56] See "Common Questions and Answers on the Amendments to Regulation Y of the Federal Reserve Board", effective date: April 21, 1997, prepared by Federal Reserve Bank of San Francisco, April 1997. Available at [http://www.frbsf.org/banking/bsr/regulations/regy.html]

of-strength doctrine, to require that BHCs send funds "down stream" to assist their subsidiary banks in times of financial trouble or distress. The *Bank Holding Company Act* (BHCA) confers broad authority on the Fed to regulate and supervise the day-to-day operations of BHCs. Among BHCs' various activities, of particular concern, from the Fed's perspective, are operations that have a significant impact on the "stability and soundness" of subsidiary banks, individually, and the banking system, overall. Whether the Fed has the authority to assert the source-of-strength doctrine had been disputed before, however there is now a consensus amongst legal experts that the Fed does not overstep its statutory bounds in promulgating the source-of-strength regulation[57] on the basis that the doctrine speaks to public interest and the safety and soundness of individual banks and of the nation's banking system as a whole, the same rationale found in the BHCA's legislative history by the court in First Lincolnwood[58]. Since the BHCA is the ultimate legal source that confers broad authority on the Fed to oversee the day-to-day operation of BHCs, as long as the source-of-strength doctrine does not contradict this purpose or unduly burden BHCs or their shareholders, it is, from the Fed's perspective, only one of the mechanisms the Fed utilizes to ensure the integrity of the nation's banking system. It should be noted also that the Fed is conferred this authority by the BHCA. When subsidiary banks have done well, it is the bank holding company and the BHC's shareholders who have reaped the benefits of bank ownership in the past and stand to gain from the renewed health of the subsidiary bank in the future. Conversely, when subsidiary banks get into financial trouble, the parent/bank holding companies should at least be held partially responsible for any bailouts.

In practice, the Fed would normally apply the source-of-strength doctrine in order to alleviate serious risks of loss to the bank insurance fund ("BIF") and to the banking system presented by an impending bank failure. Now in the U.S., the deposits in most banks are insured by the Federal Deposit Insurance Corporation ("FDIC") up to US$ 100,000 per depositor. This means the responsibility of bank monitoring lies with the government, rather than the bank's depositors, which used to be the case before the *Banking Act of 1933* brought the federal deposit insurance into regulation. The banking business is highly leveraged, and moral hazards can easily

[57] Groth, *supra*, note 13 at 112-121.
[58] *Board of Governors* v. *First Lincolnwood Corp.*, 439 U.S. 234, 247-52 (1978).

arise where banks aggressively lure depositors' money with higher interest rates and the banks in turn use depositors' money to engage in risky and yet lucrative non-banking investments. The interest payable by a bank to its depositors is only a minimal cost, compared to the potential gain that banks and their shareholders can profit from other risky and sometimes unsafe investments by using the depositors' money. If the investment fails, depositors get their money back through federal deposit insurance, hence, government subsidies, which were designed to protect depositors' interests and NOT the bank and its shareholders, could easily be taken advantage of. Such circumstances would intensify or get worse, after the BHCA relaxed the old restrictions by allowing banks to engage in non-banking activities. From here, it is not difficult to understand why the prevention of moral hazard is the underlying rationale as it is with other regulation (Regulation Y) and theory (Source-of-Strength Doctrine). Regulation Y sets the parameters that any permissible non-banking activities for a BHC have to be "closely related to banking" otherwise, moral hazard could easily occur and thus impose threats on the safety and soundness of individual subsidiary banks and the overall banking system. From an economic and policy point of view, the source-of-strength doctrine is a necessary and proper regulatory tool for use in addressing the problem of bank failure.[59]

(1.3.3) Supreme Court Decisions Reflected the FRB's Interpretation of Regulation Y

A Supreme Court decision[60] of the United States made in 1981 shows that the Federal Reserve Board ("FRB") issued an interpretive ruling in connection with its amendment to Regulation Y. That ruling distinguished "open-end" investment companies (commonly referred to as "mutual funds") from "closed-end" investment companies. The ruling explained that "a mutual fund is an investment company, which, typically, is continuously engaged in the issuance of its shares and stands ready at any time to redeem the securities as to which it is the issuer; a closed-end investment company typically does not issue shares after its initial organization

[59] Groth, *supra*, note 13 at 114.
[60] *Board of Governors of Federal Reserve System* v. *Investment Company Institute*, 450 U.S. 46 (1981) (Available also 101 S. Ct. 973, or 67 L. Ed. 2d 36)

except at infrequent intervals and does not stand ready to redeem its shares."[61] Because open-end investment companies will redeem their shares, they must constantly issue securities to prevent shrinkage of assets. This structure raises conflict of interests in part because the mutual funds are likely to require bank resources. Mutual funds are obligated to redeem their outstanding shares on demand and do so constantly. Therefore, to maintain adequate capitalization, mutual funds continuously require infusions of money from new purchases of their securities[62]. In contrast, the capital structure of a closed-end company is similar to that of other corporations; if its shareholders wish to sell, they must do so in the marketplace. Without any obligation to redeem, closed-end companies need not continuously seek new capital.[63] Given this fundamental difference, it is clear that the capital base of an open-end investment company is subject to volatility, whereas, the capital base of a closed-end investment company is relatively stable. Therefore, if a bank holding company sponsors a closed-end investment company, as opposed to sponsoring an open-end investment company, chances are that this excessive risk-taking would be unusual. In the Board's opinion, the *Glass-Steagall Act* provides that, as interpreted by the U.S. Supreme Court, a bank holding company may not lawfully sponsor, organize, or control an open-end investment company, but the Board perceived no objection to sponsorship of a closed-end investment company provided that certain restrictions are observed. Among those restrictions is a requirement that the investment company may not primarily or frequently engage in the issuance, sale, and distribution of securities; a requirement that the investment adviser may not have any ownership interest in the investment company, or extend credit to it; and a requirement that the adviser may not underwrite or otherwise participate in the sale or distribution of the investment company's securities. In conclusion, if a bank were to operate mutual funds, this action would constitute a violation of Sections 16 and 21 of the *Glass-Steagall Act.*

In addition to Regulation Y, court decisions also state that the Federal Reserve Board must "articulate the ways in which banking activities and the proposed activities are assertedly connected, and must determine, not arbitrarily or capriciously,

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[61] *Ibid.*
[62] *Howard, supra*, note 1, at 697.
[63] *Supra* note 60.

that the connections are close"[64]. The court also enumerated a number of factors for the Federal Reserve Board to consider in determining whether a proposed activity is "closely related to banking".[65] In making this determination, the Board generally has followed the guidelines announced in *National Courier Assn.* v. *Board of Governors*, 170 U.S. App. D. C. 301, 516 F. 2d 1229 (1975). That case held that an activity is "closely related" to banking within the meaning of Section 4(c)(8) of the *Bank Holding Company Act* if any one of the following is demonstrated:

(i) Banks generally have in fact provided the proposed services;

(ii) Banks generally provide services that are operationally or functionally so similar to the proposed services as to equip them particularly well to provide the proposed service;

(iii) Banks generally provide services that are so integrally related to the proposed services as to require their provision in a specialized form[66].

Despite having these guidelines in place, the Board has recognized, however, that the *National Courier* guidelines do not provide the exclusive basis for finding that an activity is "closely related to banking", and has stated that it will consider "any...factor that an applicant may advance to demonstrate a reasonable or close connection or relationship of the activity to banking."[67]

(1.4) Bank Holding Company Act Bans Banks from Crossing over into Insurance Business

The *Bank Holding Company Act 1956* created another barrier between banking and insurance in response to aggressive acquisitions and expansions transacted by commercial banks. In the U.S., many state laws limited the ability of state-chartered banks to establish branches in other states. Furthermore, the *McFadden Act of 1927* made these state law restrictions on branching applicable to

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[64] Burke, *supra*, note 42, at 107.
[65] *Ibid.*
[66] *National Courier Assn.* v. *Board of Governors*, 170 U.S. App. D. C. 301 at 313. See also 516 F. 2d 1229 at 1237.
[67] 49 Fed. Reg. 806 (1984).

national banks located within the particular state. These restrictions were designed to protect existing banks from competition. Nevertheless, as a result of strict restrictions on banks, many banks engaged in actual cross-state operations, for example by aggressively acquiring insurance companies. For example, TransAmerica Corp. was considered at one time to have grown too large—it owned not only the Bank of America but also an array of other businesses.[68] The U.S. Congress thought it improper for banks to risk possible losses from underwriting insurance. In fact, before the enactment of the GLBA in 1999, many banks in the U.S., despite selling insurance products provided by insurers, could not take on the risk of underwriting. This is because, theoretically speaking, insurance companies (especially those providing life insurance) to some extent function similarly to commercial banks, by taking deposits and then returning the deposit with some additional interest. The insurance company ("the insurer"), upon maturity of its policy term, is responsible to give its "insuree" an amount of money, usually higher than the aggregated insurance premium "the insuree" had paid previously over this term. Therefore, in terms of being lawfully bound to "return" the money to its "insuree", the insurance company to some extent functions similarly to commercial banks, taking deposits and then returning same with some additional interest.

As mentioned, The Ban*k Holding Company Act* of 1956 limited ownership of non-banking subsidiaries to subsidiaries that engaged in activities determined to be "so closely related to banking or managing or controlling banks as to be a proper incident thereto". Therefore, except for a few exceptions listed in Section (4)(c)(8) (A) to (G) of the *Bank Holding Company Act*, for a bank holding company to provide insurance as a principal, agent, or broker is NOT regarded as being closely related to banking. Consequently, such activities are non-permissible activities for bank holding companies, either to engage in these activities directly or indirectly through its subsidiaries. Despite the restrictions of the *Bank Holding Company Act*, it is said that the bank holding company remains the most prevalent organizational structure for banks in the United States today[69], at least before the promulgation of the GLBA. In fact, even after the GLBA, for bank holding companies that are either unable to meet the heightened requirements for financial holding company status or which have

[68] See [http://www.cftech.com/BrainBank/SPECIALREPORTS/GlassSteagall.html#anchor852185].
[69] Burke, *supra*, note 42, at 106.

no intention of expanding present financial services product offerings beyond what was previously allowed, they can still elect to retain their status as bank holding companies.

2. Deregulation

Deregulation was manifested most obviously by repealing the *Glass-Steagall Act 1933* and relaxing the *Bank Holding Company Act 1956.* Following years of debate and setbacks, Congress passed historic legislation in November 1999, known as the *Gramm-Leach-Bliley Financial Modernization Act* ("GLBA"), which removed the legal barriers between the insurance, securities, and banking industries—barriers which separated them for the previous sixty-six years. The law's intended objectives of modernization were accomplished by repealing the anti-affiliation provisions of the 1933 *Glass-Steagall Act*, which imposed barriers between the banking and securities industries, and the 1982 amendments of the *Bank Holding Act of 1956*, which erected barriers between the banking and insurance industries. As a result, the GLBA opened the doors between these financial services industries, allowing them to offer insurance, banking, and securities products all under one roof[70].

Such deregulation is far from being an overnight change. In fact, restrictions in previous laws on bank holding company's non-banking activities had gradually loosened since the early 1970s, after U.S. Congress modified the *Bank Holding Company Act 1956* by inserting Section 4(c)(8) as part of the Act's amendment in 1970. In actual effect, this allows bank holding companies to engage in non-banking activities that the Board of Governors of the Federal Reserve System (the "Fed", or "FRB") determines to be "closely related to banking". It is said that as technology has advanced and competitive pressures intensified in the financial services industry, the Fed intends to use the provision (i.e. Section 4(c)(8)) to allow expansion by bank holding companies into many traditionally defined non-banking activities that were previously prohibited by the *Bank Holding Company Act 1956.* The advent of new technology and financial products, for example the ATM (automated teller machine),

[70] Danielle F. Waterfield, "Insurers Jump on Train for Federal Insurance Regulation: Is it Really what they Want or Need?" (2002) 9 Conn. Ins. L.J. 283 at 292.

derivatives, and securitization, together with other contributing factors (such as insurance and securities firms competing for banking business by providing their customers with loans and financing), has made the banking industry competitive like never before. Therefore, it has become increasingly necessary to allow bank holding companies to diversify their operations in order to remain profitable[71].

Deregulation is a response to both internal and external pressures. Internal pressures, brought about by the U.S. banking industry, have successfully caused the U.S. Congress to permit cross-marketing among commercial banking, securities brokerage and underwriting, and insurance brokerage. External pressures, faced by the U.S. government and the world at large, has been most manifest in the continuing success of deregulation elsewhere, for example, in the European Union following the adoption of the Second Banking Directive[72] and in the global context of the ongoing pressures for financial services liberalization under the WTO/GATS.[73] With WTO/GATS guidelines in place, the global economic system not only requires a freer flow of capital but also creates a more competitive environment for global investment activities. This phenomenon also means that business entities in any given country draw much-needed operational or investment capital from the international community instead of purely domestic sources. Business enterprises are inclined to pursue mergers and acquisitions in order to further their chances for survival (by cross-marketing banking, securities, and insurance deals); considerations include obtaining market priority and technology, lowering cost, and tax planning[74]. Under these circumstances, if current legal restraints stand in the way of achieving such economic goals, legal reform is inevitable and will come about prior to economic reform. As one commentator has pointed out, in the U.S. no one event was likely more responsible for the renewed interest in financial reform than the creation of Citigroup[75]. The Citigroup merger eventually led to the U.S. *Gramm-Leach-Bliley*

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[71] Groth, *supra*, note 13, at 125.
[72] R. B. Walker III, "The U.S. Financial Services Modernization Act of 1999: New Financial Order, or Financial Chaos?" (2000-2001) 16 Banking & Finance Law Review 47 at 69 (original footnote# 5), quoted as, "EC, Second Council Directive 89/646/EEC of 15 December 1989 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions and amending Directive 77/780/EEC, [1989] O.J.L. 386/1."
[73] *Ibid* at 49.
[74] Wen-yu Wang, "The Review of and Suggestions to Taiwan's Company Law in Respect of Mergers and Acquisition" (2001) 68 Yueh Dan Journal of Law 24 at 24. (In Chinese)
[75] Walker III, *supra*, note 72, at 56.

Financial Modernization Act 1999. A detailed case study of the Citigroup merger will follow in the next section.

On the other hand, as banking is driven more by technology, the distinction between banks and communications/information technology firms blurs. However the formal issue of whether to permit banks to affiliate with commercial firms or industrial businesses has yet to be resolved. For example, just a few years ago, Microsoft attempted to acquire Intuit, a leading consumer banking software firm[76]. The acquisition failed because of the government's objection to possible anticompetitive effects in the banking industry. With respect to this issue, even before the *Gramm-Leach-Bliley Act*, a company engaged in any kind of commercial or industrial business could own a single savings association, and become a "unitary" savings and loan holding company. As a result, agricultural producers, automobile manufactures, electric utilities, and real estate developers have, in fact, owned thrifts. After the *Gramm-Leach-Bliley Act*, except for some grandfathered rules, it now bans commercial or industrial firms from acquiring a savings association. In other words the GLBA maintains that "commerce and banking still don't mix". Nonetheless, as suggested by commentators, even though the newly passed GLBA does not permit banks to affiliate with commercial firms or industrial businesses, this issue is not likely to disappear. Consequently, this issue remains to be resolved by yet another law.

Deregulation as reflected in the GLBA does not imply that the financial industries are total strangers to current and modern banking practice, now that cross-barrier engagement of banking, insurance, and securities is permissible by the modernized regulation. Historically, the insurance industry and the banking industry have engaged in a turf battle over banks' ability to sell insurance[77]. Two major unanimous Court decisions made within one year of each other—*NationsBank of N.C., N.A.* v. *Variable Annuity Life Ins. Co.*[78] and *Barnett Bank of Marion County,*

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[76] PricewaterhouseCoopers, "An Executive's Guide to U.S. Financial Modernization", published in January 2000.
[77] Waterfield, *supra*, note 70, (original note# 59). See also Karol K. Sparks, *Bank Insurance Sales: A Compliance Guide*, SG023 ALI-ABA 451 (2001).
[78] 513 U.S. 251 (1995)

N.A. v. *Nelson*[79]—resulted in expanded powers of national banks to sell insurance and sufficient obfuscation of state insurance regulation of national bank insurance sales activities. This stands in stark contrast to the *McCarran-Ferguson Act of 1945*, which holds that the insurance business is state (and not national) business and therefore is governed by state law. The *Barnett* decision radically altered the landscape of state regulation of bank insurance sales. In a unanimous decision, the Court held that federal banking law preempted a Florida statute (the state law) prohibiting banks from selling insurance. The federal law authorized national banks in towns with populations not exceeding 5000 to sell insurance. The Court ruled that states may continue to regulate national banks' insurance sales only as long as the states do not significantly interfere with the national banks' powers. The decision also made clear that small town national banks may act as insurance agents "under such rules and regulations as may be prescribed by the Office of the Comptroller of the Currency" ("OCC"). This incited controversy and questions were asked as to the scope of national banks' insurance authority[80]. That is because the current regulatory structure for the insurance industry is traditionally rooted in the *McCarran-Ferguson Act of 1945*, which provides that the "business of insurance" in the United States belongs to and is within the jurisdiction of the individual states. On the other hand, it also goes without saying that commercial banks had long engaged in the securities business. In fact, it was exactly for this reason that banks tended to take on excessive risks prior to the Great Depression era that a barrier between commercial banking and securities underwriting was set up through the *Glass-Steagall Act 1933*. In order to avoid repeating history, calls for deregulation were matched to a certain degree for re-regulation. We can see this in the GLBA, which focuses mainly on safeguard measures applied to the supervision of financial conglomerates.

3. Re-regulation

Theoretically speaking, "Re-regulation" is probably a more accurate term than "De-regulation" when it comes to describing the historical and statutory evolution of the U.S. banking industry. This is because deregulation, usually denoting a certain

[79] 517 U.S. 25 (1996)
[80] Waterfield, *supra*, note 70, at 293-294.

degree of relaxation of laws, does not necessarily mean the total dismissal of earlier regulations. As put by Richard A. Posner, "[d]eregulation in the United States means the removal or reduction of comprehensive controls over particular industries. These industries are what U.S. lawyers call 'regulated industries', while recognizing that all industries were (and are) regulated to a greater or a lesser extent. It was the relative handful of comprehensively regulated industries that became and has remained the focus of the deregulation movement, which began in the late 1970s in the airline industry and has continued ever since. The deregulation movement has actually coincided with increased regulation of health, safety, and labor markets, which is why to speak of 'deregulation' in large is misleading—regulation has changed rather than diminished."[81]

In the financial services industry, in order to foster competition and innovation, Title I of the GLBA repealed Sections 20 and 32 of the *Glass-Steagall Act* and amended Section 4 of the *Bank Holding Company Act of 1956*[82]. While the primary focus of Title I is to break down the firewalls between banks, securities firms and insurance companies and the prohibition on interlocking management, the Act did not change the fact that any activities in which a bank holding company wishes to engage in must be "closely related to banking". Only the definition of this phrase has been broadened. In essence, a financial holding company is again authorized to engage in the same activities as bank holding companies (either directly or through non-bank subsidiaries), and is further permitted to engage in activities deemed to be "financial in nature or incidental or complementary to such financial activities". That is to say, after the "deregulation" of the previous regulatory restraints, the new GLBA "re-regulates" permissible activities for a financial holding company.

The history of how the GLBA was passed can fairly explain how re-regulation was needed in the face of a lack of decisive statutory reform within Congress. In one commentary, the author described how Congress' attempts to pass financial modernization legislation was mired in partisanship and an inability to get consensus, despite pressure from the U.S. banking industry to pass the law since the 1970s.

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[81] Richard A. Posner, "The Economic Analysis of the Law Approach—The Effects of Deregulation on Competition: The Experience of the United States" (2000) 23 Fordham Int'l L.J. 7 at 8.
[82] 12 U.S.C. §1843 (2000).

"After a series of delays and maneuverings, the reworked bill in the House, known as H. R. 10, won a floor vote on May 13 (1998) by a razor-thin one-vote margin, 214-213. Republicans say the measure represented a chance to establish a system that could shape the commingling of financial services and avert another crisis for bank insurance funds. But with Congress bitterly divided over the bill and the banking industry sharply opposed, the opportunities for passage in the Senate this year are very slim...."[83] Indeed, the GLBA was not passed until November 1999. Re-regulation, referring to a long list of safeguard measures enacted in the law, as supervised by functional regulatory institutions, is regarded by the Congress as a necessary tool to ensure the safety and soundness of financial holding companies.

Re-regulation in the form of the GLBA includes the following requirements[84] on a financial holding company: it must comply and be (1) well-capitalized, (2) well-managed, (3) Section 23A and 23B of the *Federal Reserve Act* (which limits the exposure of a bank to a financial subsidiary to the amount of permissible exposure to an affiliate, (4) capital deduction principles[85] and safeguards for the bank, and (5) subsidiaries (which is understood as affiliates of a financial holding company) must conduct activities that are either financial in nature or incidental or complementary to such financial activities.

Regulations for functional regulatory institutions require that federal banking regulators and the Securities Exchange Commission ("SEC") share the results of any examination, reports, records, or other information regarding the investment advisory activities of any bank, bank holding company, or separately identifiable department

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[83] Jeffrey Marshall, "Capital Question: Does Might Make Right? With financial modernization legislation very likely dead for this year, the focus in Washington is shifting to the regulators. Bank lobbyists have descended, and the debate about bigness is underway." (June 1998) U.S. Banker. Available at Lexis Nexus research network.

[84] Section 121 of the *Gramm-Leach-Bliley Act* titled "Subsidiaries of National Bank". For the same regulations on state banks, see 12 U.S.C.S. § 1831w.

[85] According to 12 U.S.C.S. § 1831w (a)(2), the State bank complies with the same capital deduction and financial statement disclosure requirements that applies to national banks in section 5136A(c) of the Revised Statutes of the United States [12 U.S.C.S. § 24a(c)]. That is, in determining compliance with applicable capital standards, (i) the aggregate amount of the outstanding equity investment, including retained earnings, of a national bank in all financial subsidiaries shall be deducted from the assets and tangible equity of the national (and state) bank; and (ii) the assets and liabilities of the financial subsidiaries shall not be consolidated with those of the national bank. The same restrictions apply non-discriminatory to state banks as well.

registered as an investment adviser. The purpose of this regulation is to promote interagency consultation.[86]

In determining whether subsidiaries' activities are "financial in nature or incidental to such financial activities", the GLBA requires coordination between the Federal Reserve Board and the Secretary of the Treasury ("the agencies") wherein each agency must notify the other of any "request, proposal or application....for a determination of whether an activity is financial in nature or incidental to a financial activity"[87]. The agency that did not receive the initial request then has thirty days to notify the other agency, in writing, of its belief that the activity is not financial in nature or incidental to a financial activity[88]. Through the two agencies' decisions, the GLBA provides a means by which the list of permissible activities in which a financial holding company may engage could be expanded beyond the list enumerated in the Act itself[89]. A simple example is the debate on whether banks should be permitted to engage in real estate brokerage and management services. As of this writing in 2007, the real estate business is still *not* yet a permissible activity by GLBA.

Because financial services products evolve over time, the GLBA is flexible and requires the Federal Reserve Board and the Secretary of the Treasury to consider, *inter alia*, changes or reasonably expected changes in both the marketplace and in technology when determining whether an activity is financial in nature or incidental to a financial activity. If neither the Federal Reserve Board nor the Secretary of the Treasury objects to a request for such a determination, both agencies may then initiate a public rulemaking to find the activity permissible under the GLBA. Equally important, to make both agencies' job easier by providing certain guidelines, the GLBA enumerates the factors which the agencies are to consider when making a determination of whether an activity is financial in nature or incidental to a financial activity. The factors include (i) examining the intent of the *Bank Holding Company Act* and the *Gramm-Leach-Bliley Act*, (ii) changes or reasonably expected changes in

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[86] K. R. Benson, K. M. Bianco & J. Hamilton *et al.*, Financial Services Modernization *Gramm-Leach-Bliley Act of 1999* Law and Explanation (Chicago: CCH, 1999) at 71.
[87] 12 U.S.C. §1843(k)(2)(A)(i)
[88] 12 U.S.C. §1843(k)(2)
[89] 12 U.S.C. §1843(k)

the marketplace in which financial holding companies compete, (iii) changes or reasonably expected changes in the technology for delivering financial services, and (iv) whether such activity is necessary and appropriate to allow a financial holding company and the affiliates of a financial holding company to compete effectively with any company seeking to provide financial services in the United States[90].

III. Case Study: Citigroup Merger (Example of "Deregulation + Re-regulation")

1. Background Introduction for Citigroup Merger

Following the promulgation of the GLBA, on May 1, 2000, the Board of Governors of the Federal Reserve System approved the Charles Schwab Corporation's acquisition of the U.S. Trust Company and Schwab adopted financial holding company status. These actions make Schwab the first cross-industry conglomerate formed under GLBA[91]. Nonetheless, a merger greater than this scale had been completed even before the GLBA. In 1998 one year before the actual promulgation of the GLBA, Citicorp merged with Travelers Group to become Citigroup, the first financial conglomerate in the U.S.. An announcement made on April 6 1998 launched Citicorp and Travelers Group in a bold bid for global leadership in financial services. The merger was a deal valued at US$ 83 billion with joint assets adding up to approximately US$ 700 billion. The deal became the largest in U.S. corporate history and the relevant numbers have escalated ever since. According to a recent business review, Citigroup has "total assets of over (US$) 1.26 trillion...and a market capitalization of approximately (US$) 253 billion as of year end 2003. Citigroup is the largest diversified financial services organization in the (U.S.) and one of the largest (financial services organizations) in the world. Its Global Investment Management business, which includes its Life Insurance & Annuities business, is the world's second largest global wealth management business. The organization has exceptional financial flexibility based on its diverse operating

[90] 12 U.S.C.§1843(k)(3)
[91] *Supra* note 76 "An Executive's Guide to U.S. Financial Modernization", published by PricewaterhouseCoopers, in January 2000.

profile, moderate leverage position and strong cash flows. It provides consumers, corporations, governments, and institutions with a broad range of financial products and services, including consumer banking and credit, corporate and investment banking, insurance, investment advice, financial planning, securities brokerage, and asset management. Major brand names under Citigroup's trademark red umbrella include Citibank, Citifinancial, Primerica, Smith Barney, Banamex, and Travelers Life & Annuity."[92] On a global level, Citigroup also is the world's biggest financial conglomerate, dwarfing European universal banks like Deutsche Bank, Union Bank of Switzerland, and HSBC Holdings. It boasts relationships with 100 million customers in 100 countries and has 3,200 offices around the globe.[93]

There are three interesting aspects of the Citigroup merger that make it warrant conducting a case study. First, it is almost indisputable that the Citigroup merger renewed interest in financial reform within the U.S. and eventually forced Congress to establish the GLBA so as to allow the financial conglomerates to deliver all-around financial services. Secondly, the Citigroup merger spawned a flurry of financial services firms mergers in 1998. For example, immediately following Citigroup's announcement of their merger on April 6 1998, one week later, NationsBank Corp./BankAmerica Corp. and BankOne Corp./First Chicago NBD Corp. also announced their plans to merge.[94] Thirdly, the recent break-up of Citigroup (announced in February 2005) provides an opportunity to reassess the feasibility of synergies between the insurance and banking industries.

The merger of Citicorp and Travelers Group Inc. intensified the focus on the insurance-banking interplay by creating the largest financial services conglomerate in the world. Commentators have pointed out that commercial banks are the single largest U.S. asset holder followed by life insurance companies and private pension funds[95]. Before the merger, Citibank was the commercial banking arm of the

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[92] Best's Company Reports, July 16, 2004. Available by Lexis Nexus search for News & Business > Company & Financial > Company Profiles & Directories > Individual Publications > Best's Company Reports. (Load-Date: May 23, 2005).
[93] Jennifer Saboley, "Mergers & Acquisitions in the Financial Services Industry; 1st Quarter 1998" Research Review (1998) Journal of the Society of Insurance Research. Available at Lexis Nexus Company News search.
[94] "Capital Question", U.S. Banker, June 1998.
[95] M. E. Nance & B. Singhof, "Banking's Influence over Non-Bank Companies after Glass-Steagall: A German Universal Comparison" (2000) 14 Emory International Law Review 1305 at 1309.

successfully run Citicorp. Travelers itself had huge insurance holdings. In view of this it is not surprising there emerged a mutual interest between these two business entities.

Growing competition was the primary driver in the merger. Before the merger, commercial banks, like Citibank (under the former parent company Citicorp) competed with other banks in a less regulated environment. Competition from other commercial banks and from non-bank providers of financial services put mounting pressure on banks to expand their market share. Likewise, insurance companies, faced with challenges such as competitive threats from banks and securities brokers, formed strategic alliances and consolidated with financial service firms. Given these circumstances, Citicorp and Travelers Group joined forces in an effort to gain economies of scale and scope and become more cost-efficient.

2. Important Features of the Citigroup Merger

(2.1) 'Grey' Distinctions

Traditional commercial banking limits its business dealings to only receiving deposits and making loans. However, commercial banks are not totally prohibited from securities underwriting. For example, a commercial bank's trust department has historically been permitted to buy and sell securities on behalf of its depositors. This permissible banking activity had been authorized by even the restrictive *Glass-Steagall Act 1933*. In a passive fashion, Section 16 of the *Glass-Steagall Act* limited a bank to purchasing and selling securities only at the request of a customer and not for the bank's own account. Progressive changes in the regulatory framework have continuously blurred some of the distinctions between investment and commercial banking activities. Innovation by market players, such as Citicorp and Travelers, had also kept regulators busy, by introducing new financial services prior to wholesale legal reforms.[96]

[96] *Ibid* at 1310.

(2.2) Regulatory Rulings

In the same vein of thought, other commentators suggested regulatory rulings also provided some leeway to formal regulatory restraints. For example, "in September 1997, the Office of the Comptroller of the Currency ("OCC") issued an interpretive letter that allowed (i) banks to advance retail commissions for mutual fund shares sold by the bank's operating subsidiary under a back-end load arrangement and (ii) the receipt of Rule 12b-1 fees and contingent deferred sales charges as compensation. In addition, the OCC approved Zion's First National Bank's application to underwrite and deal in municipal revenue bonds through its subsidiary, Zion's Investment Securities, Inc. Further, in November 1999, prior to passage of reform (i.e. the *Gramm-Leach-Bliley Act*), the OCC granted permission to National Bank of Commerce to underwrite and deal in corporate debt securities through an operating subsidiary."[97]

With these regulatory rulings in place, and before statutory reform, although the U.S. system was generally considered to be composed of two distinct entities, investment and commercial banking, upon closer examination, these distinctions blurred and the relevance of *Glass-Steagall* emerged.[98]

3. The Citigroup Merger: a Journey from Regulation, to Deregulation, and Further to Re-regulation

(3.1) The Essence of "Regulation-Deregulation-Re-regulation" (Linear Direction Development)

Compared to the *Banking Act of 1933* (more precisely, the *Glass-Steagall Act*) which strictly prohibits U.S. banks from doing business on Wall Street, the U.S. GLBA exemplifies a great degree of deregulation. It is generally accepted that the *Glass-Steagall* distinction between investment banking and commercial banking was

[97] *Ibid* at 1314-1315.
[98] *Ibid* at 1314.

the result of the collapse of the stock market in 1929. This concern had been articulated to the Comptroller of the Currency, by the attorneys of First National City Bank. Prior to the 1933 Act, U.S. banks were generally lured by the lucrative returns from the money-spinning stock market—banks were investing in speculative securities putting deposits at risk, lending money to the firms they invested in to ensure the financial security of their own investments, and driven to coerce client firms to invest in speculative offerings which the banks themselves were underwriting or selling[99]. What needs to be emphasized here is that deposit insurance did not come about until 1933—in fact, one of the greatest achievements in the *Banking Act of 1933* was the establishment of the Federal Deposit Insurance Corporation. In view of this, it is not difficult to understand that given the minimal interest return payable to their depositors, banks were tempted to use deposits to engage in risky stock underwriting in anticipation of gaining a greater 'spread'. In doing so, banks became not only susceptible to the vicissitudes of the stock market, but investors also became vulnerable to the banks' risky stock holdings, and doing so without the protection of deposit insurance. It was against this backdrop that the *Glass-Steagall Act 1933* came into place.

Even though regulation of the banking industry via the *Glass-Steagall Act* had remained largely unchanged for nearly seven decades, what needs to be pointed out is that even the stringent *Glass-Steagall Act* "did not prohibit banks from being affiliated with entities that underwrite or deal in corporate securities, so long as those entities were not principally engaged in those activities."[100] That is to say, under such a structure, banks can do non-banking business through their affiliated non-banking entities. In fact, this is at the heart of the *Bank Holding Company Act 1956*. Both Acts upon examination (the *Glass-Steagall Act 1933* and the *Bank Holding Company Act 1956*) and considered together, can lead to the following conclusions:

(i) First, under the language in Section 20 of the *Glass-Steagall Act*, if banks wanted to entertain business in securities, ultimately, banks were required to form Bank Holding Companies.

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[99] Laski & Hemley, *supra*, note 17.
[100] *Ibid* at 3. See also R. Locker & H. Hansche, "Financial Services Modernization and Corporate Finance" (2000) 15 Commercial Lending Review 2.

(ii) Secondly, Section 32 of the *Glass-Steagall Act* prohibited banks from having closely tied boards of directors, and shared officers between themselves and firms 'principally engaged' in securities underwriting.

(iii) Thirdly, Section 16 of the same Act (*Glass-Steagall*) further prohibited banks from purchasing securities for their own account, with a few exceptions laid out in Section 21, those including federal and municipal debt[101].

With the firewalls set up within the framework of *Glass-Steagall Act*, it effectively separated traditional commercial banking from investment banking. A bank, with its affiliated arms within the bank holding company, not only could take deposits and make loans (as in commercial banking) but also is permitted to act on businesses such as underwriting, selling, and distributing most other classes of securities, including but not limited to stocks, bonds, corporate debt, etc. (as in investment banking). Moreover, banks were able to offer brokerage services and investment advice to clients, as long as it was done through a "subsidiary" as regulated in Section 20 (hereafter "Section 20 subsidiary") of the *Glass-Steagall Act*. That is to say, even though banks themselves could not engage directly in non-banking businesses, they could still manage to do so, indirectly, within regulatory limits, through affiliated non-banking arms of bank holding companies. Nonetheless, as the pressure from the industry mounted to attain greater profits and more operational flexibility, bricks, in a sense, were starting to be taken down from the proverbial "regulatory fire wall"[102].

Deregulation of the *Glass-Steagall Act* was done in a progressive fashion. For example, in terms of regulatory restraints in the original *Glass-Steagall Act*, before it was finally repealed by the new GLBA, in 1987, the Federal Reserve Board (FRB), in order to ensure compliance with the intent of the *Glass-Steagall Act*, required that any Section 20 subsidiary be limited to 5% of revenues from securities activities. However, within a few years that 5% number grew to 10%, and by 1997, just two years prior to the new GLBA, the FRB considerably reduced the significance of the

[101] Laski & Hemley, *supra*, note 17, at 3.
[102] *Ibid.*

cap by allowing 25% of a Section 20 subsidiary's revenues to be generated from non-banking activities or heretofore, non-permitted activities[103]. By stretching the law so thin to actually allow 25% revenue be generated by Section 20 Subsidiary, in an effort to meet the needs of struggling U.S. banking industry, compared to those without such restrictions as a result of financial deregulation and liberalization elsewhere in the world such as European Union ("EU"), arguments then ensued as to whether there was anything of substance left to the *Glass-Steagall Act.* Commentators further pointed out that it was in fact this decision—changing the limitation percentage of revenue to 25%—that ultimately paved the way, at least ideologically if not politically, for the complete repeal of *Glass-Steagall Act* through the new *Gramm-Leach-Bliley Act.*[104]

While deregulation is aimed at stimulating the market economy by repealing outdated regulatory restraints, re-regulation is also in place to ensure that market participants do not undertake excessive risks. Risk must be undertaken on a scale larger than the comfortable confines existing in a risk-free asset in order to generate profits. Therefore, on a regulatory and supervisory level, as Alan Greenspan, Chairman of the Federal Reserve Board, has suggested, a bank supervisor may need to balance the risks of bank failure with the risks of bank growth.[105]

In order to facilitate the market's business growth imperative, re-regulation entails a bigger scope of examination, not only with respect to banking operations, but also with respect to other risk distribution/aversion measures, such as securitization and derivatives. (Detailed discussion as to whether securitization and derivatives are now being considered as "GLBA-permitted financial activities" can be found in Chapter Four of this dissertation.) There are many financial products capable of managing risk and arguably acting like insurance in that they are functionally designed to diversify away or hedge against risk in the marketplace. Financial products such as securitizations and derivatives are capable of maintaining a hybrid identity suitable for the fields of securities, banking, and insurance. Two

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[103] *Ibid.*
[104] *Ibid.*
[105] T. McMillan, "Securitization and the Catastrophe Bond: A Transactional Integration of Industries Through a Capacity-Enhancing Product of Risk Management" (2001) 8 Connecticut Insurance Law Journal 131 at 133.

examples include securitizations of mortgage loans, whereby risks for banks (especially bank investors/shareholders) are pooled together and redistributed through mortgage-backed securities in banking and catastrophe bonds in the insurance industry. As such new financial products span across both the banking and insurance sectors, regulatory focus should be paid to more than just the name of a financial product as the exclusion of the product's functional application could result in overlooking safeguard measures designed by each proper regulatory authority.[106]

(3.2) Citigroup's Recent Loss from Securitization Settlements Call for Further "Re-regulation"

According to an earlier report by *Business Week*, Citigroup, together with Bank of America and four securities firms, accounted for having acted in almost three-quarters of all securitizations of subprime mortgages during 1999.[107] The annual securitizations of subprime mortgage loans rose from US$ 3 billion in 1995 to US$ 60 billion in 1999, totaling a growth of twenty-fold.[108] A more recent report also indicates the CitiFinancial Mortgage Company (CFMC[109])'s servicing portfolio totaled $24.85 billion as of Dec. 31, 2004.[110]. Citigroup is CFMC's corporate parent. CFMC primarily services fixed-and variable-rate first- and second-lien subprime residential mortgage loans. Home mortgage lending in the United States is divided into two market segments—prime and subprime. The prime market caters to individuals with solid credit histories whereas the subprime market offers financial products to prospective homeowners with less than perfect credit histories. Borrowers in the subprime market present an increased risk of default, and subprime lenders compensate for this with higher interest rates, points, and fees than would be

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[106] *Ibid.*
[107] A. E. Wilmarth, Jr., "The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation, and Increased Risks" (2002) University of Illinois Law Review (original footnote# 824).
[108] *Ibid.*
[109] According to a business report, CFMC, as structured today, was formed after Citigroup merged with Associates First Capital Corp., in November 2000. See "Fitch (Ratings) Assigns CitiFinancial Mortgage Company 'RPS3+' Servicer Rating" *Business Wire* (8 August 2002). Available at [http://www.findarticles.com/p/articles/mi_m0EIN/is_2002_August_8/ai_90216751/print]
[110] "Three Subprime Lenders Achieve Servicer Ratings" *Mortgage Servicing News* (June, 2005) (Section: B&C SERVICING; Vol. 9; No. 5; Pg. 15).

found in prime market loans.[111] Subprime mortgage loans are thus viewed as riskier lendings, at least from the bank's perspective, than prime mortgage loans. It has been observed that from 1994 to 1999, the subprime market witnessed an explosion of activity and, in 1999, was estimated to represent $ 160 billion in loan originations—approximately 13% of the total home mortgage lending market.[112] The volume of subprime mortgage loans continue to grow in large numbers, taking CFMC for example, as of March 31, 2002 CFMC serviced over 340,000 loans for over $ 20 billion, which is almost entirely subprime product.[113] These factors, considered together, make it necessary for banks to redistribute their risks through securitization. However, as pointed out, a securitization entity[114] could unwittingly purchase a large bundle of loans from a predatory lender[115] over time and assume the aggregate of the increased risk of default that inheres in each of these loans. With the specter of $ 700 million in combined damages from the Household and Citigroup settlements still fresh in recent memory[116], it is important for regulators to streamline institutional operations by re-regulating not only traditional banking products but also other financial products (securitization) as well to safeguard the overall financial system.

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[111] S. Venkatesan, "Abrogating the Holder in Due Course Doctrine in Subprime Mortgage Transactions to More Effectively Police Predatory Lending" (2003) 7 New York University Journal of Legislation and Public Policy 177 at 178-179.
[112] *Ibid* at 179.
[113] *Supra* note 109 "Fitch (Ratings) Assigns CitiFinancial Mortgage Company 'RPS3+' Servicer Rating".
[114] A commentator explains why securitization enables banks to redistribute their undertaking of risks from subprime mortgage loans and, on the other hand, why it is also beneficial for consumers taking subprime product. "The securitization entity is a financial organization that purchases and holds bundles of loan obligations originated by home mortgage lenders. In exchange for receiving these bundles from the lenders, the securitization entity provides capital to the lender, fueling its ongoing operations. Because the securitization entity is typically a large financial institution with an excellent reputation, it can provide lower interest rate lines of credit to the subprime lender than the lender could procure for itself. Since the lender passes part of this lower interest rate on to the consumer, securitization has had the effect of lowering home mortgage interest rates for the consumer." Venkatesan, *supra*, note 111, at 186.
[115] Although there is no clear definition of what constitutes "predatory lending", the term is generally referred to unethical lenders design predatory loans to exploit financially unsophisticated or unwary borrowers. Predatory lenders use a variety of deceptive selling practices to trap unwary borrowers in mortgages containing terms that are unreasonable, given the actual risk of default represented by the borrower's credit history. Lenders often issue these loans without regard for the borrower's ability to repay them, often resulting in stripping borrowers of the equity they have built into their home, foreclosure, or worse. In this sense, predatory loans, through a combination of fraud, deception, and unethical sales practices, are designed to exploit financially unsophisticated parties, such as low-to-moderate income African-American, Latino, and elderly homeowners. *Ibid* at 177-184.
[116] *Ibid* at 218.

Likewise, other financial products such as derivatives are also widely used by banks in increasing revenues. This can increase banks' overall operational risks as well. At the regulatory level, while legislative attempts toward re-regulating the banking, insurance, and securities sectors are commendable, legislators designing solutions to prevent financial crises should also be aware of the potential risks that major banks are assuming in their role as dealers in the Over-the-Counter (OTC) market. For example, by the end of September 1998, the Long Term Capital Management (LTCM)[117] had lost $4.4 billion, including a $3 billion loss arising out of its OTC derivatives. The LTCM's management assets were highly leveraged—by early 1998, although LTCM's equity capital was only about $5 billion, its huge investment portfolio included $125 billion of securities, including large amounts of debt securities borrowed from commercial and investment banks under repurchase agreements and derivatives having aggregate notional values of $1.25 trillion.[118] Therefore, when the Russian financial crisis occurred in August 1998, prompting global investors to unload their positions in high-risk securities or related derivatives, the volatility of equity markets soared and resulted in a fatal blow to LTCM. To complicate the matter, investors stampeded away from risky investments of all kinds and made it impossible for LTCM to sell its huge and rapidly declining positions in high-risk debt securities and OTC derivatives. The overly optimistic LTCM strategy proved to be a failure by not anticipating the liquidity risk that suddenly appeared in August 1998. This underestimation almost resulted in a catastrophic system failure. To prevent an adverse impact overall, the LTCM was saved by Federal Reserve Board intervention. The FRB-NY helped organize a rescue effort, culminating in an agreement by fourteen major banks and securities firms (including Travelers Group, Merrill Lynch, and Morgan Bank) to inject $3.6 billion into the fund in exchange for 90% of LTCM's equity.[119] Because many of these fourteen major banks and securities firms were also LTCM investors, if LTCM collapsed, this could have

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[117] According to one commentator, LTCM, a hedge fund created in 1994, had a dazzling array of partners that included two Nobel Prize laureates—Myron Scholes and Robert Merton. Scholes and Merton were the founders, along with Fischer Black, of modern option pricing and risk management theories. LTCM's partners also included David W. Mullins, Jr., a former FRB vice chairman, and John Meriwether, who managed Salomon Brothers' legendary bond trading business during 1984-91. The reputations of LTCM's partners, and the large profits that LTCM produced between 1994 and 1997, caused the fund's investors, lenders, and counterparties to ask few questions about the risks inherent in its capital position and trading strategy. Wilmarth, Jr., *supra*, note 107, at 346-347.
[118] *Ibid* at 347.
[119] *Ibid* at 348.

adversely impacted them as well. This case showed how the rapid growth of the OTC derivatives market could aggravate systemic risk within the financial markets at large. More importantly, as far as "re-regulation" is concerned, legislators, while designing regulatory supervisory measures and solutions in preventing systemic risks, should be more aware of the excessive risk-taking of banks, insurers or securities firms, while dealing with non-traditional banking products such as derivatives.

4. Strategic Transformation of the Citigroup Merger: Its Past, Present, and Future

The Citigroup merger marked the beginning of a strategic transformation within the financial services industry which was previously impossible under the *Glass-Steagall Act of 1933* that would have prohibited the merger of insurance, securities, and banking companies.[120]. This milestone transformation is described below by one commentator:

> "In the U.S., no one event was likely more responsible for the renewed interest in financial reform than the creation of Citigroup."[121]

The Citigroup merger eventually led to the U.S. *Gramm-Leach-Bliley Financial Modernization Act 1999*. The Act does three fundamental things. First, it officially repeals the then 66-year-old *Banking Act of 1933* to permit commercial banks to affiliate with investment banks. Secondly, it substantially modifies the then 43-year-old *Bank Holding Company Act of 1956* to permit companies that own commercial banks to engage in any type of financial activity. Thirdly, it allows subsidiaries of banks to engage in a broad range of financial activities that are not permitted for banks themselves.[122] In order to identify the problem of separating commercial banking from investment banking and, accordingly, the development of

[120] Gunawan, Joo & Kim *et al.*, *supra*, note 14.
[121] Walker III, *supra*, note 72, at 56.
[122] Covington & Burling, *supra*, note 37.

Congress's legal reform, it is here I will re-examine the Citigroup merger by providing some statistics.

(4.1) The Billion Dollar Deal

The merger between Citicorp and Travelers represents a milestone in financial history. Enhanced by its ability to cross-market and to provide one-stop shopping in financial services, the merger makes Citigroup the number one corporation in the world, given its combined market value and value of joint assets. When the merger was announced on April 6, 1998, the deal was valued instantly at US$ 70 billion in the markets, soon increasing to more than US$ 84 billion later in the day as Citicorp's shares soared. Even though some of the initial euphoria among investors waned on the following day (April 7, 1998), as Travelers shares fell 6.3 percent, trimming the value to US$ 78 billion[123], this number remained at a very high level. In addition, Citigroup's joint assets were also assessed as high as US$ 698 billion[124]. To split the number, according to *Washington Times*, "Citicorp, the nation's second-largest commercial bank, with US$ 311 billion in assets, agreed to merge with Travelers Group, an insurance and investment-banking firm with US$ 387 billion in assets."[125] A merger of this size would definitely put great pressure on Congress, inspiring some to act based on fear alone that dismantling this gigantic financial conglomerate might trigger an economic crisis or even a meltdown of the U.S. financial industry. Indeed, observers suggest that "within 24 hours of the deal's announcement, lobbyists for insurers, banks and Wall Street firms were huddling with Congressional banking committee staff members to fine-tune a measure that would update the 1933 *Glass-Steagall Act* separating commercial banking from Wall Street and insurance, to make it more politically acceptable to more members of Congress."[126] And, for Citicorp-Travelers, there were as many political reasons as business ones to dictate speed. As

[123] Timothy L. O'Brien, "Shaping A Colossus: The Vision; The One-Stop Financial Mall: Is It What Peoria Longs For?" *The New York Times* (8 April 1998). See also Leslie Wayne, "Shaping A Colossus: The Politics; Deal Jump-Starts a Stalled Banking Bill" *The New York Times* (8 April 1998).
[124] "Citicorp's Merger Approved by Fed" *The New York Times* (24 September 1998). This news otherwise reported a higher number of US$ 751 billion. Even though the number from assessments varies, however, legal news reports generally accept that the joint assets of Citigroup, at the time of merger, was about U.S.$ 700 billion.
[125] "Citigroup Points the Way" *The Washington Times* (9 April 1998) A18.
[126] Leslie Wayne, "Shaping A Colossus: The Politics; Deal Jump-Starts a Stalled Banking Bill" *The New York Times* (8 April 1998).

a Travelers lobbyist pointed out, "We have to strike while the iron is hot....This deal is a real live manifestation of how the markets are changing and that puts the legislation against a different political backdrop than a week ago (before the Citigroup merger was announced)"[127].

(4.2) Strategic Transformation

Citigroup announced its merger on April 6, 1998 and by that time, there was still no law that would permit the merger of these varying types of financial services. Commentary positioned the situation as "two financial concerns, tired of Congress's inaction and determined to forge a financial services firm capable of competing on the world stage, unilaterally pursued the common-sense strategy that the derailed reform legislation would have approved...The combined company, Citigroup, would be comparable in size to foreign financial services firms based in Germany, Japan, and Switzerland."[128] At that time, the merger deal called for Travelers to acquire Citicorp and then convert to a bank holding company. Citigroup was running the risk of divestiture, if Congress failed to pass reforms. Citigroup relied on the "two plus three rule" that allows insurance company to acquire banks, and not the other way around, without divestiture, before the five-year extension expires.

Based on an exemption in the federal *Bank Holding Company Act* (i.e. Section 4(a)(2) of BHCA), Travelers applied to the Federal Reserve in May 1998 for a new bank holding company charter and the new holding company would acquire Citibank. The result was that the Federal Reserve Board ("FRB") allowed Citigroup to offer securities and insurance services beyond the scope of the BHCA for up to five years after Travelers merged with Citicorp. Practically speaking, the FRB's 1998 order permitted Citigroup to operate as a universal bank for up to five years, without being required to divest any of its securities or insurance activities[129]. This strategic

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[127] *Ibid.*

[128] *Supra* note 125 "Citigroup Points the Way".

[129] Travelers very much relied on this exemption provided in section 4(a)(2) to apply for the merger with Citicorp, under section 4(a)(2) of the BHCA, 12U.S.C. 1843 (a)(2) (Supp. V 1999), a nonbanking company is exempt from the activity restrictions contained in section 4 of the BHCA for up to two years after it acquires a bank. In addition, section 4(a)(2) permits the FRB to grant up to three one-year extensions of this exemption period. See Laura J. Cox, "The Impact of the Citicorp-Travelers

transformation of Citigroup made it possible for Citigroup to provide its customers with one-stop shopping financial services.

The underlying reason behind this *strategic behavior* is that at the time of approving the Citigroup merger in 1998, Citibank (the banking arm of the Citicorp and a federally chartered bank holding company) would not have been able to complete the deal if they applied to the Federal Reserve to buy Travelers, because under the BHCA it is illegal for banks to engage in Travelers' business of underwriting property and casualty insurance. Travelers relied on the exemption provided in Section 4(a)(2) to apply for the merger with Citicorp—under Section 4(a)(2) of the BHCA, 12U.S.C. 1843 (a)(2) (Supp. V 1999), a non-banking company is exempt from the activity restrictions contained in Section 4 of the BHCA for up to two years after it acquires a bank. In addition, Section 4(a)(2) permits the Federal Reserve Board (the regulatory authority) to grant up to three one-year extensions of this exemption period. Therefore, in total, the exemption that permitted Citigroup to operate as a universal bank was for up to five years. The underlying theory for this strategic behavior is "game theory". In the case of Citigroup merger, the game choices available to Citibank were clear: if the new GLBA had not become law, Citigroup had two choices. The simplest option for Citigroup would be to *divest*[130] its insurance underwriting businesses to conform to the law, and the other would be to begin the process of *debanking*[131]. Citigroup decided to hedge its bets while forcing the hand of Congress to legitimize the merger through reform legislation. With over 100 million customers in 100 countries, as well as more than 700 billion dollars in assets under management, a merger of this scale forced the U.S. Congress to modernize banking regulations, or otherwise feel the economic impact of dismantling

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Group Merger on Financial Modernization and the Repeal of Glass-Steagall" (Spring, 1999) 23 Nova L. Rev. 899.

[130] It might seem odd for an insurer and bank to merge only to get rid of insurance, but not all of that business is underwriting, much of it is sales and distribution. If the merger requires the Citigroup to divest important parts of the business, then the Citigroup was still able to retain the insurance distribution side of the business. See Cox, *Ibid.*

[131] Debanking ranges from actually dropping the bank charter to spinning off complete lines of business. The easiest of this broad spectrum is the option of giving up its banking charter and moving to a thrift charter. A thrift charter is much more liberal than a bank charter and might permit Citigroup to keep its business intact. The more impractical debanking option would be for Citigroup to liquidate its bank charter. A company that debanks can no longer take government insured deposits. It would have to look to funding sources such as commercial paper or other forms of debt and equity. This may not be practical since consumer deposits accumulated through a retail branching system are much cheaper than purchased money. *Ibid.*

such a titan in a market place that was bursting through the regulatory dam to create more diverse financial institutions[132]. Congress' action also made it doubtful, for many close observers, whether the marriage between Citicorp-Travelers was "too-big-to fail"?

(4.3) Mega-Merger Plan Hinges on Congress

(4.3.1) Lobbying Costs

With two large financial groups attempting to merge, H. R. 10 had really become the Citicorp Travelers 'bail out bill'. However, in retrospect, even before the Citigroup Merger was announced on April 6, 1998, "the financial services industry [had] tried to repeal the two banking laws (i.e. the *Glass-Steagall* and *Bank Holding Company Acts*) 11 times since the early 1980s"[133]. After Citigroup announced its merger, with 70 billion at stake, "officials at Citicorp and the Travelers Group were amassing an army of lawyers and [in-house] lobbyists to navigate the numerous legislative and regulatory hurdles that stood in the way of legitimizing the merger."[134] Both Citicorp and Travelers spent millions of dollars in lobbying on favor of the new law, overhauling both Acts which dated from the Depression era. In 1997, just one year prior to the merger, "Citicorp spent (US$) 9 million on lobbying, Travelers spent $1.2 million, and Salomon Smith Barney, a Travelers subsidiary, spent $1.56 million."[135]

As pointed out, despite the fact that both Citicorp and Travelers had at that time "dispatched legions of advocates to the myriad state, federal, and international agencies that must sign off on the deal...the ultimate target [was] Congress."[136] That also meant if Congress had not passed the new law, the two giants, Citicorp and Travelers, could still merge but would have to pull off a costly and complicated restructuring. As merger mania swept through the banking industry, the Citigroup

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[132] Walker III, *supra*, note 72, at 56-57.
[133] "Merger Plan has Advocates Scurrying" Legal Times (27 April 1998) 4.
[134] *Ibid.*
[135] *Ibid.*
[136] *Ibid.*

merger could not have been announced at a better time. Market forces compelled the arms of the Congress to pass the new law. James Hyland, staff director for the Senate Banking Subcommittee on Financial Institutions and Regulatory Relief, chaired by Sen. Lauch Faircloth (R-N.C.), who favored overhauling the [then] current banking system, commented "it might be easier to just change the laws rather than force Citicorp and Travelers to spend millions trying to create a convoluted corporate structure in order to carry out all of their present activities...The market makes this a fait accompli...Congress is good at rubber-stamping what the market has already done."[137]

(4.3.2) Respective Revenue of Citicorp and Travelers before the Merger

In 1997, Citicorp reported profits of US$ 3.6 billion on revenue of 23.3 billion. Travelers reported net income of US$ 3.1 billion on 27.1 billion in revenues.[138]

As for their respective strategies behind the creation of such large revenues—Citicorp, under Mr. John S. Reed's direction, "has [in recent years] emphasized its global consumer business, which includes such things as credit cards and savings accounts, while decreasing the bank's involvement in domestic wholesale businesses like corporate lending. Overseas, however, Citicorp still focused its energies on corporate lending, because the bank has a competitive advantage in many emerging markets."[139] Travelers, under Mr. Sanford I. Weill's direction, ensures that "more than half of [its] revenues [came] from consumer finance, individual investments, investment banking and bond underwriting and trading. It sells life insurance and annuities through two subsidiaries, including Primerica Financial Services, which specializes in term or basic insurance without investment features."[140] Also, reported on April 7 1998, "Travelers is the sixth-largest property and casualty insurer [in the U.S.], selling auto, homeowners and commercial coverage, with [US$] 8.6 billion in premiums last year....By adding Salomon Brothers [under its wing for the final quarter of 1997] to its Smith Barney brokerage and investment banking arm,

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[137] *Ibid.*
[138] Timothy L. O'Brien & Joseph B. Treaster, "Shaping A Colossus: The Overview; In Largest Deal Ever, Citicorp Plans Merger with Travelers Group" *The New York Times* (7 April 1998).
[139] *Ibid.*
[140] *Ibid.*

Travelers became the third-biggest stock underwriter in the United States and the fourth biggest in the world. It also moved into first place in underwriting municipal bonds, and second in overall underwriting of American and International debt offerings."[141]

(4.3.3) Majority Consensus Led by Market Forces

Americans strongly support financial services reform. "According to a recently completed survey conducted by The Tarrance Group (commissioned by Merrill Lynch), the U.S. electorate, by a margin of 60% to 31% overwhelmingly favors regulatory reform of America's financial services laws, allowing banks, insurance companies, and securities firms to enter each other's businesses and offer clients the full range of financial services and products."[142]

As banking organizations in the United States grow larger and are enabled to merge with other finance services industries (insurance and securities), their operations also become more complex and more diversified. The level of complexity also increases in the regulatory arena. In order to overcome many of the shortcomings of government supervision and regulation, market discipline has in fact been enacted in Article 108 of the new *Gramm-Leach-Bliley Act*. According to some commentators, market discipline helps preserve the integrity of the U.S. banking system.

> "Tucked comfortably in the middle of Title I of the *Gramm-Leach-Bliley Act* is a provision that instructs the Federal Reserve Board and the Treasury Department to study the feasibility of requiring large banks and their holding companies to maintain a portion of their capital in the form of subordinated debt[143]. This requirement is a way to bring *market forces* to bear on the operation of banking institutions and to reduce the risks that these institutions

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[141] *Ibid.*
[142] Walker III, *supra*, note 72, at 56-57.
[143] Article 108 (c)(3) of the *Gramm-Leach-Bliley Act* defines subordinated debt to mean unsecured debt that:
(A) has an original weighted average maturity of not less than 5 years; (B) is subordinated as to payment of principal and interest to all other indebtedness of the bank, including deposits; (C) is not supported by any form of credit enhancement, including a guarantee or standby letter of credit; and (D) is not held in whole or in part by any affiliate [of the bank].

and their expanded activities may pose to the federal deposit insurance fund.[144]"

Despite the positivism in factoring into the GLBA the dynamic of market forces, the use of market discipline has not been without critics. Concerns for incorporating private forces into the new law include the observation that (i) proponents of market discipline have not presented workable models that can achieve the goal of monitoring and curbing bank risk-taking activities[145]; (ii) among potential market disciplinarians, subordinated debt holders are ill-suited to serve as monitors of bank behavior[146]. These arguments subject the *Gramm-Leach-Bliley Act*'s commission of a federal study of subordinated debt to a long series of calls from academics, regulators, and public officials for investigation into the potential benefits that market discipline may provide to the U.S. system of banking regulation. That is, to use the private sector to monitor and regulate banks' risk-taking activities[147].

Market discipline can take different forms. Academic writers have since the 1980s suggested that depositors, non-deposit creditors, and shareholders of banks are the market participants best situated to monitor and regulate bank behavior. Several commentators have also argued that subordinated debt holders are the preferred source of market discipline.[148] These various perspectives differ in contending which form of market discipline provides the most efficient mechanism in curbing and monitoring banks' risk taking, one thing in common though, is its rationale of employing market discipline to preserve the federal deposit insurance fund. Federal deposit insurance, which was first introduced in the *Banking Act of 1933*, is funded by taxpayers' money and government subsidy. In the latter case, when there is a shortage of funds, government subsidies become the ultimate source of depositor and shareholder remedies.

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[144] Van Der Weide & Kini, *supra*, note 33, at 196.
[145] *Ibid* (original note#7). See also, Helen A. Garten, "What Price Bank Failure?", (1989) 50 Ohio St. L. J. 1159 at 1161 (including footnote#1); Helen A. Garten, "Still Banking on the Market: A Comment on the Failure of Market Discipline", (1988) 5 Yale J. On Reg. 241 at 241-242.
[146] *Ibid* (original note#8). See also, E. J. Gouvin, "Shareholder Enforced Market Discipline: How Much is Too Much?", (1997) 16 Ann. Rev. Banking L. 311 at 322-23. (suggesting shareholders as source of market discipline).
[147] Van Der Weide & Kini, *supra*, note 33, at 196.
[148] *Ibid* at 196-197.

Moral hazard[149] has a lot to do with the federal deposit reserve and the concern of introducing the concept of market forces. In order not to unduly drain the federal deposit insurance fund, market forces may eventually become an effective discipline in the place of, or in addition to, existing regulators who must supervise failing financial holding companies as a result of excessive risk-taking.

(4.4) Market Forces have Power to Displace Outdated Regulations

As previously mentioned, growing competition was the main reason for Citicorp (the second largest commercial bank in the U.S.) and Travelers Group to merge and become Citigroup. Before the merger, commercial banks, like Citibank (under the former parent company Citicorp) competed with other banks in a less regulated environment. Competition from other commercial banks and from non-bank providers of financial services intensified pressure on banks to expand their market share. Likewise, insurance companies, faced with challenges such as heightened competitive threats from banks and securities brokers, have formed strategic alliances and consolidated with financial service firms. It is exactly this pressure from economic forces that enabled Citicorp and Travelers to merge regardless of the extraneous difficulties of blending different corporate cultures, potential discord between co-CEOs and other operational concerns.

The idea of the Citigroup merger began as a glimmer in the eye of Travelers' CEO (Sanford I. Weill), back in February, 1998. For Weill it was an inevitable progression. Before the merger, Travelers was almost entirely a domestic company, lacking Citicorp's cachet, clout, and depth of experience. Even though in 1997, prior to the merger, the revenue of Travelers (US$ 27.1 billion) was higher than that of Citicorp's (US$ 23.3 billion)[150]. But to Weill a successful-run corporation was more than about making money; it was also about achieving company goals. For Weill, the attraction about Citicorp is that it had the biggest credit-card business in the world

[149] For detailed discussion about "moral hazard", please refer to the "Methodology" section of this dissertation. See also Groth, *supra*, note 13, at pp. 136f.
[150] Timothy L. O'Brien & Joseph B. Treaster, "Shaping A Colossus: The Overview; In Largest Deal Ever, Citicorp Plans Merger with Travelers Group" *The New York Times* (7 April 1998).

and massive retail and corporate banking operations[151].

For Citicorp's CEO (John S. Reed), the mega-merger appealed to him as well, at least for a couple of reasons. Firstly, for revenue enhancement—Travelers "offered Citicorp new distribution channels through Travelers' 10,600 Salomon Smith Barney brokers, 28,000 Primerica Financial Services reps, and 11, 800 Travelers Life & Annuity agents."[152] Secondly, for better management—Reed admitted since 1984, Citicorp "had failed to build a management team that could cut through Citi's entrenched bureaucracy. [Nonetheless] Travelers had better managers...."[153] Under these circumstances, Reed stood to learn a lesson from Travelers. As Reed put it, "I had been frustrated in trying to get greater operational disciplines into the old Citibank...I felt the merger would help me in that quest, and it has."[154]

Equally important, Citicorp and Travelers Group joined forces in an effort to gain economies of scale and scope and become more cost-efficient. Economies of scale refers to the ability of Citigroup after the merger to more efficiently offer consumers a comprehensive range of financial and insurance services ("one-stop-shopping financial supermarket"). Economies of scope means that the creation of Citigroup brought together several different businesses including commercial banking, consumer finance, credit cards, investment banking, securities brokerage, asset management, property casualty and life insurance. With this combination of such a wide range of products and services, Citigroup was able to provide services for consumers, corporations, institutions, and governments all around the world under a "one-stop-shop" umbrella[155]. Consequently, being cost-efficient suggests that by providing a one-stop shop for financial services, Citigroup was able to benefit from economies of scale because it was cheaper for it to offer a variety of services as one firm than for several different firms to offer the same services individually. Cost-efficiency also implies Citicorp, by consolidating with Travelers Group, would be able to eliminate the costs of heavy investment in new technology, human resources, physical capital, management processes and capital market access. That is to say, the

[151] Gary Silverman *et al.*, "Is This Marriage Working" *Business Week* (7 June 1999) 126.
[152] *Ibid.*
[153] *Ibid.*
[154] *Ibid.*
[155] See Citigroup's web site at [http://www.citigroup.com], see also Gunawan, Joo, Kim *et al.*, *supra*, note 14.

Citigroup merger allowed Citicorp access to expertise in underwriting, corporate trading and equity research resources rather than developing these disciplines and business units internally[156]. Furthermore, in terms of generating revenue-efficiency, by reaping the benefits of economies of scale and scope, Citigroup would have access to a larger capital base, which would allow the bank (Citibank) to take on more transactions and provide more loans. Likewise, the investment arm of Citigroup (for example, Salomon Smith Barney) can now connect with Citibank's consumers, which can help Salomon sell its underwriting services. The merger gives Citigroup an opportunity to *cross-sell* their banking and insurance services to its new customer base acquired from the merger. With its diverse array of financial services, Citigroup is now able to provide one individual customer many potential services ranging from investment banking and insurance to commercial banking. This is strategically important because of the nature of this customer-focused industry[157]. In addition diversification also reduces the resources required to managing risk and the risk deduction can result in lower operational costs.

The goal of the Citigroup merger was revenue-enhancement, as Citigroup looked for a greater competitive edge and a larger share of the market. According to *Business Week*, one year immediately prior to the merger, Citicorp reported to have US$ 23 billion in 1997 adjusted revenues; while Travelers reported to have US$ 37 billion in revenues.[158] In comparison, on April 6, 1998 when the merger was announced, the total stock value of combined Citicorp and Travelers reached to US$ 70 billion. The Citigroup merger was therefore labeled by some commentators as a "$70 billion dare".[159] For investors, they appear to have been enriched by the merger as well, at least in the first place. On the same day (April 6, 1998), "the stock of Citicorp soared, rising US$ 37.625 to close at US$ 180.50. Travelers stock rose US$ 11.3125, to US$ 73"[160]. The revenue increase justifies and makes it understandable why this attempted merger stood against the old regulatory framework and even took place before being legitimized by later financial legislation reform (the *Gramm-Leach-Bliley Act*, passed on November 12, 1999.)

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[156] *Ibid.*
[157] *Ibid.*
[158] *Supra* note 151 Gary Silverman *et al.*, "Is This Marriage Working".
[159] Walker III, *supra*, note 72, at 57.
[160] *Supra* note 150 "Shaping a Colossus: The Overview; In Largest Deal Ever, Citicorp Plans Merger with Travelers Group".

In analyzing the case of the Citigroup merger, a conclusion can be summed up as follows: a banks' huge client base and distribution ability has the potential to be attractive to insurance companies that seek to maximize their profit margin. As pointed out in a research review conducted in 1998, "in the life insurance sector, consolidation has been driven by life insurer's pursuit of scale, volume, breadth of products, breadth of distribution, and expanded expertise."[161] This analysis was underpinned by numerous merger announcements among banks and insurance companies. "Insurers that were previously repelled by the notion of bank involvement in insurance began to put an eye to profits made possible by banks' distribution capacity."[162] Therefore, "while the fear of being swallowed whole by banks remains, insurers' more pressing challenge is to avoid being squeezed out of opportunities to participate in the profits generated by bank distribution."[163] This explains the fact that among bank-insurer mergers, insurers are usually more aggressive in pushing the deals, compared to their counterparts at the banks. In the case of the Citigroup merger, for example, it was Travelers' executive, Sanford I. Weill, who took the initiative to approach Citicorp's chief executive, John S. Reed, to put together this deal, and not the other way around.[164] According to *The New York Times*, "Mr. Reed and Mr. Weill first discussed a merger on Feb. 25 (1998), during the Business Council's annual economics and public policy conference of the nation's top corporate leaders. At a dinner that evening in Washington, Mr. Weill invited Mr. Reed to his hotel room at the Park Hyatt. When Mr. Reed arrived, Mr. Weill, known on Wall Street as something of a deal maven, made a marriage proposal."[165] The immediate response was, as the report continued 'Gee, I didn't think that was what you were going to talk to me about', "Mr. Weill recalled Mr. Reed as saying. Mr. Reed, who has had a longstanding aversion to the investment banking business, said that the logic of the deal was compelling enough for him to put his reservations aside."[166]

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[161] Walker III, *supra*, note 72, at 57.
[162] *Ibid.*
[163] *Ibid.*
[164] "The Cult of Gigantism: Is Size being Pursued and Celebrated for its Own Sake?" *Financial Times* (London, England) (11 April 1998). See also *supra* note 150.
[165] *Supra* note 150 "Shaping a Colossus: The Overview; In Largest Deal Ever, Citicorp Plans Merger with Travelers Group".
[166] *Ibid.*

In this regard, "cross-selling" may benefit insurers more than it does banks, due to at least a couple of reasons. First, banks are highly-leveraged businesses, so the capital that banks need to maintain is smaller than insurance companies. Secondly, banking products are wider and more versatile than those of insurance companies. There are usually four insurance products: life, injuries, casualty, and property; whereas banking activities cover a wide range of services, from commercial banking to asset management, credit card issuance, consumer finance, global trading, and even partial securities brokerage and underwriting (limited banking capacity, before the GLBA). This profound difference explains why banks generally have a larger client base than insurers and therefore insurers would benefit more from cross-selling/marketing.

(4.5) Government Focus Shifted from Competition Policy to Economic Analysis

In the midst of passing the bill, debate focused on whether such a mega-size merger would harm the U.S. economy as a result of the potential to create a monopoly. Under these circumstances, the question was whether there was such a thing as a bank that was too large. After the merger, Citigroup became the world's largest financial services corporation. This merger would create a financial conglomerate that provided all types of financial services, including commercial and investment banking, and insurance services. That is because Citicorp (renowned for its world-wide banking business) could now absorb the insurance operations by Travelers and the securities brokerage and underwriting arm of Salomon Smith Barney (Traveler's subsidiary). In this regard, Citigroup, being the number one financial corporation in the word (size-wise at least), would hold top positions worldwide in commercial banking, asset management, global trading, securities brokerage, and consumer finance. It would also underwrite both property and casualty and life insurance. "With (US$) 698 billion in assets and a market capitalization of (US$) 135 billion, Citigroup would dwarf European universal banks like Deutsche Bank, Union Bank of Switzerland, and HSBC Holdings. It would boast relationships with 100 million customers in 100 countries and have 3,200

offices around the globe."[167] By comparison, "the proposed merger of the Royal Bank of Canada and the Bank of Montreal is small potatoes. If Ottawa approves that deal, the new Canadian bank will have a market value of just $39 billion and assets of $453 billion (both in Canadian dollars), making it 22nd in the world."[168]

It is said that the impact of technology is the reason why size is becoming critical. "Technology requires huge amounts of capital. Consumers are increasingly accustomed to technology. PC banking and fund management are here; consumers increasingly expect those services. A year ago, 5% of Fidelity's equity trades took place by personal computer; today that figure is about 35%."[169] Others have commented that some factors including rising levels of excess capital, low returns, falling regulatory barriers, and the lower market value of insurers relative to other financial services players"[170] seem to have provided enough critical mass to trigger the restructuring of the industry.

IV. Conclusion

The banking system in the U.S. has undergone tremendous changes over the last decade, as pressured by the needs of cost-cutting and weaning greater efficiencies by U.S. banks looking for opportunities for large-scale mergers and acquisitions within not only the banking but also other related financial sectors. The influential banking laws in the 1930s' Depression era was therefore doomed to be repealed or substantially amended, as traditional demarcations, both functional and geographical, faded, with the growing competition between all types of financial intermediaries. Now non-bank financial institutions can provide alternatives to investment advice and bank loans. U.S. local banks are no longer able to enjoy the tremendous benefit of local protectionism, as a result of the restrictive banking laws in the 1930s. At that

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[167] Research Review, Journal of the Society of Insurance Research 1998, Summer "Mergers & Acquisitions in the Financial Service Industry; 1st Quarter 1998 (Available at LexisNexus news search).
[168] "On Top of the World; Citicorp and Travelers from a Financial Behemoth" *Maclean's* (20 April 1998). (Available at LexisNexus news search). In the same news commentary, it is said that "[i]n fact, the marriage of Citicorp and Travelers puts more pressure on Ottawa to let the Royal and the Bank of Montreal consummate their union. It dramatically underscores the global trend towards consolidating financial services. And it lends weight to the argument of Canadian bankers that they must unite—or be crushed by the new worldwide giants." *Ibid.*
[169] Research Review, *supra* note 167.
[170] *Ibid.*

time, "restrictive regulations, combined with favorable international and macroeconomic conditions and the absence of alternatives to the investment and bank loan, allow U.S. banks to borrow cheaply from depositors and to lend safely and profitably to borrowers"[171]. Even though this framework restored the U.S.'s then troubled banking system, banks were lured by the lucrative stock market, and therefore traded on Wall Street with depositors' money, and without the safety net of government-funded deposit insurance. The result was that bank failures were worsened and magnified by depositors' panics and runs on banks. Nonetheless, local banks were now faced with a bigger problem: strong competition not only from foreign banks and agencies, but also internally, from other financial institutions such as insurance companies and securities firms. Therefore, the process of deregulation, called upon by market forces, had appeared to embark on a path of no return.

The economic forces are caused and characterized by the increased interdependence of the world economy, innovations in new information technologies, facilitation of logistics, integration of human resources, and the internationalization of financial markets. The result is, these economic forces have facilitated huge international capital flows, flexible financial asset prices, and new modes of business and have redefined financial services marketplaces on a global scale, making the old functional and geographic boundaries disappear. That is because the underlying reason for 1930s banking regulations was protection—protecting U.S. banks from competition and protecting U.S. banking customers from losses through government-funded deposit insurance. The pressure for ongoing deregulation was also intensified by the success of deregulation elsewhere in the world, especially in the European Union following the adoption of the *Second Banking Directive*. Under these circumstances the GLBA came to be established in an effort to save and maintain the U.S. banking sector on the global competitive stage.

The Citigroup merger pioneered the wave of bank mega mergers which swept the U.S. in 1998. It also eventually brought about legal reform in the form of the GLBA. In retrospect, laws separating investment and commercial banking operations were not in place until the 1930s. Until the GLBA finally repeals the *Glass-Steagall*

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[171] Wei-wen Yang, *World Banking Revolution: The Legal Perspective* (Taipei: Hwa-Tai, 2001) at 54. (In Chinese)

Act of 1933, observers have attributed legal reform to the temporal victory of free market ideals. Exemplified by the Citigroup merger, which forced the U.S. Congress to pass the GLBA, it seems that the banking industry in the U.S. prepared the ground for reforms and directly challenged legal limitations on permissible activities. This is because the legal limits in previous laws hindered the efficiency of both investment and commercial banks and in the mean time were oblivious of the realities of actual commercial practice. Today, investment banks are involved in a wide array of financial services. Some offer accounts that strongly resemble checking accounts. For instance, Merrill Lynch, among other investment banks, has for some time offered a "Cash Management Account" that allows customers to tie their brokerage, money market mutual fund, and credit card accounts together.[172] Likewise, commercial banks are not limited to receiving deposits and making loans. Indeed, a commercial bank's trust department has historically been permitted to buy and sell securities on behalf of its depositors. This practice was even endorsed by Section 16 of the *Glass-Steagall Act of 1933*.

By repealing the *Glass-Steagall Act 1933* and dramatically amending the *Bank Holding Company Act 1956*, the changes made by the GLBA appear to be evolutionary, rather than revolutionary. This is especially true given that the bank holding company in the U.S. was initially permitted to hold only 5% of bank ineligible securities by its "Section 20 securities affiliates". The legal limit on bank ineligible securities has however, over the past years, been relaxed to a 10% and then, subsequently, a 25% threshold. As a result of progressive relaxation of previous laws, the GLBA allows financial holding companies to hold all securities, with no percentage limit, by its securities affiliates. In fact, the GLBA finally permits the conglomeration of all financial services. In retrospect, regulation of absolute separation of commercial and investment banking, embodied in the *Glass-Steagall Act 1933*, led to another layer of regulation, as the *Bank Holding Company Act 1956* created another barrier between banking and insurance in response to aggressive acquisitions and expansions done by commercial banks. Regulations in both Acts stifled competition within the U.S. financial industry. The upside to it was to have, over the past six decades, effectively prevented bank failures such as those witnessed

[172] Nance & Singhof, *supra*, note 95, at 1306 and its original note 38.

in the great depression era in the 1930s. The downside, however, was that the U.S. financial industry started to lose its global competitiveness in recent years.

Because the underlying principle for the regulation in two Acts of both 1933 and 1956 was to prevent excessive competition from impacting the U.S. financial industry, and the underlying reason for "deregulation" (as most scholars suggested) in the GLBA of 1999 was to increase the industry's competitiveness, it then begs the question, as harmonizing the two opposite goals becoming necessary, whether the overall concerns of the Federal Reserve are still preserved through the new GLBA in regard to issues such as the agency problem, moral hazard, and adverse selection. "Re-regulation" as embodied in the 1999 GLBA reemphasizes the importance of safeguarding the federal deposit insurance fund, which had a direct impact on these issues. These safety measures in the new GLBA reflect the "profound antipathy to concentration of capital and conglomeration in general"[173]. Re-regulation also stresses the profoundness of the underlying principles of previous regulations. This dexterity reminds us that "even politicians who seek reform of bank regulation often stop short of advocating the abolition of banking and commerce distinctions such as those found in the *Bank Holding Company Act*"[174], as suggested by commentators. The *Bank Holding Company Act 1956* strengthened the Federal Reserve System's "lender of last resort function" by "limiting the growth of interstate banking to holding companies and by completely separating banking from commerce"[175]. This spirit also continues the previous *Banking Act of 1933* and the principle of the *McFadden Act of 1927* that imposed geographic expansion barriers on all federally-chartered banks and thrifts to limit competition[176]. That is to say, even the new GLBA does not deny there still exists deep-rooted distinctions between commercial and investment banking (especially referring to "functional regulation"), while the Act's intention is to facilitate the interplay of both in order to increase the FHC's overall efficiency.

In order to imbue some practical experience into the theoretical framework (Regulation—Deregulation—Re-regulation) set up in this chapter, I used the

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[173] *Ibid* at 1347.
[174] *Ibid.*
[175] Yang, *supra*, note 171, at 54.
[176] *Ibid* at 53.

Citigroup merger as an example for a case study, for a few distinctive reasons. First and foremost, it is almost indisputable that the Citigroup merger eventually led to the promulgation of the new GLBA. Secondly, at a domestic level, the Citigroup merger spawned the financial market merger craze back in 1998, in fact, immediately following its merger announcement, a number of banks also announced their merger plans. Thirdly, on a global level, Citigroup is the world's biggest financial conglomerate, and as a result Citigroup intensified the focus on the insurance-banking interplay by creating the largest financial services conglomerate in the world. Last but certainly not least, the recent break-up of Citigroup (announced in February 2005) provides an opportunity to reassess the feasibility of synergies between the insurance and banking industries. This concern then leads to another question as to whether it would be better off for Taiwan's financial conglomerates to adopt the U.S. FHC model or the German Universal Banking model instead? I will expand upon this in Chapter Five of this dissertation.

Chapter Four

Re-regulation and De-segmentation: Post-GLBA Era Financial Liberalization

I. Introduction

On November 12, 1999 then-American President, Bill Clinton, signed the *Gramm-Leach-Bliley Financial Modernization Act* (short titled "the *U.S. Financial Modernization Act of 1999*", also known as "the *Gramm-Leach-Bliley Act*", "the U.S. Financial Holding Company Law", or "the U.S. FHC law", hereafter "the GLBA"). The law came into effect in March 2000, marking a milestone in the history of deregulation. The new law abolished the then 66-year-old *Glass-Steagall Act* and substantially changed the then 43-year-old *Bank Holding Company Act*, hereon permitting a bank to affiliate with securities dealers, insurers, mutual funds, and other firms whose activities are "financial in nature", "incidental" or even "complementary" to financial activities. It also meant that beginning in March 2000 any company that already owned a U.S. bank that is "well-managed", "well-capitalized", and had a satisfactory or better rating in serving its community, could elect to become a financial holding company ("FHC").

More than twenty years ago, the financial industry had begun pressuring the U.S. government to relax the restraints imposed by the old *Glass-Steagall Act*, which barred commercial banks from engaging in the securities business. This pressure was intensified as the U.S. financial industry began to become less competitive globally because of domestic legal restraints which protected the banking industry and which looked more antiquated following the continuing success of deregulation elsewhere in the world—especially in the European Union following the adoption of the *Second*

Banking Directive[1]. With respect to the long-standing restraints, commentators also contested that "although the *Glass-Steagall Act* was a response to perceived banking abuses during the Great Depression, several researchers find commercial banks' venturing into securities activities played only a minor role in the banking crisis during the depression"[2]. Eliminating the barriers that strictly separated the insurance, banking and securities fields since the Great Depression, the *Gramm-Leach-Bliley Act* was anticipated to make major changes in the way that these three industries could interact with one another. Even before the enactment of the GLBA, supporters suggested the Act would contribute to the formation of diversified financial services firms that could provide a wider array of products and services to their customers through cross-marketing. In a similar vein, the Act's passage would clear the way for these financial services firms to move increasingly into each other's territory, thereby forcing each arm of these new financial conglomerates to become more efficient, more creative, and more customer-focused.[3] Since the *Gramm-Leach-Bliley Act* finally lifted up the so-called "Depression-era limits" on domestic banking growth the result has been, according to one commentator, that investors, institutions, and companies are quickly benefiting from enhanced organizational agility and greater competition in the industry[4]. Benefits derived from "cross-marketing" not only are welcomed by financial institutions but also by their customers, as the latter can enjoy the convenience and efficiency of "one-stop shopping financial services" brought forth by the former. One estimate suggests that consumers of financial holding companies save $15 billion a year in fees levied on financial services thanks to greater competition and a more efficient financial services system[5]. This is because, from a financial holding company's perspective, mergers of financial services companies, including banks, registered investment companies, securities firms, and insurance companies afford them the opportunity to meet all their customers'

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[1] R. B. Walker III, "The U.S. Financial Services Modernization Act of 1999: New Financial Order, or Financial Chaos?" (2000-2001) 16 Banking & Finance Law Review 47 at 69 (original footnote# 5), quoted as, "EC, Second Council Directive 89/646/EEC of 15 December 1989 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions and amending Directive 77/780/EEC, [1989] O.J.L. 386/1."

[2] M. C. Collins, S. A. Kwag, & H. S. Yildirim, "An Examination of the Equity Market Response to the Gramm-Leach-Bliley Act—Across Commercial Banking, Investment Banking, and Insurance Firms", published in September 2002, available at [http://bus.utk.edu/finance/WP/Gramm-Leach-Bliley%20Paper%202002.pdf]

[3] *Ibid.*

[4] "No Turing Back-Now A Year Old, the *Gramm-Leach-Bliley Act* Has Changed The Industry Forever", by Alan E. Sorcher, Vice President and Associate General Counsel, Securities Industry Association"

[5] Collins, Kwag, & Yildirim, *supra*, note 2.

financial needs at an immensely lower cost[6]. It is also suggested that financial institutions are financially more sound because they diversify the risk in their activities and are able to consolidate their global position. The new regulatory playing field—by permitting securities firms, banks, and insurance companies to affiliate with each other—has provided the financial services industry the essential flexibility to pursue more diverse business strategies. As a result, new competition is defining the entire financial marketplace. The anticipation and enactment of the GLBA has hastened even greater consolidation. Since 1997, there have been more than 400 mergers and acquisitions where U.S. securities firms were acquired. In 1999 alone, there were 126 mergers, compared to as recently as 1995, where the average deal was a mere $100 million. So far in 2000, deals were averaging $2.5 billion.[7]

In the same vein, the "Statistical Abstract of the United States: 2004-2005", provided by the U.S. Census Bureau, reveals several important features in the summary of mergers and acquisitions that had been completed in the U.S. from 1990 to 2003, as seen in Appendix 1. First, the number of mergers and acquisitions jumped to a new high one year after the promulgation of the *Gramm-Leach-Bliley Act* in 1999. However, unfortunately this information is not specific enough to tell us whether the increased number is directly linked to the changes in the banking sector. And yet, as general as it is, the statistics show that the total number of all activities of mergers and acquisitions spiked to its highest point of 11,169 (in 2000), only one year after the promulgation of the GLBA. In fact, every year after its lowest point of 4,239 (in 1990), the number has increased annually at an ever faster pace, which continued to grow steadily with a total number of 9,634 (in 1998) and then slightly waned by dropping to 9,599 (in 1999). As indicated, the number of mergers and acquisitions reached the highest point in 2000—from this point onwards, it started to drop but still maintained a respectable number of 7,713 in 2001. This number dropped slightly again in 2002, and as recently as in 2003, a satisfactory number of 7,743 mergers and acquisitions went through.

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[6] *Ibid.*

[7] *Supra* note 4 "No Turing Back-Now A Year Old, the *Gramm-Leach-Bliley Act* Has Changed The Industry Forever".

From the same set of statistics provided by the U.S. Census Bureau, the table for "Mergers and Acquisitions by Industry" shows for 2003 that the value created through mergers and acquisitions in "commercial banks, bank holding companies" industry, stood for nearly 14.26% of total value involving mergers and acquisitions (i.e. 65,995 ÷ 462,808). In retrospect, unfortunately, statistics for the years of 1999 and 2000 are not available from the U.S. Census Bureau[8]. It is unclear why statistics for these two most important years following the promulgation of the GLBA are not available. Nevertheless, supplemented by other related statistics, it can be reasonably predicted that following the promulgation of the GLBA in November 1999, the number and value for mergers and acquisitions in the category of "commercial banks, bank holding companies" would dramatically increase, an indication of the industry's embrace of the long-awaited law that had finally been passed by the Congress.

Even though the *Gramm-Leach-Bliley Act* had been credited for raising the profits of the banking sector in the U.S., in a recent issue of *The Economist*[9], it was reported otherwise. That being said, on average for companies around the world, business has enjoyed several strong years. Nonetheless, some pundits also warned that predictably, this profit boom is spawning its own worries. "America, in particular, relies too much on financial firms as a source of profit growth. Since 1982, the profits of financial firms in America have risen from 4% of overall profits to more than 40%. (Neither Europe nor Japan has experienced the same phenomenon.) As a whole, the finance industry makes up nearly one-quarter of America's overall stock market capitalization, up from a bit over 5% in the 1970s. Bill Gross, a bond-market veteran, adds these numbers to soaring consumer debts to arrive at what he calls the 'finance-based economy'—a perilous venture sustained by the Fed's super-low

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[8] See U.S. Census Bureau, "Statistical Abstract of the United States: 2004-2005". Excerpted from which, "No. 741. Mergers and Acquisitions—Summary 1990 to 2003" & "No. 742. Mergers and Acquisitions by Industry: 2003" both constitute as "Appendix 1" to this dissertation. [Author's Note: With helps from both law librarian and government documents librarian at Koerner library, it is confirmed that statistics for "Mergers and Acquisitions by Industry" are unavailable from a few possible sources, including Lexis-Nexus Statistical, ASI (short term for: American Statistics Index) 2000, 2001. Even though available in microfiche form, ASI 2000 9294-5 "Merger Decisions, 1999 Federal Deposit Insurance Corporation, Annual Report 2000", does not record the total number and value for mergers and acquisitions completed in the "commercial bank and bank holding company" industry. Likewise, in microfiche form, in both ASI 2000 8402-3 "Quarterly Journal: Comptroller of the Currency Administrator of National Banks Quarterly. Dec. 1999" and ASI 2001 8402-3 "Quarterly Journal: Comptroller of the Currency Administrator of National Banks Quarterly. Dec. 2000", total number and value for mergers and acquisitions in the banking industry is not seen, either.]

[9] The Economist is a periodical published by a London-based publisher. For the context reference, see The Economist, published on Feb. 12, 2005 vol. 374, Iss. 8413, page 66.

interest rates." What that means is, first and foremost, some cautionary measures should be taken, as this phenomenon may merely be creating an economic bubble. It becomes worse when the bubble bursts, and the threat of a depression hangs over the U.S. economy. This commentary therefore begs the question: have financial holding companies overgrown America? If so, how does this adversely impact on the overall economy of the U.S.? A recent theory titled "Too Big To Fail" can properly answer these questions. The question however is—could the theory of "too big to fail" apply in elucidating the U.S. banking history? And if so, would it be flying in the face of the 'Anti-competition' regime? For details about "too big to fail" and its implications with respect to bank cartels or monopolies, please refer to the "Introduction" chapter at the beginning of this dissertation. Hence, there is no need to repeat it here except to sum up the maturity of the current anti-competition regime, coupled with the nature of banking business (bank business is relationship-focused and professionalism-oriented), 'banking cartel or monopoly' is not likely to occur.

As mentioned in the previous chapter (Chapter Three), the GLBA signifies "re-regulation", rather than "de-regulation" (though it is suggested by most scholars), because the GLBA does not mean total liberalization but rather 'the *scope* of *permissible* financial activities' has been *expanded*'. To better explain this view, in this chapter, Part II provides details as to the statutory definitions for the "expanded" activities, including those that are "financial in nature", or "incidental" or "complementary"; while Part III is devoted to discussing the GLBA's implications on some of the most disputable and controversial non-banking products such as 'merchant banking', 'derivatives' and 'securitization'. Whether or not these financial instruments (stemmed from advanced information technology) are defined under the GLBA's "newly-authorized activities" (i.e. *expanded* activities) has been a great concern for many banking organizations, as they either are currently holding or have been involved with these financial instruments. Another reason is because these relatively new financial instruments are usually of very high market value, though bearing higher risks too. Reportedly, the stake and number directly linked with these financial instruments has increased, over recent years following the GLBA's promulgation in 1999. Faced with this new challenge, the Board, being an umbrella regulator, has issued both an interim rule and final rule for merchant banking, as well as Regulation W for bank-affiliate derivative transactions, to ensure depository

institutions strictly comply with statutory restrictions on these "more volatile" financial instruments, and more importantly, to prevent banks from incurring problematic levels of credit exposure to affiliates in these transactions. The rationale underlying these statutory restrictions is to preserve the integrity of the federal reserve fund; in other words, to prevent member banks from opening federal reserve subsidy access to their affiliates. The interim and final rules for merchant banking were jointly issued by the Treasury and the Board ("Federal Reserve Board"), and the final rule for Regulation W was issued by the Board. To better appreciate the statutory restrictions on these financial instruments, I therefore undertook to examine each of these rules as well as Regulation W. To understand the controversies associated with the permission or non-permission of these financial instruments, I also looked into some congressional records (on 'S. 900', the Senator's bill for GLBA) for senators' debates on these issues in order to gain some perspective.

With new permission comes new supervision. As FHCs are basically permitted to engage in any kind of financial business across all financial sectors (banking, insurance, and securities), in order to ensure a sound regulatory system, the *Gramm-Leach-Bliley Act* also relies on "umbrella supervision" and "functional regulation". What it says here is the Board of Governors of the Federal Reserve System, also known as the Federal Reserve Board ("FRB"), becomes the "umbrella regulator" for all FHCs in the U.S. That is, the FRB has the umbrella supervision of the overall organization to identify and address potential risks to the depository institution associated with the securities and other activities in the organization (i.e. FHC). Therefore, any bank holding company in the U.S. wishing to become an FHC, must first notify the FRB of the company's election, and inform the FRB about its new activities. Also, the *Gramm-Leach-Bliley Act* grants the FRB authority to impose restrictions or requirements on relationships or transactions between a depository institution and any affiliate. The FRB may impose a prudential limitation if the FRB finds that the limitation is appropriate to avoid a significant risk to the safety and soundness of the depository institution or Federal deposit insurance funds, to avoid other adverse effects or to prevent evasions of the banking laws. That being said, the FRB believes that most of the concerns that are raised by the affiliation of a securities firm with a financial holding company are addressed by the requirements of

the *Gramm-Leach-Bliley Act*, other banking laws and regulations, and securities laws and regulations[10].

"Functional regulation" refers to the regulation of similar financial activities by the same financial regulator, for instance, banking by bank regulators (OCC, FRB, and FDIC)[11], securities by the Securities Exchange Commission (SEC), insurance by State Insurance Commissioners, and holding company or affiliate regulators' reliance on that industry specific regulation and supervision[12]. This basically means that in addition to the FRB being the umbrella regulator for an FHC, whose responsibility is to supervise an FHC's overall risk and an FHC's activities that might harm a bank subsidiary; other regulators—such as the Securities and Exchange Commission and state insurance commissioners—will continue to exercise their normal oversight of FHC activities falling within their specific jurisdictions. The *Gramm-Leach-Bliley Act* distinguishes itself by establishing functional regulation for FHCs. Functional regulation is premised on mutual cross-industry reliance and cooperation among the regulators. In view of this, the regulator with the most experience and expertise in an industry will oversee each of the FHC's diverse activities. For instance, a state insurance commissioner will oversee insurance activities; the SEC, the National Association of Securities Dealers ("NASD") and state securities regulators will oversee securities activities. Most importantly, each regulator—including the FRB as the FHC's overall umbrella regulator—will rely on the work of the other functional industry regulators, who Congress presumed to be the most expert in their respective fields[13].

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[10] "Bank Holding Companies and Change in Bank Control; Securities Underwriting, Dealing, and Market-Making Activities of Financial Holding Companies", by Board of Governors of the Federal Reserve System, 12 CFR Part 225, [Regulation Y; Docket No. R-1063].

[11] For National banks, the *Gramm-Leach-Bliley Act* gives the Office of the Comptroller of the Currency (OCC) the authority to regulate transactions and relationships between national banks and their subsidiaries. For State banks, on the other hand, they can be further divided into two categories. For State *Member* Banks, the Federal Reserve Board (FRB) may impose regulations on relationships and transactions between State member banks and their subsidiary. For State *Non-Member* Banks, the power to regulate relationships and transactions between state non-member banks and their subsidiaries is vested in the Federal Deposit Insurance Corp. (FDIC). See K. R. Benson, K. M. Bianco & J. Hamilton, *Financial Services Modernization Gramm-Leach-Bliley Act of 1999 Law and Explanation* (Chicago: CCH Incorporated, 1999) at 43-44.

[12] PricewaterhouseCoopers, "An Executive's Guide to U.S. Financial Modernization", published by PricewaterhouseCoopers in January, 2000, available at [http://www.pwcglobal.com/extweb/indissue.nsf/2e7e9636c6b92859852565e00073d2fd/5f8b28031aa7f4b0852568b200603732/$FILE/final%20exec%20guide-GLBA.pdf] at p. 42.

[13] *Ibid* at 11.

The *Gramm-Leach-Bliley Act* addresses several important features: (1) functional regulation, (2) bank securities activities—as a corollary to functional regulation, banks (as well as U.S. branches and agencies of foreign banks) must "push-out" certain securities activities, which means that banks can not directly engage in securities underwriting but could do so through their subsidiaries. Banks must locate these activities in a broker-dealer or an investment adviser regulated by the SEC. Banks themselves, however, receive new power to underwrite municipal revenue bonds[14]. (3) "Insurance regulation", the *Gramm-Leach-Bliley Act* preserves regulation of the business of insurance by various states, but preempts State laws that would prevent or hamper affiliations between bank and insurance companies[15]. That is to say, the GLBA reaffirms the *McCarran-Ferguson Act*, recognizing the primacy and legal authority of the States to regulate insurance activities of all persons. No persons are permitted to engage in the business of insurance unless they are licensed by the States, as required under State law. However, States are not allowed to prevent certain affiliations or activities or discriminate against depository institutions in providing such insurance licenses.[16]

The colossal *Gramm-Leach-Bliley Act* is a comprehensive and complicated piece of legislation reflecting at least 20 years of work, from both the U.S. government and industry. The enormity of the GLBA can be assessed by examining the impact it puts forth on existing laws. A review of the legislature reveals that the GLBA amends, among other laws: the *Banking Act of 1933 (more specifically Glass-Steagall Act), the Bank Holding Company Act of 1956 (and Bank Holding Company Act Amendments of 1970), The Interstate Banking and Branching Efficiency Act of 1994, the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Securities Act of 1933, the Securities Exchange Act of 1934, the Community Reinvestment Act of 1977, the International Banking Act of 1978, Right to Financial Privacy Act of 1978, Riegle Community Development and Regulatory Improvement Act of 1994, Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, the Federal Reserve Act, the Federal Deposit Insurance Act, the Federal Home Loan*

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[14] *Ibid* at 42.
[15] *Ibid.*
[16] Legislative History, House Conference Report 106-434, at 251.

Bank Act, the National Bank Consolidation and Merger Act, Bank Service Company Act, Electric Fund Transfer Act, Fair Credit Reporting Act, and the Home Owners' Loan Act.[17] As immense as the GLBA is (It covers a wide array of concerns and decisions ranging from "permissible activities", "functional regulation" (and its derivatives: "functional-regulated subsidiary[18]" and "functional regulator"), "customer disclosure", "privacy protection", "community reinvestment", "state and national banks", "bank holding companies", "thrifts", "U.S. branch or agency of foreign banks", "national treatment for foreign banks", etc.) it is however, not my intention to include a comprehensive analysis in my dissertation. Rather than providing an introduction of the GLBA by regurgitating some standard explanations, my focus, however, is on permissible activities granted by the law for new financial holding company structures, their functional regulation, the transformation of bank holding companies to financial holding companies, as well as the aftermath of the GLBA, meaning its impact on U.S. banks (both national and state banks)[19].

Based on such a premise, the most important questions to be answered in this chapter include: what differences does the GLBA make? Does the new change toward deregulation increase the overall operating risk of an FHC compared to a bank holding company with Section 20 Subsidiary, as in the old model before it was replaced by the new GLBA? Furthermore, how does the new law protect the financial conglomerate's best interests?

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[17] See "Table of Statutes Added or Amended" in Benson, Bianco & Hamilton, *supra*, note 11, at 9-13.
[18] "Functionally-regulated subsidiary" refers to a subsidiary within an FHC that is a broker-dealer, investment adviser or investment company regulated by the SEC, or an insurance company regulated by a State Insurance Commissioner, or a company regulated by the Commodity Futures Exchange Commission, with respect to its commodity activities. PricewaterhouseCoopers, *supra*, note 12, at 42.
[19] The U.S. adopts the so-called "dual banking system", meaning that the U.S. banks fall into either one of the two categories: (1) state banks; (2) national banks. In a brief history of U.S. financial service industry regulation, one commentator points out that "Promulgated at the height of the Civil War, the National Bank Act of 1863 created the dual bank regulation system that is particular to America and is still prevalent today. Under this dual system, banks may choose to be state-chartered banks or federally-chartered national banks. One of the primary factors considered when deciding between a state or national charter is the difference between regulating bodies. Nationally chartered banks fall under the regulatory aegis of the Office of the Comptroller of the Currency, a division of the Department of Treasury. State banks are primarily regulated by the regulating bodies in their respective states, and can be subjected to federal regulation by electing to become a member of the Federal Reserve System or by insuring deposits through the Federal Deposit Insurance Corporation. Though the emergence of state wild card statutes and federal preemption has had a smoothing effect on the differences between federal and state banking charters, the dual banking system remains an integral part of the U.S. banking system." See P. J. Burke, "Should Banks be Permitted to Engage in Real Estate Brokerage and Management Services?: How the Current Debate Demonstrates the Inadequacies of the Gramm-Leach-Bliley Act", 50 Cleveland State Law Review 103 at 105.

I conclude that first, GLBA marks a watershed change in nearly seven decades by eliminating the Depression-era limitations on financial consolidation that strictly separated the insurance, banking, and securities industries from merging. Under the new GLBA, commercial banks are now permitted to affiliate with securities dealers, insurers, mutual funds, and advising firms whose activities are "financial in nature, incidental or even complementary to financial activities", as opposed to Depression-era limits where permissible activities are strictly limited to those that are "closely related to banking". By doing so, benefits of achieving economies of scale and scope, such as cross-marketing, sharing client information, and revenue enhancement, can be attained by newly formed financial conglomerates. Other advantages also include the ability to acquire much-needed technology and to renovate systematic banking networks and ATM machines, as well as management skill training. For example, commercial banks have long been restricted to only providing traditional banking services, and they have been usually less well attuned to the modernization of advanced technologies and management skills. Secondly, the new change toward deregulation does not necessarily result in increased operating risk due to the effect of "re-regulation" imposed by the financial holding companies' umbrella regulator (the Federal Reserve Board). Thirdly, the Board has, through administrative interpretations and court decisions, established rules to identify circumstances where the Board would interfere with financial holding companies' decision-making or actions, by commanding corrective changes from these institutions' excessive risk-taking. Now with transparency and accountability in place, the new GLBA protects the financial conglomerates' best interests by only exercising "minimum regulatory power" over them, as a result of financial and regulatory liberation.

II. "Re-regulation" and "De-segmentation" As a Result of GLBA

"Re-regulation", as prototypically manifested by the GLBA, was described in Chapter Three as a more correct term to depict GLBA rather than "deregulation", as the GLBA does not mean total liberalization. The GLBA expands the scope of "permissible financial activities" and crosses into all three segments of financial

industries ("de-segmentation"). More specifically, the GLBA blurs the previous segmentation between banking and non-banking sectors, which is arguably the most distinctive feature of the U.S. financial services industry in the post-GLBA era.

As it stands now, the GLBA's newly-authorized activities (i.e. expanded financial activities 'permissible' by GLBA) would typically allow a financial holding company ("FHC") to engage in *any type* of *financial activity* that was permissible for a bank holding company to engage in before the enactment of the GLBA, plus, certain *non-financial activities* (subject to statutory restrictions).

GLBA sets forth the types of new activities that are *PERMISSIBLE* for an *FHC*; these new activities now include:

(i) All Securities Underwriting and Dealing Activities,
(ii) All Insurance Underwriting and Sales Activities,
(iii) Merchant Banking/Equity Investment Activities,
(iv) Future "Financial in Nature" and Incidental Activities (as determined by both the Board of the Federal Reserve and the Secretary of the Treasury), and
(v) "Complementary" Non-Financial Activities[20]

Emphasis needs to be made that the above noted newly-authorized activities for an '*FHC*' are different than those permissible for '*Financial Subsidiaries*'.

In general, the GLBA permits *Financial Subsidiaries* (of national banks) to engage in any of the newly-authorized activities for FHCs, including those that the Board of Federal Reserve ("FRB") determines to be financial in nature for FHCs or incidental to such financial activities. However, a financial subsidiary may *NOT* engage in the following activities:

(i) insurance and annuities underwriting,
(ii) insurance company portfolio investments,

[20] Covington & Burling, Financial Modernization: The Gramm-Leach-Bliley Act Summary, American Bankers Association, 1999 (See Executive Summary) at pp. 10-11.

(iii) real estate development and investment,

(iv) merchant banking (until 2004, at the earliest, and then only with the joint approval of the FRB and the Treasury Secretary), and

(v) complementary (non-financial) activities[21].

In consideration of the dual banking system in the U.S., the GLBA makes it clear that a state bank is permitted to establish a financial subsidiary as well as to own or invest in one. Commentators have pointed out that "many state banks have such authority already, and many will obtain such authority through their state 'wild card' statutes because of the newly-authorized authority for national banks to own such subsidiaries. 'Wild card' statutes allow state banks to engage in activities authorized for national banks to ensure *competitive equity* (emphasis added) between the two types of charters."[22] The GLBA imposes federal conditions on the ownership of a financial subsidiary by state banks that are similar but not identical to the conditions imposed on a national bank's ownership of a financial subsidiary. For example, like a national bank, a state bank is also subject to the "well-capitalized", CRA rating (satisfactory or better), and safety and soundness firewall requirements; however, a state bank is not subject to the "well-managed" and the investment-grade debt rating requirements that otherwise would apply to a national bank[23].

In juxtaposition of the respective "permissible financial activities" for 'FHCs' and 'Financial Subsidiaries (of banks)', the most important difference is that the financial subsidiary is prohibited by the GLBA to engage in certain financial activities as "principal" that are otherwise permitted for an FHC. That is to say, in general, a financial subsidiary (of a bank) can engage in "any of the [GLBA's] newly-authorized activities for FHCs, including *all* financial activities as agent (such as insurance sales) and some financial activities as principal (such as securities underwriting)."[24] However, a bank's financial subsidiary cannot engage in any of the five types of activities as stated above. It is important to note the difference as the

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[21] *Ibid* at 10. See also Arthur E. Wilmarth, Jr., "POINT-COUNTERPOINT: FEDERAL PREEMPTION: The OCC's Preemption Rules Exceed the Agency's Authority and Present a Serious Threat to the Dual Banking System and Consumer Protection" (2004) 23 Ann. Rev. Banking & Fin. L. 225 at 277 (original note# 203).
[22] Covington & Burling, *supra*, note 20, at 8-9.
[23] *Ibid* at 9.
[24] *Ibid* at 10.

GLBA, which amends Section (4) of the *Bank Holding Company Act of 1956*, actually permits existing bank holding companies (that do not elect to become FHCs or do not meet the requirements for becoming FHCs) to engage in certain newly-authorized activities through the financial subsidiary of its holding banks. Beyond that flexibility, if existing bank holding companies wish to engage in all-round newly-authorized activities by GLBA, they must conform by transforming themselves into FHCs by meeting certain extra requirements, such as being "well-capitalized", "well-managed", obtaining a CRA (Community Reinvestment Act) rating (satisfactory or better), and providing adequate privacy protection (of customers' non-public personal information), etc.

The term "well-capitalized", provided in Section 121 (g)(5) of the GLBA, has the meaning given the term in Section 38 of the *Federal Deposit Insurance Act.*

The term "well-managed", as set out in Section 121 (g)(6) of the GLBA, otherwise involves certain technical criteria in composite ratings assessment:

> "(A) in the case of a depository institution that has been examined, unless otherwise determined in writing by the appropriate Federal banking agency, ["well-managed" is given the meaning of]
>
> (i) the achievement of a composite rating of 1 or 2 under the Uniform Financial Institutions Rating System (or an equivalent rating under an equivalent rating system) in connection with the most recent examination or subsequent review of the depository institution; and
>
> (ii) at least a rating of 2 for management, if such rating is given; or
>
> (B) in the case of any depository institution that has not been examined, the existence and use of managerial resources that the appropriate Federal banking agency determines are satisfactory."[25]

But what are "permissible financial activities"? Though the meaning according to the GLBA is "activities that are financial in nature, incidental, or complementary to such financial activities", in actual implementation, this statutory definition is not complete unto itself and we have to look elsewhere for assistance in

[25] United States Public Laws, P.L. (106-102) (S.900), November 12, 1999, Gramm-Leach-Bliley Financial Modernization Act.

interpretation. Section 103 (3) of the GLBA provides a few *guidelines* on "factors to be considered in determining whether an activity is financial in nature or incidental to a financial activity". Such guidelines are actually construed by referring to themselves as an amendment (by adding new subsections) to Section (4) of the *Bank Holding Company Act* ("BHCA"). Citing the prescribed provisions:

> Section 103 (3) FACTORS TO BE CONSIDERED—In determining whether an activity is financial in nature or incidental to a financial activity, the Board (i.e. FRB) shall take into account--
>
> (A) the purpose of this Act (BHCA) and the Gramm-Leach-Bliley Act;
>
> (B) changes or reasonably expected changes in the marketplace in which financial holding companies compete;
>
> (C) changes or reasonably expected changes in the technology for delivering financial services; and
>
> (D) whether such activity is necessary or appropriate to allow a financial holding company and the affiliates of a financial holding company to--
>
> (i) compete effectively with any company seeking to provide financial services in the United States;
>
> (ii) efficiently deliver information and services that are financial in nature through the use of technological means, including any application necessary to protect the security or efficacy of systems for the transmission of data or financial transactions; and
>
> (iii) offer customers any available or emerging technological means for using financial services or for the document imaging of data.

The 'regulatory definitions' are thus vague at best and so, with large stakes at hand, many financial institutions have been striving to find other 'interpretation issues' (by the Fed, OCC, or SEC etc.) that could shed some light on whether their certain undertakings are permissible by the GLBA or not. Of particular concern by most financial institutions is whether "merchant banking", "securitization", and "derivatives" are considered permissible financial activities by GLBA. I will expound upon this further below, following the regulatory examples subscribed to a fairly broad term like "permissible financial activities", capped under which are three other subcategorical definitional terms: activities that are "financial in nature", "incidental", or "complementary" to such financial activities.

1. "Financial in Nature" and "Incidental" Financial Activities

Although the GLBA, in Section 103 (4), expressly spells out what activities are statutorily defined as "financial in nature" for an FHC, commentary further points out that the prerequisite for becoming an FHC is "control of an FDIC-insured bank", or in the case of a foreign FHC, "control of a U.S. branch or agency of a foreign bank"[26].

The GLBA permits most companies that meet the statutory requirements ("well-capitalized", "well-managed", and "satisfactory or better Community Reinvestment Act (CRA) rating" to become FHCs for engaging a broader array of activities that the Fed determines to be "financial in nature" or "incidental" or "complementary" to such financial activities. In this regard, it is essential to find out first what activities are "financial in nature".

(1.1) Statutory Definition/Examples for "Financial in Nature"

The GLBA expressly declares, through Section 103(4), that the following activities are "financial in nature"[27]:

(i) Lending, exchanging, transferring, investing for others, or safeguarding money or securities;
(ii) Underwriting, dealing, and making markets in securities;
(iii) Insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability or death, as principal or broker;
(iv) Issuing or selling annuities;
(v) Providing financial or investment advisory services to individuals, businesses, and mutual funds;
(vi) Issuing or selling instruments representing interests in pools of assets that a bank could own;

[26] PricewaterhouseCoopers, *supra* note 12.
[27] *Ibid* (at p. 3).

(vii) Owning through a securities affiliate shares or assets acquired as part of underwriting or merchant banking activities;

(viii) Owning through an insurance company shares or assets acquired as an investment in the ordinary course of business;

(ix) Engaging in any activity permitted to a bank holding company on November 11, 1999 (that is one day prior to the GLBA's promulgation) (i.e. referring to those financial activities already permitted by BHCA prior to GLBA); and

(x) Engaging in the United States in any activity permitted to a U.S. bank holding company outside the U.S..

(1.2) The GLBA Authorizes the Fed to Determine, in Consultation with the Treasury, What is "Financial in Nature" or "Incidental" thereto

At another level, through Section 103(a), the GLBA further grants the Fed the authority to add to this list what it determines to be financial in nature, either by general regulation or by decisions on a specific application. In doing so, Section 103(a)(k)(2) requires coordination between the Board (the Board of Governors of the Federal Reserve System) and the Secretary of the Treasury. The Secretary of the Treasury may veto the addition of any activity—Section 103(a)(k)(2) provides that:

> "[t]he Board shall not determine that any activity is financial in nature or incidental to a financial activity under this subsection if the Secretary of the Treasury notifies the Board in writing, not later than 30 days after the date of receipt of the notice described in clause (i) (or such longer period as the Board determines to be appropriate under the circumstances) that the Secretary of the Treasury believes that the activity is not financial in nature or incidental to a financial activity or is not otherwise permissible under this section."

Likewise, in the same provision (Section 103(a)(k)(2)), it further prescribes that the Treasury may, at any time, recommend to the Board, in writing, that the Board find an activity to be financial in nature or incidental to a financial activity. In

this case, the Board should make a decision whether to stage a public hearing for rulemaking within a prescribed time period. That is, in Section 103(a)(k)(2):

> "Not later than 30 days after the date of receipt of a written recommendation from the Secretary of the Treasury under clause (i) (or such longer period as the Secretary of the Treasury and the Board determine to be appropriate under the circumstances), the Board shall determine whether to initiate a public rulemaking proposing that the recommended activity be found to be financial in nature or incidental to a financial activity under this subsection, and shall notify the Secretary of the Treasury in writing of the determination of the Board, and, if the Board determines not to seek public comment on the proposal, the reasons for that determination."

The Secretary of the Treasury has the right (provided by the GLBA) to veto any Board's determination that a new activity is "financial in nature or incidental to such activity". Likewise, the Board has the right to veto any similar determination made by the Treasury that a new activity to be engaged in by a financial subsidiary of a bank is "financial in nature or incidental to such activity"[28]. This has most to do with the fact that while the Treasury is a bank regulator, the Board is nonetheless the "umbrella regulator" for the entire FHC (including the FHC's bank subsidiary).

(1.3) Factors to be Considered

In addition to the statutorily-illustrated examples as listed above, the Board has broad discretion to determine whether any other types of activities are "financial in nature" or "incidental" to such financial activities. The GLBA, in Section 103(3), otherwise directs the Board to take into account the following factors, while making the decision:

(i) the purpose of the BHCA and the GLBA;

(ii) changes or reasonably expected changes in the marketplace in which financial holding companies compete;

[28] Covington & Burling, *supra* note 20, at 20.

(iii) changes or reasonably expected changes in the technology for delivering financial services; and

(iv) whether such activity is necessary or appropriate to allow a financial holding company and the affiliates or a financial holding company to--

(iv-i) compete effectively with any company seeking to provide financial services in the United States;

(iv-ii) efficiently deliver information and services that are financial in nature through the use of technological means, including any application necessary to protect the security or efficacy of systems for the transmission of data or financial transactions; and

(iv-iii) offer customers any available or emerging technological means for using financial services or for the document imaging of data.

A report by American Bankers Association further suggested that some of these factors appear to "encourage the agency [the Board] to be especially flexible regarding the ability of an FHC to engage in new financial 'e-commerce' activities."[29] Of note are those which enable an FHC to "use changes or reasonably expected changes in the technology for delivering financial services", or to "offer customers any available or emerging technological means for using financial services or for the document imaging of data".

(1.4) Regulation Y

Worth noting, as part of an ongoing process to provide regulatory interpretations in question, the Fed continues to add to the list of "Regulation Y", which is a separate bill to implement provisions relevant to Section (4) of the BHCA and Section 103(4) of the GLBA where separate authorities for financial activities are defined. For details about Regulation Y, please refer to Chapter Three of this dissertation.

[29] *Ibid* at 19.

2. What is "Complementary" to Financial Activities?

In addition to the newly-authorized financial activities described above, the GLBA also authorizes an FHC to engage in certain "non-financial activities". As prescribed in Section 103(a)(k)(1)(B) of the GLBA, an FHC may engage in a non-financial activity, or acquire or retain shares in a company engaged in a non-financial activity, if the Fed determines, either by (later issued) regulation or order, that the activity (i) is "complementary" to a financial activity; and (ii) does not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally. A classic example for the Fed's authorization for an FHC to conduct traditionally defined "non-financial activities" is "derivatives", through the Fed's issuance of "Regulation W". I will expound upon this further below.

For further clarification, a report by PricewaterhouseCoopers suggested that, in determining whether or not an activity is 'complementary to financial' activity, "the Fed must determine only that the complementary activity poses no substantial risk to the safety and soundness of depository institutions or the financial system. The Fed otherwise appears free to find any non-financial activity to be complementary."[30] In this regard, compared to the other process where the Board needs to approve new financial activities, in response to any request, proposal, or application under this subsection (Section 103(a)(k)(2) of GLBA), the same report suggested that the "GLBA does not require the Fed to consult the Secretary of the Treasury or anyone else before deciding that an activity is complementary."[31]

[30] PricewaterhouseCoopers, *supra*, note 12, at 4.
[31] *Ibid.*

III. GLBA-Authorized Expanded "Permissible Financial Activities", Subject to Statutory Restrictions and Bank Regulators' Interpretations

1. Merchant Banking

What is 'merchant banking'? As suggested by one commentator, the term 'merchant banking' derives from the practices of early European financial intermediaries and was later formalized in the 19th century by the formal establishment of so-called merchant banks[32]. Merchant banks (European financial institutions) are cited to have engaged in "investment banking, counseling, and negotiating in mergers and acquisitions, and a variety of other services, including securities portfolio management for customers, insurance, the acceptance of foreign bills of exchange, dealing in bullion, and participating in commercial ventures."[33] Merchant banking has embedded itself in commerce, securities underwriting, and equity shares and assets investment. In the words of former chairman of the Federal Reserve (Alan Greenspan), merchant banking is defined as "financial equity investment in non-financial firms, most often, but not always, in non-public companies, with the investor providing both capital and financial expertise to the portfolio company."[34] Merchant banking involves a higher risk than commercial banking does. This may explain why prior to the GLBA's financial liberalization, which consolidates merchant banking into one of its newly-authorized activities for FHCs, banking organizations were left to make "indirect investment in equities through private investment groups, occasionally acting as manager of the group for performance-based fees"[35]. Alternatively, banking organizations also had the authority to "directly invest in equities via non-banking subsidiaries under the *Bank Holding Company Act*"[36]. Commentators have remarked that "in addition to the

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[32] Ashley D. Fluhme, "NOTES & COMMENTS: I. CAPITAL REQUIREMENTS Capital Requirements For Merchant Banking" (2001) 5 N. C. Banking Inst. (North Carolina Banking Institute) 265 at 268.
[33] John Downes & Jordan Elliot Goodman, *Dictionary of Finance and Investment Terms*, 5th ed. (Hauppauge: Barron's, 1998) at 357.
[34] Fluhme, *supra*, note 32, at 268-269.
[35] *Ibid* at 271.
[36] *Ibid.*

newly-authorized securities and insurance activities, perhaps the most significant new activity authorized by the [GLBA] is 'merchant banking' or equity investment power."[37]

Merchant banking is considered more volatile and carrying a higher risk because it often (but not always) involves securities underwriting in the private equity market. Before the enactment of the GLBA, a banking organization was "substantially limited in its ability to make an equity investment, including a 'controlling' equity investment in any company engaged in activities that were not 'closely related to banking'. At the same time, a securities or insurance firm was free to make such a 'merchant banking' or 'private equity' investment in virtually any kind of financial or non-financial company."[38] Due to such competitive inequities, during the enactment of the GLBA, many banking groups were lobbying vehemently for Congress to consolidate merchant banking into the GLBA's newly-authorized activities. They did so not only for the sake of 'competitive equity' but also because merchant banking could be highly profitable. In fact such activity has grown very quickly in both its book of business and its risk and profile. Therefore, banks do not want to forfeit the possibility of benefiting from the merchant banking business. Citing statistics from a recent banking report, "[a]s of year-end 1999, the private equity market represented over [US$] 400 billion in assets under management. The financing of new firms via equity, or the venture capital component, had outstanding capital of at least $ 125 billion. Venture capital financing focuses on seed capital for the creation of new companies or the addition of equity needed for the continuation or growth of small firms. The non-venture private equity sector, the equity financing or middle-market firms and leveraged buyouts, is a much larger share of the merchant banking market, with outstanding capital of about $ 275 billion."[39]

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[37] Covington & Burling, *supra*, note 20, at 16.
[38] *Ibid.*
[39] Fluhme, *supra*, note 32, at 269.

(1.1) GLBA Grants FHCs Merchant Banking Authority (Subject to Five Conditions)

The GLBA substantially expands the authority of a banking organization to "make a 'controlling' equity investment in any kind of company, including a non-financial company."[40] The GLBA, in Section 103 (a)[41], authorizes financial holding companies ("FHCs") to acquire or control "shares, assets, or ownership interests of any non-financial company as part of a *bona fide* underwriting, or merchant or investment banking activity."[42] Furthermore, merchant banking authority is codified in Section (k)(4)(H) of the *Bank Holding Company Act* ("BHCA")[43]. Merchant banking is a newly-authorized activity granted by the GLBA. Technically speaking, the GLBA allows for FHCs 'greater investment interest' than bank holding companies were allowed for under the BHCA, in terms of "the scope of permissible investment activity". "Prior to the GLBA, a bank holding company's (BHC) investments in non-banking companies were limited to permissible investments under Section 4(c)(6) of the BHCA, which permitted investments in up to 5 percent of the outstanding shares of any class of voting securities and up to 25 percent of the total equity of a company, provided the BHC did not 'control' the company within the meaning of the BHCA."[44]

Building on the provisions of the BHCA, the GLBA, in Section 103 (4)(H), provides that an FHC may, directly or indirectly (whether as principal or on behalf of one or more 'entities') invest in shares, assets, or ownership interests of a company or

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[40] Covington & Burling, *supra*, note 20, at 16.
[41] Section 103 (a) of GLBA is encoded in 113 Stat. at 1344.
[42] 66 FR 8993, Federal Register, Vol. 66, No. 24 (at p. 8996). 66 FR 8993 records the notices issued by the Office of the Comptroller of the Currency ("OCC"). According to the "Summary" in 66 FR 8993 report, "the OCC has prepared this report as required by the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). FDICIA requires the OCC to provide a report to Congress on any differences in capital standards among the federal financial regulatory agencies. This notice is intended to satisfy the FDICIA requirement that the report be published in the Federal Register."
[43] 12 U.S.C. 1843 (k)(4)(H).
[44] Jonathan Filas, "Detailed Analysis of Final Merchant Banking Rule" (2001) Vol. 20 No. 3 Banking & Financial Services Policy Report (Part I) at p. 10. [Hereafter "Part I"] According to the same commentator, "BHCs could also make investments in non-banking companies through a small business investment company (SBIC) (which permits greater investment than under Section 4(c)(6) and could make certain investments outside the United States under Section 4(c)(9) and Section 4(c)(13) of the BHCA. In addition, a non-US bank could make certain equity investments outside the United States and certain investments in non-US companies with US operations under Section 2(h)(2) or Section 4(c)(9) of the BHCA. While these options remain available for BHCs and for FHCs (and non-US banks), the merchant banking authority under the GLBA provides a broader option for equity investment by an FHC."

other entity (whether or not constituting control of such company) engaged in activity not authorized pursuant to Section 4(c)(k) of the BHCA, but subject to a few restrictions[45] (i.e. five conditions as set out below). Respective definitions for "entities" and "ownership interests" are described in greater detail in Section 103 (4)(H) of the GLBA. Specifically, the 'entities' that an FHC may act on behalf of include entities (other than a depository institution or a subsidiary thereof) that the BHC controls, so as to prevent the spread of investment risks from non-financial companies. "Ownership of interests" otherwise includes debt or equity securities, partnership interests, trust certificates, or other instruments representing ownership. Worth noting now even after the establishment of the GLBA (i.e. in the post-GLBA era), is that bank holding companies that do not elect to become FHCs, are still circumscribed in their investments in non-financial companies which remain subject to Section 4(c)(k) of the BHCA (which is amended by GLBA). However, judging by the expanded scope of permissible investments as set forth under Section 103 (4)(H) of GLBA, it is clear that the merchant banking authority under the GLBA provides a broader option for equity investment by an FHC.

Upon the GLBA's enactment in 1999, FHCs were authorized to engage in virtually any kind of activity including merchant banking. The same privilege, however, did not extend to the financial subsidiary of a bank (at least for the first five years after the enactment of the GLBA, and even until 2004, the ban can only be lifted if the Federal Reserve and the Treasury both agree.) Specifically, Section 103 (7) of the GLBA provides both the Federal Reserve and the Treasury with broad discretion to jointly issue regulations regarding the merchant banking provision. These two banking authorities are expected to issue implementation rules for facilitating FHCs' merchant banking activities if they "deem appropriate to assure compliance with the purposes and prevent evasion of [both the BHCA and GLBA] and to protect depository institutions". Commentators have indicated that these regulations may even be "issued before [GLBA's effective date (March 11, 2000)]. As a result, the actual scope of an FHC's merchant banking authority will depend very much on regulations that interpret the provision's exceptionally broad and vague

[45] *Ibid* (Jonathan Filas, "Detailed Analysis of Final Merchant Banking Rule").

terms"[46]. It has been suggested that an FHC may make a controlling investment in the shares, assets, or ownership interests of any equity, subject to five conditions:

(i) The investment is not made by a depository institution subsidiary of the FHC, or by a subsidiary of a depository institution.

(ii) The FHC owns a "securities affiliate." But the investment need not be made by that securities affiliate. (How it would work is that for an FHC without a securities affiliate, it can still engage in the newly-authorized equity investment if it owns a registered investment adviser that is affiliated with an insurance company and provides investment advice to an insurance company.)

(iii) The investment is made as part of a "*bona fide*" underwriting or merchant or investment banking activity, including investment activities engaged in for the purpose of appreciation and ultimate resale or disposition of the investment.

(iv) The investment is "held for a period of time to enable the sale or disposition thereof on a reasonable basis consistent with the financial viability of the [*bona fide* underwriting or merchant or investment banking activity."]

(v) The FHC does not "routinely manage or operate" the entity in which the investment is made, "except as may be required to obtain a reasonable return on investment upon sale or disposition."[47]

These vaguely-worded five conditions, excerpted from a report by the American Bankers Association (prepared by Covington & Burling, a Washington law firm), may have just created enough confusion to substantially impede domestic FHCs' ability to fully comply with the GLBA. Without legal certainty, of 600 U.S. FHCs at the end of 2002, reportedly less than 1/3 of them have actually engaged in any new activities authorized under the GLBA. Furthermore, of these 600 domestic FHCs in the U.S., only about 20 said they held significant merchant banking assets authorized under the GLBA[48]. In this light, in order to take advantage of the GLBA's

[46] Covington & Burling, *supra*, note 20, at 17.
[47] *Ibid* at 16-17.
[48] Jonathan B. Engel, "Developments in Banking and Financial Law: 2003: XV. Merchant Banking

newly-authorized activity, domestic FHCs would otherwise need to rely on the Federal Reserve's issuance of regulatory implementation rules on the new Section 4(K) of the *Bank Holding Company Act*, of which the merchant banking provision is a part. This is especially true after the GLBA came into effect on March 11, 2000. It can be reasonably assumed that once a clearer set of guidelines are in place, there would be more FHCs wanting to take advantage of this newly-authorized authority for merchant banking equity underwriting.

(1.2) 'Interim Rule' and 'Final Rule' for Merchant Banking

The Federal Reserve and the Treasury were mandated by Section 103 (7) of the GLBA to jointly implement regulations for governing merchant banking activities of financial holding companies ("FHCs"). The Board of Governors of the Federal Reserve System and the Secretary of the Treasury (collectively "the Bank Regulators") first issued the 'Interim Rule' and later the 'Final Rule'. Technically speaking, the Interim Rule consists of three parts: Part I (65 FR 15053[49]), Part II (65 FR 16460[50]), and Part III (65 FR 16302[51]). The Final Rule also consists of three parts: Part I (65 FR 80735[52]), Part II (66 FR 8466[53]), and Part III (67 FR 76560[54]). While all these rules were issued to provide legal certainty, technically speaking, the final rule is "the culmination of analysis of an Interim Rule promulgated in March 2002"[55].

The Interim Rule was issued for public comments on the established procedures for bank holding companies and foreign banks that operate a branch, agency, or commercial lending company in the U.S. to elect to become FHCs. The rule was promulgated on an interim basis to implement provisions of the then recently enacted GLBA; its purpose was to enable bank holding companies and foreign banks

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Developments" (2004) 23 Ann. Rev. Banking & Fin. L. 179 at 185. The author made this report citing Vice Chairman of the Federal Reserve, Roger W. Ferguson, Jr., who made his remarks at the Future of Financial Services Conference (Oct. 8, 2003). Remarks available at [http://www.federalreserve.gov/boarddocs/speeches/2003/200310082/default.htm].

[49] 65 FR 15053, Federal Register, Vol. 65, No. 55.

[50] 65 FR 16460, Federal Register, Vol. 65, No. 60.

[51] 65 FR 16302, Federal Register, Vol. 65, No. 60.

[52] 65 FR 80735, Federal Register, Vol. 65, No. 247.

[53] 66 FR 8466, Federal Register, Vol. 66, No. 21.

[54] 67 FR 76560, Federal Register, Vol. 67, No. 239.

[55] Filas, *supra*, note 44 at 10.

that meet applicable statutory requirements ("well-managed", "well-capitalized", and "satisfactory or better Community Reinvestment Act rating") to successfully become FHCs and thereby engage in a broader range of financial and other activities that are permissible for bank holding companies[56]. The interim rule set some standards in order to confirm that the election (by banking holding companies or foreign banks) to become an FHC was effective. Worth noting is that Part II of the Interim Rule was issued with request for public comments on a rule that will govern merchant banking investments made by FHCs.

The Final Rule, jointly adopted by the Federal Reserve Board and the Treasury, implements provisions of the GLBA that permit FHCs to make investments as part of a *bona fide* securities underwriting or merchant or investment banking activity. The Board and the Treasury incorporated a number of amendments to the final rule to address issues reflected by public comments, to reduce potential regulatory burdens, and to clarify the application of the rule.

The Final Rule set out some standards for governing an FHC's newly-authorized merchant banking activity:

(i) *Bona Fide Requirement*: the Final Rule retains the Interim Rule's "*bona fide*" requirement imposed to prevent the merchant banking authority from being used to make strategic investments or other types of investments that are not permitted under the *Bank Holding Company Act* ("BHCA"). "As the Interim Rule, the preamble to the Final Rule emphasizes that the Bank Regulators recognize the importance of the good faith requirement in preserving the GLBA's fundamental purpose of maintaining the separation between banking and commerce."[57]

(ii) *Types of Ownership Interests that May be Acquired*: Both the Interim and Final Rules deferred to the BHCA's delineation of the types of investments permitted for FHCs. As it set out in both rules, merchant banking investments include "the full range of ownership interests,

[56] See "Summary" of 65 FR 15053, Federal Register, Vol. 65, No. 55.
[57] Filas, *supra*, note 44 at 10.

including securities, warrants, options, partnership interests, trust certificates, and other instruments representing an ownership interest in a company, whether the interest is voting or nonvoting. They also include any instrument convertible into a security or other ownership interest. In addition, the merchant banking investment may be in any amount of ownership interest of a portfolio company, whether or not such investment would constitute control of such company under the BHCA."[58]

(iii) *Maintaining Portfolio of Investments Purpose*: The Bank Regulators concluded that an FHC and any subsidiary (other than a depository institution or subsidiary of a depository institution) may make 'merchant banking investments' in a company or other entity that is engaged in any activity that is not financial in nature or incidental to a financial activity or otherwise permissible for an FHC to conduct under Section 4 of the BHCA. The types of the above-mentioned 'merchant banking investments', such as 'shares, assets or other ownership interests' in a company or an entity (whether or not is controlled by the FHC) must be 'part of a diversified portfolio of investments' by the FHC in connection with its merchant banking business and in accordance with the other restrictions in the rule.

(iv) *Limitations on Managing or Operating a Portfolio Company*: Although an FHC and any non-depository subsidiary can acquire merchant banking companies as part of its portfolio investments, the Bank Regulators nonetheless imposed a restriction that the FHC may *not* routinely manage or operate any portfolio company. By extension, an FHC may also not routinely manage or operate any portfolio company that is part of a private equity fund, in which it has direct or indirect interest, and any portfolio company held by any company in which the FHC has an ownership interest, subject to limited exceptions. The Final Rule further clarifies the elements and divisions between "investment funds" and "private equity funds" and continues to permit

[58] *Ibid.*

director interlocks with companies in which merchant banking interests are held.

(v) *Securities (and Insurance) Affiliate Requirement*: The Bank Regulators "reiterated the GLBA's securities affiliate language as one of the two prerequisites to FHC status, the other being an insurance affiliate with an investment adviser affiliate."[59] This requirement corresponds to the same concerns of "covered transactions" in derivatives found in Regulation W that is used to implement provisions in both Sections 23A and 23B of the *Federal Reserve Act.* The Interim Rule provided that an FHC and any subsidiary (other than a depository institution or subsidiary of a depository institution) may make merchant banking investments if the FHC (i) controls any registered securities broker or dealer, or (ii) controls both an insurance underwriter and a registered investment adviser that provides investment advice to the insurance company. The Final Rule retained the Interim Rule's requirement that an FHC control both an insurance underwriter and a registered investment adviser that provides investment advice to the insurance company. Building upon it, the Final Rule however augmented the Interim Rule's broker or dealer language with 'municipal securities dealers', including "any separately identifiable department or division of a bank that is registered with the Securities and Exchange Commission (SEC) as a municipal securities dealer."[60] Although, as one commentator has noticed, "[i]t is clear that merchant banking investments are not restricted to only the securities affiliates or an investment adviser to an insurance company. A qualifying FHC and any subsidiary (other than a depository subsidiary or a subsidiary thereof) may acquire or control merchant banking investments."[61]

(vi) *Procedures for Engaging in Merchant Banking Investments (under BHCA authority)*: The GLBA, in Section 103 (6), has clearly set out the notification requirement that an FHC that "acquires any company or commences any activity pursuant to this subsection shall provide

[59] *Ibid.*
[60] *Ibid.*
[61] *Ibid.*

written notice to the Board describing the activity commenced or conducted by the company acquired not later than 30 calendar days after commencing the activity or consummating the acquisition, as the case may be." The same subsection also prescribes that unless otherwise as provided in subsection (j) with regard to the acquisition of a savings association, an FHC may commence any activity, or acquire any company, without prior approval of the Board. As this procedural requirement has been laid out by the GLBA, the Final Rule deferred to the GLBA for such "post-transaction notice procedures" but further added that "the FHC must file a notice with the Fed for each merchant banking investment that represents more than 5 percent of the target's voting shares, assets, or ownership interests, and the cost of which exceeds the lesser of 5 percent of the Tier 1 Capital of the FHC or $ 200 million. Moreover, in response to reaction to the Interim Rule, the Fed amended Regulation Y's general notice requirements to provide that additional notice is not required when further activity is commenced through any other authorized subsidiary of an FHC as to the particular target. The Fed has retained the authority to require notice in individual circumstances."[62]

The "permissible investment activities" for FHCs are stipulated in both Section 4 of the BHCA and Section 103 of the GLBA. That is to say "FHCs have separate authority under the BHCA to make investments in companies engaged in financial activities. The GLBA does not restrict the authority of FHCs to acquire or control ownership interests in companies engaged in financial activities. Rather, it authorizes FHCs to make investments in companies that would otherwise be prohibited. Together these sets of authorities allow FHCs, without prior approval in most cases, to acquire ownership interests in any type of company other than a depository institution."[63] This reassurance however is questioned by commentators (to the Interim Rule) as to the implication for the underlying *bona fide* investment portfolio requirement, saying that "[t]he Bank Regulators intended to discourage or

[62] Jonathan Filas, "Detailed Analysis of Final Merchant Banking Rule, Part II" (2001) Vol. 20, No. 4 Banking & Financial Services Policy Report, at 11. [hereafter "Part II"]
[63] Filas, *supra* note 44 [Part I].

prohibit FHCs from making merchant banking investments in companies engaged in real estate investment or development"[64]. The commentator's concerns stemmed from the preamble to the Final Rule stating "the good faith requirement is intended to distinguish merchant banking investments from strategic or other types of investments that are not permitted under the BHCA or the GLBA, such as the purchase of a commercial company or a real estate project, made for the purpose of engaging in a commercial or other non-financial activity."[65]

In response to the commentator's concern about the Final Rule, the Bank Regulators explained that "the good faith requirement does not prevent the acquisition of an interest in a company engaged in real estate development as part of a diversified portfolio of investments by the FHC in connection with its merchant banking business and in accordance with the other restrictions in the rule. .... [The Bank Regulators stressed that] in considering whether investments meet the Rule's good faith requirement, the Fed will consider all the relevant facts and circumstances surrounding the investment, including the documented purpose for making the investment and overall relationship with the portfolio company. The Bank Regulators concluded that the good faith requirement does not prohibit an FHC from specializing in making merchant banking investments in particular industries or from making its first merchant banking investment in a company engaged in real estate investment or development, provided such investments are made for investment purposes as part of an ongoing underwriting or investment or merchant banking activity and are otherwise held in accordance with the requirement of the rule. As the Interim Rule, the Final Rule does not distinguish between real estate investment, real estate brokerage, and real estate development."[66] From here, it can be inferred that the Fed wants to reserve the right for monitoring supervision on an individual basis. Hence, at the Fed's discretion, the approval of a 'more extreme' type of merchant banking activity will depend on whether the portfolio investments have exceeded a certain amount that would no longer be considered as 'part of a diversified portfolio of investments' by the FHC but rather constitute 'an activity or control comparable to

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[64] *Ibid.*
[65] *Ibid.*
[66] *Ibid.*

strategic or other types of investments' that are otherwise not permitted under the separate authorizations of either the BHCA or the GLBA.

(1.3) New Development for Merchant Banking's Cross-Marketing: Section 501 of the *Financial Services Regulatory Relief Act of 2003*

New developments towards merchant banking have come into place in 2003. Section 501 of the *Financial Services Regulatory Relief Act of 2003* amends the *Bank Holding Company Act of 1956* by practically lifting the GLBA's cross-marketing prohibitions with respect to merchant banking activities. As a result, FHCs are permitted to cross-market their commercial activities if they own or control less than 25% of the total equity or any class of voting security of a non-financial company. Legislatively speaking, this provision would "lift cross-marketing prohibitions put in place by the GLBA to remove competitive inequities with non-banks."[67] Practically the provision will allow "a bank to cross-market its products and services with companies held by the bank's financial holding company's merchant banking authority"[68], even if these companies are non-financial firms engaging in commercial activities. It has been reported that both "the Fed and the American Bankers Association support this provision."[69] The remaining restriction, however, continues to exist that would bar FHCs from making direct investment in merchant banking's equity shares or assets through a depository institution subsidiary of the FHC, or by a subsidiary of a depository institution. The restriction is "intended to help preserve the separation between the financial holding company's depository institutions on the one hand, and the non-financial portfolio company on the other."[70] That is because the GLBA of 1999 still upholds the fundamental principle of separating banking from commerce. But through the introduction of the *Financial Services Regulatory Relief Act of 2003* (on March 20, 2003), it is generally agreed that the 2003 Act would provide regulatory relief to insured depository institutions. Therefore commentary has dubbed the *Financial Services Regulatory Relief Act of 2003* as "further

[67] H.R. 1375 § 405. See also Engel, *supra*, note 48, at 183.
[68] Engel, *supra*, note 48, at 184.
[69] Legislative Update, Am. Banker, Dec. 13, 2002, at 9.
[70] Kate Long & Nevin Bopari, "Developments in Banking and Financial Law: 2003: I. Financial Services Regulatory Relief Act of 2003" (2004) 23 Ann. Rev. Banking & Fin. L. 2 at 12-13.

deregulation"[71] that works to consolidate merchant banking into the realm of "newly-authorized financial activities", following previous deregulation manifested by the GLBA in 1999.

Despite the tendency to claim the 2003 *Financial Services Regulatory Relief Act* is one further step in blurring the traditional boundary of banking and commerce, following what the GLBA had initiated in 1999, a review of FHCs' current practice tells that the 2003 Act may as well be a recognition of the status quo, by removing some of the unnecessary regulatory hurdles faced by FHCs. Citing the testimony of Governor of Federal Reserve, Mark W. Olson, in the 108th Congress in 2003[72], "[t]he GLBA currently permits a depository institution subsidiary of a financial holding company to engage in cross-marketing activities with non-financial companies held by an insurance underwriting affiliate through statement stuffers and internet website. These activities must comply with anti-tying restrictions."[73] Emphasis needs to be made that the relaxation is restricted to 'cross-marketing' only and the remaining 'non-financial business investment' restriction still stands. Worth noting, insurance underwriting is 'non-financial' in nature and even though it is a permissible activity for FHCs, it is nonetheless not permissible for a depository institution subsidiary of the FHC or a subsidiary of a depository institution. This is because the GLBA still upholds the principle of separating banking from commerce, in order to protect the integrity of the federal reserve fund. Assuming the Federal Reserve Governor's testimony attests to the current practice among domestic FHCs in the U.S., from a competitive equity point of view, it is not difficult to appreciate why the 2003 *Financial Services Regulatory Relief Act* allows for "depository institutions controlled by a financial holding company ("FHC") to engage in cross-marketing activities with (non-financial) companies held under the merchant banking authority to the same extent, and subject to the same restrictions, as companies held under the insurance company investment authority."[74] Commentary ascribes the "further deregulation" in the 2003 Act to the Fed's authority (granted by GLBA)—"the Fed

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[71] Engel, *supra*, note 48, at 185.
[72] *Ibid* (original note # 38). Financial Services Regulatory Relief Act of 2003: Hearing Before the Subcomm. on Fin. Insts. and Consumer Credit of the Comm. on Fin. Servs., 108 Cong. (2003) (testimony of Governor of Federal Reserve Mark W. Olson), available at [http://www.federalreserve.gov./boarddocs/testimony/2003/20030327/default.htm].
[73] *Ibid* at 184.
[74] Engel, *supra*, note 48 at 184.

condoned this 'parity of treatment' and recognized no reason to treat merchant banking differently from insurance company investments of financial holding companies."[75] Merchant banking is gradually being accepted as a "financial" activity and therefore has been consolidated as one type of the GLBA's "newly-authorized activity" for FHCs; comparable to the "insurance company investments" that are another type of "permissible financial activities" for FHCs, with the same authorization by GLBA there is no reason for any differential treatment between merchant banking and insurance company investments.

2. Derivatives

(2.1) Derivatives (Definition, Market Value, Controversy etc.)

"Derivative" is short for derivative instrument, generally referring to a contract whose value is based on the performance of an underlying financial asset, index, or other investment[76]. There are various kinds of derivative contracts depending on different commodities: securities underwriting, hedge portfolios, interest rates, foreign exchange, and various domestic and foreign indexes. Of these, one thing in common is their connection with "more volatile" price transactions. Derivatives can be highly profitable because they afford leverage; therefore, when used properly by knowledgeable investors, derivatives can enhance returns and be useful in hedging portfolios[77]. There are four types of commonly used derivative instruments, including (i) options, (ii) forward contracts, (iii) futures, and (iv) swaps. Innovations in these financial instruments offer the advantages of liquidity from the capital market. That also means the banks' once dominant role as financial intermediaries, by accepting deposits from depositors and then making loans to borrowers, has been diminished.

Derivatives gained notoriety in recent years because of the recent travails of a hedge firm, Long-Term Capital Management ("LTCM"), which reportedly had

[75] *Ibid.*
[76] Downes & Goodman, *supra*, note 33, at 147.
[77] *Ibid.*

invested more than US$ 1 trillion in derivatives in the unregulated hedge fund[78]. In fact, the unregulated hedge fund practice before the GLBA was one of the underlying reasons that prompted the Congress's debate to refine GLBA. In one congressional record, one senator challenged the comprehensiveness of the GLBA by stating that "[t]his bill ('S. 900', which is Senate's bill for GLBA, whereas 'H. R. 10' is the House of Representatives' bill for the same Act) addresses a lot of issues. But it does nothing, for example, to deal with mega banks engaged in risky derivatives trading. I do not know if many know it, but we have something like (US$) 33 trillion in value of derivatives held by U.S. commercial banks in this country."[79] Concerns of 'federally-insured banks in the U.S. trading in derivatives out of their own proprietary accounts' are reported to have prompted the amendments to the bill in order to "stop bank speculation in derivatives in their own proprietary accounts and to take a look at some sensible regulation of risky hedge funds."[80]

Whether derivatives should be classified as a GLBA "newly-authorized activity" has initiated many debates, not only in the Congress but also among the federal reserve and banking organizations. Those in favor of banks taking on risk by trading in derivatives mainly based their arguments on derivatives' 'hedge benefit'—they can hedge against certain kinds of risks, for example, interest rate and foreign currency exchange risks. Those against it nonetheless uphold that derivatives are highly volatile by nature as they are tied up against all sorts of assets and liabilities. Commentary quickly pointed out that "derivatives are contracts that create rights and obligations that meet the definitions of assets and liabilities"[81]; which means, if derivative transactions turned out well, they can be highly profitable, but if not, the loss can be disastrous.

Distinctions need to be made between "non-risky derivatives" (i.e. hedge derivatives; 'exchange-traded derivatives' is one example) and "risky derivatives" ('over-the-counter derivatives', for instance), in order to better appreciate the above

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[78] *Infra* 145 Cong Rec S 13883. [In page # S13897]
[79] 145 Cong Rec S 13883. [Congressional Record—Senate, Vol. 145, No. 154. Thursday, November 4, 1999. 106th Congress, 1st Session.]
[80] *Ibid.* [In page # S13896]
[81] Wilton McDonald, "Note on FAS 133 Accounting for Derivatives: Do the New Regulations Decrease Operating Risk and Prevent Ultimate Failure of Banking Institutions in Light of the Basle Committee's New Capital Accord?" (2004) 37 U. West. L.A. L. Rev. 138 at 150.

question. First, 'exchange-traded derivatives' offer a "relatively high degree of 'transparency' to investors, because they have standardized terms, are traded on organized markets, and are protected from default risks by clearinghouse guarantee. In these cases, due to their long established reputation, banks have a relative small advantage over competing financial institutions and other sophisticated investors in buying or selling exchange-traded derivatives."[82] Secondly, and contrary to the first one, 'over-the-counter derivatives' ("OTC derivatives") are "individually negotiated contracts that do not have standardized terms, are not traded on any organized market, and are not protected against default risks by clearinghouse guarantees."[83]

From the banks' perspective, advanced information technology makes it possible for them to use their own internal computerized system to reasonably calculate the operating risk linked to their derivative transactions, simply based on available credit information pertaining to their clients (both existing and prospective). Credit risks (for their debtors, investors, or underwriting institutions) can also be calculated in a systematic manner with individual bank's credit rating systems, without even having to have the outstanding derivatives traded on open public markets (especially referring to those major index markets).

Derivatives are generally considered high-risk securities mainly because most derivatives transactions (either domestic or global) are 'over-the-counter', controlled by a small number of big banks. Statistically speaking, at the end of 2000, "OTC derivatives accounted for more than four-fifth (4/5) of the derivative portfolios held by five of the seven largest bank dealers [in the U.S.], and for more than three-fifth (3/5) of the portfolios held by the other two dealers."[84] A similar cartel situation exists on the global derivative market as well. This could send off some warning signals as systematic risk can happen if derivatives markets run off track. The situation could even be disastrous due to the fact that major derivatives dealers are big players and hence could be adversely affected by the volatility tied into their derivative dealings. "U.S. banks and securities firms control around 40% of the worldwide market for OTC derivatives. Like the U.S. domestic market, the global

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[82] Arthur E. Wilmarth, Jr., "The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation, and Increased Risks" (2002) 2002 U. Ill. L. Rev. 215 at 336.
[83] *Ibid.*
[84] *Ibid* at 335.

derivatives market is dominated by a small group of major financial institutions. Four big U.S. banks, together with two large American securities firms and six major foreign banks, controlled half of the global market for financial derivatives in 1998."[85] Taking LTCM's debacle for example, many were concerned that the overgrowth of OTC derivatives might create a situation that is "too big to fail". One would think that the Federal Reserve would try to avert creating another systematic risk that may, if triggered, dismantle the entire financial market.

OTC derivatives are considered risky and volatile for a few stated reasons:

(i) OTC derivates are difficult to monitor for their total risk exposure, as they do not trade on an open market and hence lack a comprehensive market evaluation support. "The lack of comprehensive information on the derivatives positions of banks made it difficult for banks to monitor the risk of their positions"[86]. On the other hand, from a financial regulators' perspective, with only notional values of derivative positions provided in call reports, offsite monitoring of risk is also limited. I will expound upon this further below (v).

(ii) OTC derivatives transactions are relatively opaque and non-transparent for their investors. Commentary points out that "[u]nlike exchange-traded derivatives, OTC derivatives cannot be 'marked to market' on a daily basis. Instead, the value of each OTC derivative must be estimated based on propriety computer modeling programs whose parameters are often known only by the dealers that create these programs."[87] The lack of transparency and the possibility that each banking organization might end up using different programs incomparable to others also spark problems for OTC derivatives.

(iii) In connection to the opaqueness, commentary further suggested that "[b]ecause OTC derivatives have no secondary market and are relatively opaque, large bank dealers enjoy significant institutional advantages in terms of their financial credibility as counterparties and

[85] *Ibid.*
[86] McDonald, *supra*, note 81, original note# 45.
[87] Wilmarth, Jr., *supra*, note 82, at 336.

their proprietary expertise in creating and valuing OTC instruments"[88]. That means bank consumers may be disadvantaged if they are required by large banks to pay for higher considerations for the OTC trade.

(iv) Competitive inequity is another problem. In this regard, commentary suggests that "major bank dealers enjoy [and hence may take advantage of] federal "safety net" protections that give them a significant competitive edge over most non-bank dealers in the OTC derivatives markets."

(v) OTC creates difficulty for financial supervision. It is suggested that "financial regulators do not appear to posses the sophistication or information needed to assess the riskiness of the major dealers' position on a continuous basis. OTC derivatives are largely 'opaque' to regulators because their values are based on propriety models and cannot be ascertained from trading prices established on organized exchanges. The regulators' monitoring challenges are further complicated by the fact that many OTC derivatives are highly leveraged and permit dealers to change their risk exposure rapidly. Despite recent efforts to improve supervisory procedures, many commentators believe that regulators currently lack adequate tools to prevent excessive risk-taking by derivatives dealers."[89]

(vi) Rapid growth of OTC derivatives would aggregate systemic risk within the financial market. The bankruptcy of the LTCM is a testimonial to the problem—"by the end of September 1998, LTCM had lost 4.4 billion, including a 3 billion loss arising out of its OTC derivatives"[90].

(2.2) Derivatives and 'Regulation W'

Even though GLBA is not completely silent on derivatives, the Act did not directly answer either whether derivatives are permissible or not. When the GLBA

[88] *Ibid* at 336-337.
[89] *Ibid* at 354.
[90] *Ibid* at 215 (Summary).

was enacted in 1999, it merely prescribed in its Section 121 that "rulemaking [is] required concerning derivative transactions and intraday credit"[91]. The GLBA delegated the rulemaking authority to the Board ("the Federal Reserve Board"), and stated that "no later than 18 months after the date of the enactment of the Gramm-Leach-Bliley Act [Nov. 12, 1999], the Board shall adopt final rules under this section to address as covered transactions credit exposure arising out of derivative transactions between member banks and their affiliates and intraday extensions of credit by member banks to their affiliates." The final rule[92], later encoded into "Regulation W[93]", was promulgated on December 12, 2002 (effective April 1, 2003) to implement comprehensively Sections 23A and 23B of the *Federal Reserve Act* (hereafter "Sections 23A and 23B"). The final rule combines statutory restrictions on transactions between a member bank (i.e. any bank that is a member of the Federal Reserve System) and its affiliates with numerous Board interpretations and exemptions in an effort to simplify compliance with Sections 23A and 23B.

Sections 23A and 23B have already been discussed and covered in the Introduction (the introductory chapter) of this dissertation. There is no need to repeat this here except to emphasize that Sections 23A and 23B are important statutory provisions designed to protect against a depository institution suffering losses in transactions with affiliates. More importantly, both Sections 23A and 23B also limit the ability of a depository institution (for example, a bank) to transfer to its affiliates the subsidy arising from the institution's access to Federal reserves in the event of an emergency or crisis. Regulation W was designed to reset the parameter for statutory limits under Sections 23A and 23B, in face of GLBA grants FHCs the authority to do certain quantitative derivative transactions through a depository institution subsidiary of the FHC (as opposed to only through a bank's non-affiliates, for bank holding companies at least, under the old regime of BHCA). The GLBA amended Section 23A of the *Federal Reserve Act* further necessitates a financial holding company meet the requirements set by both Sections 23A and 23B, which in turn limits the exposure of a bank to a financial subsidiary to the amount of permissible exposure to an affiliate. The amount of permissible bank exposure to both subsidiaries and affiliates

[91] 12 U.S.C.A. § 371c.
[92] 67 FR 76560, Federal Register, Vol. 67, No. 239.
[93] *Regulation W*, 12 CFR 223 (2003).

is about the same, except where a subsidiary has a higher level of permissible quantitative limit than affiliates do. The exception refers to those 'covered' transactions between a bank and any financial subsidiary that has a "direct-relationship" with the bank are not subject to the original 10 percent threshold limit (but still no exceeding 20 percent). But generally speaking, Section 23A limits a member bank's "covered transactions" with any *single "affiliate"* to no more than 10 percent of the bank's capital stock and surplus, and transactions with *all "affiliates" combined* to no more than 20 percent of the bank's capital stock and surplus[94].

As part of GLBA's financial liberalization effort to allow financial holding companies and their financial subsidiaries to engage in some of the traditionally non-financial activities that are otherwise considered "newly-authorized activities", the GLBA amended Section 23A treats a *financial subsidiary* of a bank as an *affiliate* of the bank. By extension, it is fair to conclude that a member bank may not engage in a covered transaction with *any affiliate* (including a financial *subsidiary*) if the bank's aggregate amount of covered transactions with *all affiliates* (including financial *subsidiaries*) would exceed 20 percent of the bank's capital stock and surplus[95]. Also indicated in the final rule, although the financial subsidiary of an affiliated depository institution is deemed an affiliate of the member bank for purposes of Sections 23A and 23B, the GLBA states that only "covered transactions between a bank and any individual financial subsidiary of the bank" (as in "direct relationship") are not subject to the 10 percent limit as prescribed in Section 23A of the *Federal Reserve Act*[96]. Accordingly, a member bank is barred from engaging in a covered transaction with the financial subsidiary of an affiliated depository institution (as in "indirect relationship"), should the amount of the member bank's covered transactions with that financial subsidiary (of the affiliated depository institution) exceed 10 percent of the bank's capital stock and surplus.

The final rule explains that "covered transactions" include (i) purchases of assets from an affiliate, (ii) extensions of credit to an affiliate, (iii) investments in securities issued by an affiliate, (iv) guarantees on behalf of an affiliate, and (v)

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[94] *Ibid.* (Page 3 of 119)
[95] *Ibid.* (Page 52 of 119)
[96] *Ibid.* (Page 52 of 119) See also 12 U.S.C. 371c(e)(3)(A)

certain other transactions that expose the member bank to an affiliate's credit or investment risk. Further, a member bank's "affiliates" include, among other companies, any companies that control the bank, any companies under common control with the bank, and certain investment funds that are advised by the bank or an affiliate of the bank[97]. Consistent with the GLBA, Section 223.32(a) of the final rule provides that the 10 percent quantitative limit in Section 23A does *not* apply with respect to covered transactions between a member bank and any individual financial *subsidiary* of the bank. Accordingly, a member bank's aggregate amount of covered transactions with any individual (i.e. single) financial subsidiary of the bank may exceed 10 percent of the bank's capital stock and surplus. Emphasis needs to be made that a member bank's covered transactions with all financial subsidiaries, however, are still subject to the aggregate 20 percent quantitative limit in Section 23A.

As a complementary safeguard measure, Section 23B of the *Federal Reserve Act* protects the member bank by requiring that certain transactions between the bank and its affiliates occur on market terms. "Arm's-length dealing" between these two entities requires that any transaction be conducted on terms and under circumstances that are substantially the same, or at least as favorable to the bank, as those prevailing at the time for comparable transactions with unaffiliated companies[98]. That is to say that the Board expects "member banks to comply strictly with Section 23B in their derivative transactions with affiliates. In this regard, the Board reminds member banks that Section 23B requires a member bank to treat an affiliate no better than a *similarly situated non-affiliate*"[99]. The Board interpreted the Section thus—"Section 23 B generally does not allow a member bank to use with an affiliate the terms and conditions it uses with its most creditworthy unaffiliated customer (unless the bank can demonstrate that the affiliate is of comparable credit worthiness as the bank's most creditworthy unaffiliated customer)."[100] To make it easier for compliance by all depository institutions affected by the GLBA, with respect to the final rule, the Board proposed "[i]nstead, Section 23B requires that an affiliate be treated comparably (with respect to terms, conditions, and credit limits) to the majority of third-party customers engaged in the same business, and having comparable credit quality and

[97] *Ibid.* (Page 3 of 119)
[98] *Ibid.* (Page 3 of 119)
[99] *Ibid.* (Explanatory notes for the Federal Reserve Board's current actions.)
[100] *Ibid.*

size, as the affiliate."[101] Further, because a bank usually has the strongest credit rating within a holding company, the Board indicated that it "generally would not expect an affiliate to obtain better terms and conditions from a member bank than the member bank receives from its major unaffiliated counterparties. In addition, the Board notes that market terms for derivatives among major financial institutions generally include daily marks to market and two-way collateralization above a relatively small exposure threshold."[102] Evidently, the Board, in trying to put together a most comprehensive final rule as humanly possible, had endeavored to assemble all "rules of thumb" available in current market practice. To simplify compliance with Sections 23A and 23B, the final rule was further codified into Regulation W.

It should be noted that even the most contemporary 'Regulation W' (effective as of April 1, 2003) is far from comprehensive in enlisting all statutory requirements for the country's depository institutions (including a depository institution subsidiary of an FHC, or a subsidiary of a depository institution) to observe for their derivative transactions. If anything, Regulation W provides another alternative that makes 'bank-affiliate' and 'bank-financial subsidiary' derivative transactions possible, subject to statutory quantitative limits. The statutory requirements contained in Regulation W, in some cases, mean "exemptions", and in others, "restrictions". Cited in the final rule for its "current action", the Board addressed the fact that the Federal Reserve examiners recently conducted a limited survey of a number of large banking organizations to ascertain their compliance with the Board's interim rule on bank-affiliate derivatives[103]. The Board further remarked upon the survey suggesting that "reliance on bank-designed policies and procedures, Section 23B, and active examiner supervision to regulate bank-affiliate derivatives is appropriate and should be continued."[104] That being said, the Board admitted that there is more work to be done, saying it is "not prepared at this time to subject credit exposure arising from bank-affiliate derivatives to all the requirements of Section 23A. The Board continues to collect information regarding the derivatives practices of banks and believes that more time is needed to determine whether the general approach of the

[101] *Ibid.*
[102] *Ibid.*
[103] *Ibid.*
[104] *Ibid.*

interim rule on bank-affiliate derivatives will suffice to prevent banks from incurring problematic levels of credit exposure to affiliates in these transactions."[105] One can expect that despite the fact that Regulation W has served to provide banking organizations with long-awaited and much-needed guidelines for implementing applicable regulations on 'bank-affiliate' and 'bank-financial subsidiary' derivative transactions, depository institutions would still continue to rely on upcoming Board interpretations and informal staff guidance for fuller compliance with statutory restrictions.

(2.3) With Limited Exceptions, Derivatives Are Generally Regarded as a "Non-Permissible" Activity by the GLBA

Before the GLBA was enacted, some senators proposed an amendment to S. 900 (Senate's Bill for GLBA) indicating that by providing a prudential framework for the affiliation of banks, securities firms, insurance companies, and other financial services providers, the scope of permissible activities should not be extended so far as to pose a direct threat to the safety and soundness of an insured depository institution, or an indirect and ultimate threat to the federal deposit insurance fund. In the amendment presented by Senator Santorum, it is suggested that except under limited exceptions (such as hedging transactions), derivative activities engaged in by insured depository institutions or any affiliate thereof are generally prohibited, if such purchase, sell, and engagement in any of these transactions are for the account of that institution or affiliate itself. The regulatory restraint is reflected in the proposed amendment to Section 45 of the *Federal Deposit Insurance Act*. In addition another exception to this general prohibition is for a separate capitalized affiliate of an insured depository (that is not itself an insured depository institution), to purchase, sell, or engage in a transaction involving a derivative financial instrument. In doing so, however, a separate capitalized affiliate must comply with the "appropriate public notice requirement". That is, a separate capitalized affiliate must clearly and conspicuously notify the public that "none of the assets of the affiliate, nor the risk of loss associated with the transaction involving a derivative financial instrument, are

[105] *Ibid.* (Derivative Transactions §223.33)

insured under Federal law or otherwise guaranteed by the Federal Government or the parent company of the affiliate."[106]

As one can see, how to strike a balance between permissible and non-permissible derivative activities was at the core of the amendment to Bill S. 900. It seems that given the risky nature associated with derivative activities, by the application of the safety and soundness principal, any depository institution involving a derivative financial instrument is generally prohibited unless an affiliate of the depository institution can prove that such activity is either engaged for the benefit of the depository institution (in the case of using it as a hedge fund) or its doing so would not impugn on the safety and soundness principle that otherwise should be strictly observed for maintaining the integrity of the federal reserve fund. Such regulatory relaxation, despite yielding some anticipated flexibility in the general prohibition rule, still put the safety and soundness principle at front and center of this equation. Suffice it to say, such restriction protects the public interest, which stems from the "appropriate public notice requirement", from being infringed, as well as safeguards the taxpayers' money that supports the Federal Reserve fund, from being misappropriated.

As it turns out now, only with limited exceptions that are otherwise made permissible by Regulation W, an implementing regulation to GLBA, derivatives are generally considered non-permissible activities by the GLBA. Regulation W, which is a consummation of all previously issued implementation rules issued by the Board at various times, is a manifestation of the GLBA's continuation to uphold the fundamental principle that underlies the separation of banking from commerce. The mechanisms applied by Regulation W to safeguard this principle include:

(i) limiting 'permissible derivative transactions' to those clearly defined in 'Appendix A to the Regulation Y', and any similar derivative contract, including a credit derivative contract (as is shown in Section § 223. 3 of the Regulation W). In implementing this, Section 225.1 of the Regulation Y further indicates that

[106] Congressional Record, 145 Cong Rec S 4918. (Page 13)

"Appendix A to the regulation contains the Board's Risk-Based Capital Adequacy Guidelines for bank holding companies".

(ii) setting up the 'market terms requirement' for arm's length transactions between the bank and its affiliates.

(iii) putting a cap on the quantitative ratio of derivative transactions between the bank and its affiliate (either 10 per cent or 20 per cent threshold limit, depending on the type of relationship between the bank and its affiliates, which has already been discussed in previous section), so as to enable the Fed to systematically assess the bank's credit exposure while engaging in non-banking activities with its affiliates.

(iv) requiring member banks to establish policies and procedures (i.e. the 'internal control system') to manage credit exposure arising from their derivative transactions with affiliates in a safe and sound manner.

Legislatively speaking, in Regulation W, there are basically only two sections (§ 223.3 and § 223.33) that have direct reference to 'derivatives'.

> "(§ 223. 3) What are the meanings of the other terms used in sections 23A and 23B and this part?
> For Purposes of this part: ....
> (l) 'Derivative transaction' means any derivative contract listed in sections III. E. 1.a. through d. of Appendix A to 12 CFR part 225[107] and any similar derivative contract, including a credit derivative contract."[108]

> "(§ 223. 33) What rules apply to derivative transactions?
> (a) Market terms requirement. Derivative transactions between a member bank and its affiliates (other than depository institutions) are subject to the market terms requirement of §223.51[109].

[107] Regulation Y, 12 CFR 225.1
[108] *Regulation W*, 12 CFR 223.3
[109] *Regulation W*, 12 CFR 223. 51
Section § 223.51 of Regulation W sets out the market terms requirement under Section 23B of the *Federal Reserve Act*, quoted as follows:
"§ 223.51 What is the market terms requirement of section 23B?
A member bank may not engage in a transaction described in § 223.52 unless the transaction is:
(a) On terms and under circumstances, including credit standards, that are substantially the same, or at least as favorable to the member bank, as those prevailing at the time for comparable transactions with or involving nonaffiliates; or

(b) Policies and procedures. A member bank must establish and maintain policies and procedures reasonably designed to manage the credit exposure arising from its derivative transactions with affiliates in a safe and sound manner. The policies and procedures must at a minimum provide for:
(1) Monitoring and controlling the credit exposure arising at any one time from the member bank's derivative transactions with each affiliate and all affiliates in the aggregate (through, among other things, imposing appropriate credit limits, mark-to-market requirements, and collateral requirements); and
(2) Ensuring that the member bank's derivative transactions with affiliates comply with the market terms requirement of §223.51.

(c) Credit derivatives. A credit derivative between a member bank and a nonaffiliate in which the member bank provides credit protection to the nonaffiliate with respect to an obligation of an affiliate of the member bank is a guarantee by a member bank on behalf of an affiliate for purposes of this regulation. Such derivatives would include:
(1) An agreement under which the member bank, in exchange for a fee, agrees to compensate the nonaffiliate for any default of the underlying obligation of the affiliate; and
(2) An agreement under which the member bank, in exchange for payments based on the total return of the underlying obligation of the affiliate, agrees to pay the nonaffiliate a spread over funding costs plus any depreciation in the value of the underlying obligation of the affiliate."[110]

Regulation W, suffice it to say, is the GLBA's (or the Board's) reconciliation and attempt to admit and accept the prevalence of derivative activity undertaken by banks and their affiliates. According to a commentator who I agree with, "to a large extent, Regulation W codifies and continues previous Federal Reserve rulings on affiliate transactions and its importance derives less from changes to prior policy than from the fact that it exists at all. Previously, the FRB's interpretation of Sections 23A and 23 B were scattered in the Code of Federal Regulations, the Federal Reserve Regulatory Service, and letter rulings that were not systematically collected or adequately publicized in a timely fashion."[111] That being said, legislatively speaking, "Regulation W does, however, modify some prior interpretations of Section 23A and

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(b) In the absence of comparable transactions, on terms and under circumstances, including credit standards, that in good faith would be offered to, or would apply to nonaffiliates."

[110] *Regulation W*, 12 CFR 223.33

[111] Peter Heyward, "Federal Reserve Board's Regulation W Becomes Effective" (2003) S&P's The Review of Banking and Financial Service, Vol. 19, No. 4, at p. 112A. [Author's Note: "Peter Heyward is partner in the Financial Services Group of Venable LLP in Washington, D.C. Mr. Heyward chairs the Financial Holding Companies Subcommittee of the Banking Law Committee of the Business Law Section of the American Bar Association and is a member of the Insurance Law Committee of the Association of the Bar of the City of New York.]

adds several new ones, including several specific provisions regarding affiliate transactions that were mandated in the GLBA. Still to come are further rules or guidance regarding the treatment of derivative transactions under Section 23A."[112] The GLBA grants the Board rulemaking authority under Section 121 of the GLBA (12 USCA § 371c). With respect to the treatment of derivatives by GLBA, it is suggested that "[t]he FRB (the Board) was required by the GLBA to address as 'covered transactions' the credit exposure arising from derivative transactions and intraday extensions of credit between banks and their affiliates [including a financial subsidiary that has a direct relationship with the bank]. To implement this requirement, the Board issued interim final rules in May 2001 exempting such transactions from the quantitative [10 percent limit] and collateral requirements of Section 23A, but subjecting them to the market terms requirement of Section 23B (including obtaining collateral, to the extent that the bank would require it in a market terms transaction with an unaffiliated entity). The final rule takes the same approach. However, the Board stated in the preamble to Regulation W that it intends 'in the near future' to issue a proposed rule seeking public comment on how to treat derivative transactions that are functionally equivalent to a bank's extension of credit to, or asset purchase from, an affiliate."[113] This would be the latest update on the status of derivative treatment by GLBA, after the Regulation W came into effect on April 1, 2003.

On a separate but related issue, it has been noted that "[t]he Board may also issue additional guidance or regulations regarding special purpose entities used in securitization transactions."[114]

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[112] *Ibid.*
[113] *Ibid.*
[114] *Ibid.*

3. Securitization

(3.1) A Brief Definition for Securitization (& How Securitization Works)

Securitization is widely used in all three financial sectors (banking, securities, and insurance) in order to diversify the risks they have assumed, by conceptually putting them into a 'pool' backed by securitized assets. Beyond that, securitization is also embraced by companies, not only those whose debt securities are rated "non-investment grade" but "investment grade" as well, for the benefit of reducing their interest cost for raising funds.

Securitization can be generally defined as "a structured financial transaction where an expected cashflow from receivables (an illiquid asset) is securitized into a liquid bond traded in the public securities market. The typical assets are receivables generated from the sale of mortgages (both residential and commercial), credit cards, auto loans, student loans, and home equity loans."[115] In terms of how securitization actually works (taking asset securitization for instance) if a company wants to obtain financing through securitization, it has to begin by identifying assets that can be used to raise funds. These assets typically represent rights to payments at future dates and are usually referred to as "receivables"[116]. The company that owns the receivables is called the "originator"[117]. The originator must factor in "risk" in order to reasonably predict the aggregate rate of default. The risk factor is very important because payments may not always be made on time and they may even eventually become uncollectible; therefore, the originator, in trying to avert loss from default, must have a statistically large pool of receivables due from many obligors[118]. In this regard, securitization's conceptual method for risk reduction is very similar to that of mutual funds. "[A] statistically large pool of receivables due from many obligors, for which

[115] Robert J. Rhee, "Terrorism Risk in a Post-9/11 Economy: The Convergence of Capital Markets, Insurance, and Government Action" (2005) 37 Ariz. St. L. J. 435 at 496-497.
[116] Steven L. Schwarcz, "The Alchemy of Asset Securitization" (1994) 1 Stan. J. L. Bus. & Fin. 133 at 135.
[117] *Ibid.*
[118] *Ibid.*

payment is reasonably predictable, is generally preferable to a pool of a smaller number of receivables due from a few obligors."[119]

For a company to raise funds, securitization thus taps into the capital market. "After identifying the assets to be used in the securitization, the originator transfers the receivables to a newly formed special purpose corporation, trust, or other legally separate entity—often referred to as a special purpose vehicle, or SPV"[120]. The transfer involves a true sale, which is intended to separate the receivables from risks associated with the originator[121]. That means, the SPV "must be structured as 'bankruptcy remote' to gain acceptance as an issuer of capital market securities. 'Bankruptcy remote' in this context means that the SPV is unlikely to be adversely affected by a bankruptcy of the originator."[122] In other words, the transfer in structured securitization 'severs' any legal obligation linked to original assets, so as to ensure that the receivables (backed by original assets) would not be adversely affected while being traded in the capital market.

Securitization is often utilized by insurance companies for diversifying their assumed long-and-short-term risks, given the very few number of 'reinsurance' companies, most of them being in Europe. As with insurance companies, banks also use securitization frequently to diversify their lending risks, most noticeably in credit card debts and mortgage-backed assets. On the other hand, for companies that are in need of raising funds, securitization is also popular for its cost effectiveness. Companies, referring to those rated as *'non-investment grade'* especially, can save dramatic interest costs by securitizing their available assets for further trading in the capital market. The same rationale can equally apply to even *companies with 'investment grade'*, or, *new companies* that have great assets but without a sufficient banking record. In cases of companies that are either new or being non-investment grade, had they resorted to seeking traditional bank loans, the interest cost would have been much higher.

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[119] *Ibid.*
[120] *Ibid.*
[121] *Ibid.*
[122] *Ibid.*

> "Companies whose debt securities are rated 'investment grade' can usually issue securities in the capital markets at interest rates competitive with, or even lower than, other generally available sources of funds, such as bank loans. The higher the company's rating within the investment grade categories, the lower the company's cost of funds. This reduced cost is a result of the lower interest rate necessary to induce investors to buy the company's securities.
>
> A securitization transaction can provide obvious cost savings by permitting an originator whose debt securities are rated less than investment grade or whose securities are unrated to obtain funding through an SPV whose debt securities have an investment grade rating. Even an originator with an investment grade rating may derive benefit from securitization if the SPV can issue debt securities with a higher investment grade rating and, as a result, significantly decrease the originator's interest costs."[123]

Worth noting is that from an accounting point of view debt securities can be off the balance sheet after they are properly securitized. In those cases, "debt securities" (backed by company assets) will no longer be treated as "real debt" in the accounting books. This may explain why the above commentary has suggested that "even an originator with an investment grade rating may derive benefit from securitization if the SPV can issue debt securities with a higher investment grade rating."

Securitization was first developed in the early 1970s when the U.S. federal government issued mortgage-backed "pass through" securities (which would collectively form a "mortgage pool") in order to satisfy the need by baby boomers to purchase their residential homes. The creation of a "mortgage pool" had greatly helped relieve pressure on banks that would have otherwise had to come up with a tremendous amount of capital to meet mortgage demands. Ever since then, securitization has thrived and developed into a popular financial instrument for various and extended use. By 2005, the securitization market has reportedly grown to over US$ 6.4 trillion in capitalization[124]. Furthermore, citing one commentator, "because securitization has only been applied to a portion of its potential market opportunities, it promises to be a financial technique that will continue to grow." The importance of securitization hence entailed a series of debates within the Congress in

[123] *Ibid* at 137.
[124] Rhee, *supra*, note 115, at 497.

passing the GLBA. Those debates focused around whether securitization is "financial in nature, incidental, or complementary to such financial activity" so that it should be made permissible by the GLBA.

(3.2) Congress' Debate on Securitization

Congress put securitization in a broader category of "hybrid products"[125] that pre-existed the enactment of the GLBA ("pre-existing hybrid products"). Relevant to the GLBA's mandate of permissible financial activities are suspicions surrounding "hybrid products" within the traditionally defined realm of banking/insurance activities. These so-called hybrid products include, for instance, securitizations, annuities, mortgage-backed securities, and retirement certificates of deposit. Questions arise as to whether such hybrid products would alter or undermine the financial holding company's capacity of risk management and thus should be proscribed by the GLBA as non-permissible activities.

The regulatory treatment of hybrid products is a grey zone and it was evident as such during the debate of S. 900 (Senate's bill for GLBA). There was opposition to the S. 900 claims that the bill undermines the separation of banking and commerce. The opposition put a strong emphasis on the hard-learned lesson of the Crash of 1929 and the ensuing Great Depression in the 1930s. Critics blamed the widespread bank failure on the fact commercial banks were enticed by the lucrative securities market and went overboard and continued to increase their investment on the Wall Street. Their exposure was large and they consequently were bogged down by the stock market crash. Critics assailed the bill warning that "he who does not learn from it, is doomed to repeat it. This bill bears dangerous seeds."[126] The opposition seemed to have dismissed the fact that "hybrid products" have been prevalent in the financial market for decades. The word "hybrid" denotes such financial products which transcend the distinction of and consequently challenge the traditionally delineated banking and insurance fields. In this regard, cited one congressional record, even the

[125] Todd V. McMillan, "Securitization and the Catastrophe Bond: A Transactional Integration of Industries Through a Capacity-Enhancing Product of Risk Management" (2001/2002) 8 Conn. Ins. L. J. 131.
[126] "Congress Report on S. 900, *Gramm-Leach-Bliley Act*", 145 Cong Rec E 2308.

opposition had to admit the bill wisely recognized the technological and regulatory changes that have blurred the lines between banking and other financial industries as well as banking and other financial products[127]. Showing signs of backing down, the opposition were quick to defend themselves by stating that they were not oblivious to the new regulatory structure's advantages which could potentially foster competition and innovation. The opposition was therefore conflicted. They felt that by trying to balance different values that spanned over a wide spectrum, the multi-polar view otherwise led them to draw a line by saying "to paraphrase the words Charles Dickens penned in 1859, this is the best of bills; this is the worst of bills. It is an act of wisdom; it is an act of foolishness."[128] Congress' efforts in intending the GLBA as a competition booster while making sure that GLBA upheld the fundamental principle of separating banking from commerce proved to be a delicate task.

As mentioned before, advances in information technology are hailed for inducing inter-industry consolidation. 'Scope efficiency' has thus been blueprinted by the GLBA. Revolutionary information technology precedes and is attributed to financial services deregulation. Like derivatives, securitization is also derived from and made possible by innovations in computerized systemization of almost every type of financial standing (market rating, credit rating, assets-debts leverage, etc.) that involves operating risks. To a great extent, the GLBA symbolizes the recognition that for a long time banks have been self-engaged in traditionally non-banking businesses (such as derivatives and securitization) ever since the latter's existence and that such activities were not governed by any comprehensive system of regulation (This is especially true in the pre-GLBA era). Critics have argued that "[a]lthough the Citigroup merger and the [GLBA] were landmark events, in a broader sense they are byproducts of the fundamental restructuring that has occurred in the U.S. financial services industry over the past quarter century. ... [T]he dividing lines between banks, securities firms, and insurance companies began to disappear long before Congress passed the [GLBA]. This growing 'homogenization' among the three financial sectors was spurred by rapid improvements in information technology, deregulation, and financial innovations that broke down traditional barriers between the three sectors. For example, sophisticated computer systems and new financial

[127] *Ibid.*
[128] *Ibid.*

instruments [e.g. commercial paper and asset-backed securities] made it feasible to *securitize* (emphasis added) many types of business and consumer debt."[129]

Securitization and non-bank competition have both been held culpable for eroding the once dominant position of banks as consumer lenders[130]. With the advent of securitization, securities firms are enabled to "transform a wide-array of consumer loans into asset-backed securities, including financial instruments backed by pools of credit card receivables, home mortgages, and motor vehicle loans and leases."[131] Revolutionary advances in information technology have, over the last two decades, afforded banks and other non-bank lenders with the ability to evaluate and monitor their borrowers (both existing and prospective), through their internal computerized programs. The advantage of doing so is to avert asymmetrical information problems. Now banks and non-bank lenders are equally able to provide customer loans. Banks therefore slowly lose their pricing power in the ever fierce price competition war. "Computer systems and statistical evaluation programs permit securities firms, finance companies, and other non-bank financial service providers to collect, analyze, and disseminate financial data about many kinds of borrowers that previously could be evaluated profitably only by banks. At the same time, non-bank firms have developed innovative financing techniques (e.g., asset-backed securities and high-yield debt securities) to securitize a wide variety of debt instruments, thereby linking new classes of borrowers with investors in the financial markets. In combination, these developments have enabled large groups of borrowers to shift from the bank dependent category on the 'debt continuum' into the category of firms and individuals who can obtain credit directly from the financial markets."[132] "Debt continuum" refers to the concept of putting borrowers with the highest leverages on one side and ones with the lowest leverages on the other; those with medium leverages are put in between. Banks are heavily regulated compared to other non-bank lenders therefore banks often feel disadvantaged in this price competition with non-banks. Although banks themselves have become major participants in the securitization trend and large banks still continue to hold lending positions in the credit card and resident mortgage

[129] Wilmarth, Jr., *supra*, note 82, at 222.
[130] *Ibid* at 238.
[131] *Ibid.*
[132] *Ibid* at 230-231.

markets, banks' pricing power in those businesses are nonetheless subject to relentless pressures from their non-bank competitors[133].

It is against such a backdrop that banks, faced with fierce non-bank competition and induced by prospects for lucrative profitability, have continuously strived for larger and innovative securitization markets. In its popularity as a risk diversification tool, securitization has gradually become an essential part of banks' lending practices. For this reason, securitization is generally considered "incidental" to a financial activity as prescribed by the GLBA, although the Board has not seemed to come to a final decision yet. Details will be provided below.

(3.3) Securitization—Soon To Be Considered as "Incidental" to a Financial Activity by the GLBA?

Is securitization a permissible (newly-authorized) activity by GLBA? To better answer this question, one must refer to the Board's interpretations as the GLBA delegates its rulemaking authority to the Board. According to Part III of the final rule[134] for Regulation W (issued on December 12, 2002; effective on April 1, 2003), the Board of Governors of the Federal Reserve ("the Board") states that:

> "9. Securitization Vehicles and Other Special Purpose Entities ("SPEs")
> In the proposal, the Board sought comment on whether additional clarification is necessary in the area of securitizations. The Board specifically requested comment on the question of whether securitization SPEs should in any circumstances be deemed to be affiliates of the member bank involved in the securitization. The Board received a significant amount of comment on this issue. Commentators uniformly recommended that the Board not treat SPEs as affiliates of any bank associated with the securitization. Due to the complexities of this issue and the pending proposal[135] by the Financial Accounting Standards Board ("FASB") on the consolidation of SPEs, the Board is deferring at this time any rulemaking with respect to the relationships between member banks and SPEs."[136]

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[133] *Ibid* at 238-239.
[134] 67 FR 76560, Federal Register Vol. 67, No. 239.
[135] FASB Proposed Interpretation, Consolidation of Certain Special-Purpose Entities, an Interpretation of ARB No. 51 (June 28, 2002).
[136] *Supra* note 134, 67 FR 76560 at pp. 76567-76568.

In response to the Board's question of whether SPEs should be treated as affiliates of a bank engaged in (either directly or indirectly) securitization activities, and hence to be subject to the statutory restrictions set out in Regulation W (which amended Sections 23A and 23B of the *Federal Reserve Act*), the commentators' short answer was "No". In the views of the critics, securitizations should be exempted from Regulation W's statutory restrictions (i.e. quantitative limits) that are otherwise applicable to derivatives (Details for which have been discussed in the previous section). It may be reasonably inferred from this response that securitization is an essential banking business and therefore should be treated as a permissible activity by the GLBA. The Board's interpretation was still an outstanding solution.

From a historical perspective, in the pre-GLBA era, the securitization of financial assets was considered as a "bank-ineligible activity". The reasons that underlie this prohibition include the fact that first, under then *Glass-Steagall Act of 1933*, a bank had a limited power to underwrite securities. The securitization of assets flies in the face of the Glass-Steagall prohibition as it "requires the establishment of a bankruptcy remote Special Purpose Vehicle ("SPV") for the purpose of issuing the securities."[137] Since the mix of banking and securities was proscribed by the *Glass-Steagall Act*, the securitization of assets basically "creates an appearance of a dualistic transaction consistent with the separative intent of Glass-Steagall."[138] Secondly, in juxtaposition to government bonds, the securities derived from securitized assets is riskier, as its sole purpose is to provide liquidity to the otherwise illiquid assets had it not been securitized. Critics have argued that "[t]he securitization of financial assets, i.e. loans, involves the issuance of securities that are not comparable to government obligations considered to be bank-eligible securities and thus recognized as nearly a risk-free investment."[139]

According to the same commentator, the Office of the Comptroller of the Currency ("OCC") issued an interpretation in 1986, invoking open discussions as to

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[137] McMillan, *supra*, note 125, at 145.
[138] *Ibid.*
[139] *Ibid* at 144.

whether the bank's power to sell loans in a structured securitization mechanism should be treated as "incidental" to those bank-eligible activities[140]. Citing the commentator,

> "The Comptroller of the Currency is 'charged by Congress with the superintendence of national banks....' Clearly, the explicitly enumerated powers allow for a national bank to take deposits and issue loans. Comparatively, the power to sell loans for an established securitization scheme is *absent* (emphasis added). Since the practical effect of securitizing bank loans is to free assets from the balance sheet in order to generate more assets through continued loan making, the bank is essentially issuing more loans without adjusting risk-based capital requirements. This revolving door of loan issuance allows for the bank to write loans for the purpose of sale. In light of the practical effect of loan securitization, there is little doubt that such banking activity does not fall under the specially enumerated powers."[141]

The 1986 OCC interpretation intended *not* to allow the bank's power to be expanded to include selling loans (derived from the securitization of financial assets), for some obvious reasons. First, selling loans (in securitization) requires banks to first issue securities—that in itself is outside the realm of banks' "enumerated powers" as they are confined only to traditional banking practice that includes taking deposits and making loans. Secondly, and perhaps more importantly, since the 1986 OCC interpretation did not allow banks to sell loans, it clearly singled out the reason to include underlying capital requirement concerns. The OCC upheld that without properly adjusting the risk-based capital requirements, banks associated with securitizations would normally undertake excessive risks that could not have been allowed under statutory limits. This is owing to the fact that a structured securitization scheme takes the securitized assets off the bank's balance sheet in order to free more assets for extending loans. In a revolving loan sell situation, the bank typically relies on the return of the last loan debt to provide liquidity for the next one, without weighting in the default risk against the bank's total risk-based assets.

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[140] *Ibid* at 145.
[141] *Ibid* at 146.

Interestingly enough, two bank regulators, (first, the Board, which issued its interpretation through Regulation W in 2003, and secondly, the OCC, which issued an earlier interpretation in 1986) made their reservations based on very similar grounds. The accounting principles (raised by the Board) and capital requirements (raised by the OCC) actually are two sides of the same coin. The accounting principles refer to the bank taking securitized assets off its balance sheet, hence, the bank will likely be less than well-capitalized if weighting in the loan risks they have simultaneously undertaken.

The situation may be bound to change. With the proposed rules[142] jointly issued on December 26th, 2006 by the Board, OCC, FDIC, and OTS, they are currently seeking comments to prepare for the ultimate issuance of the unification interpretation rules concerning (i) risk-based capital guidelines, (ii) capital adequacy guidelines, (iii) capital maintenance, and (iv) domestic capital modifications. In its summary, it is stated that

> "The Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System (Board), Federal Deposit Insurance Corporation (FDIC), and Office of Thrift Supervision (OTS) (collectively, the Agencies) are proposing revisions to the existing risk-based capital framework that would enhance its risk sensitivity without unduly increasing regulatory burden. These changes would apply to banks, bank holding companies, and savings associations (banking organizations). A banking organization would be able to elect to adopt these proposed revisions or remain subject to the Agencies' existing risk-based capital rules, unless it uses the Advanced Capital Adequacy Framework proposed in the notice of proposed rulemaking published on September 25, 2006 (Basel II NPR).
>
> In this notice of proposed rulemaking (NPR or Basel IA), the Agencies are proposing to expand the number of risk weight categories, allow the use of external credit ratings to risk weight certain exposures, expand the range of recognized collateral and eligible guarantors, use loan-to-value ratios to risk weight most residential mortgages, increase the credit conversion factor for certain commitments with an original maturity of one year or less, assess a change for early amortizations in *securitizations* (emphasis added) of revolving exposures, and remove the 50 percent limit on the risk weight for certain derivative transactions. A banking organization would have to apply all the proposed changes if it chose to use these revisions."[143]

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[142] 71 FR 77446, Federal Register, Vol. 71, No. 247. [Proposed Rules, Part II]
[143] *Ibid.*

The proposed rule clearly enlists banks or bank holding companies associated with securitizations to apply either the existing or proposed rules in order to properly adjust risk-based capital. Should the proposed rules be put in force, of particular interest is the provision that "a bank that securitizes revolving credits[144] where the securitization structure contains an early amortization provision must maintain risk-based capital against the investors' interest"[145]. This means when an early amortization provision is triggered, it causes investors in the securitization "to be repaid before the original stated maturity of the securitization exposures, unless the provision is triggered solely by events not directly related to the performance of the underlying exposures or the originating bank (such as material changes in tax laws or regulations)"[146]. The question now is where would the early repayment come from? To better protect the investors' interest, which is represented by "the total amount of securitization exposures issued by a trust or special purpose entity to investors"[147], the proposed rules require that the investors' loss from securitization exposures be offset by the bank's risk-based capital. The risk-based capital should be well adjusted and properly maintained. In the proposed measure, the risk-based capital for securitizations of revolving credit exposures that incorporate early-amortization provisions will be assessed "on a comparison of the securitization's annualized three-month average excess spread[148] against the excess spread trapping point[149]".[150] Without going into further details, it is quite evident that the rules require banks to maintain a well-adjusted risk-based capital system and that there are very detailed implementation procedures.

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[144] The proposed rules defined "revolving credit" as "a line of credit where the borrower is permitted to vary both the drawn amount and the amount of repayment within an agreed limit." *Ibid* at p. 77485.
[145] *Ibid* [Section E. "Securitizations of Revolving Credit with Early Amortization Provisions", at p. 77485].
[146] *Ibid.*
[147] *Ibid.*
[148] "Excess spread" is defined by the proposed rules as "gross finance charge collections and other income received by a trust or special purpose entity minus interest paid to the investors in the securitization exposures, servicing fees, charge-offs, and other similar trust or special purpose entity expenses" *Ibid.*
[149] "Excess spread trapping point", according to the proposed rules, refers to "the point at which the bank is required by the documentation governing a securitization to divert and hold excess spread in a spread or reserve account, expressed as a percentage." *Ibid.*
[150] *Ibid* at pp. 77485-77486.

With much optimism, it is expected that the rather detailed and elaborated proposed rules, if heeded by banking organizations to a satisfactory level, should gradually remove the Agencies' reservations about securitizations and instead grant banking organizations "with more power so long as such power translates into activity 'incidental' to carry on the business of banking"[151]. Since bank holding companies that meet extra requirements such as being "well-capitalized", "well-managed", and having a "satisfactory or better CRA rating", can elect to become financial holding companies (FHCs), the proposed rules (and later versions) should automatically apply to FHCs. One can reasonably assume that once public opinion has been consulted and the final rules are issued and further encoded into formal regulations, securitization may soon be included into the category of permissible (newly-authorized) activity by the GLBA, subject to conditions set out in future Agencies' interpretations and formal regulations.

IV. Conclusion

After the *Gramm-Leach-Bliley Act* ("GLBA") was signed into law by then U.S. President Clinton on November 12, 1999, it resulted in the most sweeping reform of financial services regulation in the past sixty-six years. The Act marks a watershed change by tearing down the legislative barrier that once prevented commercial banks from affiliating with securities and insurance businesses. In doing so, the Act permits the formation of a financial services holding company by enabling it to offer to its customers "one-stop shopping financial services".

While the GLBA is a comprehensive piece of financial legislation, my focus, however, is on the 'newly-authorized (i.e. permissible) activities' by GLBA, the financial affiliations of banks, securities firms, and insurance companies and on their functional regulation.

In respect of financial affiliations, Title I of the Act facilitates affiliations among banks, securities firms and insurance companies. As far as the actual corporate structure is concerned, financial organizations are able to structure these

[151] McMillan, *supra*, note 125, at 146.

new financial affiliations through a holding company structure, or a financial subsidiary (with limitations on activities and appropriate safeguards). A bank holding company can now qualify as a financial holding company and expand into a wide variety of services that are financial in nature, provided that its subsidiary depository institutions are "well-managed", "well-capitalized" and have received a "satisfactory or better" rating on their last *Community Reinvestment Act* examination[152].

With regard to functional regulation, Title II of the Act sets forth changes related to the securities industry. Among these, the Act replaces the broad exemption banks had enjoyed from Securities and Exchange Commission ("SEC") regulation with more limited exemptions and directs the SEC and the Federal Reserve Board ("FRB") to work together to establish rules for future hybrid financial products. The Act also requires banks that advise mutual funds to register with the SEC as investment advisers; it also obliges banks selling mutual funds to clearly disclose that these funds are not federally insured, in order to better protect bank customers from unexpected losses. As a corollary, for those bank customers that are interested in such investments, the "buyer beware" principle shall apply and the safety net provided by federal deposit insurance does not extend to cover this type of loss, as it was not designed for this purpose. As to the functional regulatory institution for insurance businesses, Title III of the Act reaffirms that states are the regulators for insurance activities. Nonetheless, the Act preempts any State laws that prevent depository institutions and their affiliates from conducting insurance activities[153].

The breakdown of legislative barriers sparked the merger trend among financial institutions. According to a Federal Reserve Bulletin, released briefly after the Citigroup merger, "there were approximately 9,000 banks in the United States by the end of 1997, down from 12,300 in 1980"[154]. The reduction in the number of banks, according to one commentator, "is due almost entirely to mergers and acquisitions…."[155] The merger trend then created headaches for financial sector

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[152] See "Financial Services Modernization Explanation" in Benson, Bianco & Hamilton, *supra*, note 11, at 21-23.
[153] *Ibid.*
[154] See Statements by Laurence H. Meyer, Before the Committee on the Judiciary, U.S. House of Representative, June 3, 198, Federal Reserve Bulletin, No. 8, Vol. 84, Page 619.
[155] Way-Wen Yang, *World Banking Revolution: The Legal Perspective*, (Taipei: Hwa-Tai, 2001) at 56. (In Chinese)

supervisors as it brought a challenge to the U.S. barriers between banking, insurance, and securities. Faced with the trend towards homogenization in the financial service industry, meaning the conglomeration of all financial services including banking, insurance and securities, "functional regulation" was the solution provided by the financial holding company's umbrella supervisor. The Federal Reserve Board would be the "umbrella regulator" for all FHCs, facilitating and delegating the responsibilities and works of supervisory institutions overall (the OCC, FDIC, SEC, State Insurance Commissioners, etc.) in order to identify and address potential risks to the depository institution associated with the securities and other activities, within an FHC. A case in point is the joint notice issued by the FRB, OCC, FDIC, and OTS (on December 26th, 2006) concerning four different types of capital requirements linked to securitization. Functional regulation is premised on mutual cross-industry reliance and cooperation among the regulators.

Financial liberalization in the U.S. is going forward. The GLBA was intended to increase the competitiveness of the U.S. financial industry. This is to suggest that legal reform in this case was initiated as a means to achieve economic reform. As one commentator noted "in fact, commercial banking's decline is a study in regulatory interference and disruption of natural market dynamics. *Glass Steagall*, the *Bank Holding Company Act* ... have acted to prevent banking from following a course driven by the market and thus stifled the innovative forces of competitiveness. This effect is particularly serious in the current environment of rapid technological advances and plummeting information costs. Such an environment allows smaller competitors to access markets heretofore denied to them."[156] With the GLBA finally in place, the meaning of enhancement can be interpreted in both domestic and international contexts. Internationally speaking, by removing previous legal barriers in its internal law, the GLBA provides a level playing field for U.S. financial institutions to compete for international capital market resources. This would concomitantly help increase the U.S. financial industry's global competitiveness, as more and more players, regardless of their size, vie to maintain or even increase their shares in the global market. At the domestic level, this proposition indicates that even prior to the GLBA, as investment services began to encroach into commercial

[156] M. E. Nance & B. Singhof, "Banking's Influence over Non-Bank Companies after Glass-Steagall: A German Universal Comparison" (2000) 14 Emory International Law Review 1305 at 1344.

bank services, commercial bank services moved into traditionally defined investment bank territory. This all goes to show that legal restraints have in fact failed to completely contain market forces. To some degree legal reform driven by market forces was inevitable.

Due to a wide range of services being provided, banks generally have larger clientele than other companies do in the other two financial sectors: insurance companies and securities firms. This explains why first, banks are regarded as the most important and effective distribution channel, and secondly, in a frenzy of merger mania, operational synergy is often sought by banks, rather than the other way around, as banks hold more economic power and hence can exercise more control. This phenomenon is therefore counterintuitive, at least for some who hold that the GLBA comes to the rescue for banks who must survive cross-industry mergers and acquisitions. As a matter of fact, it may be the other way around; banks have reported large amounts of revenue growth and profit, especially since the mid-1990s. In this regard, one commentator agrees that in the near future, "banks are likely to be the principal survivors of inter-industry consolidation."[157]

Since the mid-1990s, banks, faced with stronger competition from insurance companies and securities firms, which also provide certain lending services to their respective customers, have started to make a shift in their loan-making policies. As part of their strategic lending practice, banks (especially those big banks in the U.S.) reportedly have "aggressively expanded their syndicated lending to leveraged borrowers, real estate developers, and real estate development trusts (REITs), because those loans carry larger interest rate spreads and higher fees than loans made to investment-grade borrowers. Thus, major banks have 'moved away from their traditional territory of relationship-building, investment-grade lending' and, instead, have embraced a 'capital markets mentality' that seeks higher-risk, 'high-return' transactions."[158] Banks' willingness to take higher risks is especially true with the advent of securitization, whereby banks have had successful experience in redistributing their market risks from mortgage loans and credit cards.

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[157] Wilmarth, Jr., *supra*, note 82, at 436.
[158] *Ibid* at 381-382.

Many observe that the banking industry maintains their focus on "the shift of household savings from bank deposits to financial market investments, [which they believe] helps to explain the decline in traditional bank lending and the growth of capital market substitutes for bank loans."[159] In this regard, commentary which opposes the GLBA's intention to save the banking industry nonetheless dismisses the argument by stating that "the decline of traditional bank intermediation does not mean that banks have lost their importance to the national economy [or their competitive edge]. As described above, large banks continue to provide off-balance-sheet lines of credit that serve as backup sources of liquidity for major industrial corporations and non-bank financial institutions. In addition, banks have expanded into a wide array of new activities, many of which (e.g., derivatives, securitization, standby letters of credit, and trust operations) also occur off their balance sheets and, therefore, are not included in conventional asset figures. Broader measures of banking activity, which take account of off-balance-sheet operations, show that the overall significance of the banking industry in the U.S. economy has not declined since the mid-1970s."[160]

Evidence that supports the view that the banking industry is in good shape further stresses that "[p]erhaps more importantly, the market capitalization of the banking industry in 1999 was four times as large as the combined market capitalization of the securities and life insurance sectors. Due to this huge capital advantage enjoyed by banks, most of the surviving firms in future inter-industry combinations are likely to be banks. For example, since the early 1990s, large U.S. and foreign banks have acquired dozens of U.S. securities firms, and only one significant bank has been purchased by a securities firm."[161] The commentator further draws upon similar experiences in both Canada and the United Kingdom with financial deregulation since the late 1980s, citing both countries as having been places where banks were the principal survivors of inter-industry consolidation[162]. Citing Professor Jonathan Macey[163] in 2000, the same commentator noted that "banks are not on the verge of extinction now, and they were not on the verge of extinction before the [GLBA] was passed. He [Professor Macey] contends—correctly, in my

[159] *Ibid* at 435.
[160] *Ibid.*
[161] *Ibid* at 436.
[162] *Ibid.*
[163] Jonathan R. Macey, The Business of Banking: Before and After Gramm-Leach-Bliley, (2000) 25 J. Corp. L. 691 at 693.

view—that the banking industry was 'alive and well' when the [GLBA] was adopted. As he points out, banks remained powerful in 1999, despite three decades of wrenching change, because (i) their access to federal deposit insurance and the federal payments system gave them important advantages as intermediaries of short-term investment funds (i.e. deposits), (ii) they were the primary lenders for firms that could not easily be evaluated or monitored by outside investors, (iii) they provided lines of credit that were crucial to the stability and proper functioning of the capital markets, and (iv) they had already established a substantial presence in the securities business by exploiting regulatory loopholes in the Glass-Steagall Act. Professor Macey therefore concludes, and I agree, that a frequently stated justification for the [GLBA]—namely, that commercial banking had become an 'obsolete' business—was 'fundamentally false'."[164] In recent years, the banking industry not only has exemplified its economic robustness within domestic markets but has also expanded into overseas markets; in this light, the GLBA's permitting of FHCs (most of them are bank-led) to engage in newly-authorized activities would positively sustain and even multiply the economic power of U.S. banks and their banking industry as a whole. The success of U.S. FHCs (most distinctively, the Citigroup) inspired Taiwan's FHCs to attain optimal operating efficiency made possible by inter-industry consolidation. Taiwan's *Financial Holding Company Act* ("FHCA") owes much of its content to the U.S. GLBA ("the U.S. model"), therefore in the next chapter; a comparative study will be conducted featuring the key elements in both laws.

[164] Wilmarth, Jr., *supra*, note 82, at 436-437.

Chapter Five (Conclusion)

A Comparison of Taiwan's Financial Holding Company Act and the U.S. Model

I. Introduction

A financial holding company ("FHC") is a relatively new kind of bank holding company which currently can draw on two types of regulatory models. The U.S. model is represented by the GLBA (short for *Gramm-Leach-Bliley Financial Modernization Act of 1999*[1]) while the E.U. model is represented by the *Second Banking Directive of 1989*[2]. Despite the fundamental structural differences—such as the larger capital base and the maintenance and existence of a dual banking system that characterize and distinguish the U.S. financial services sector—Taiwan's *Financial Holding Company Act* ("FHCA") still opts to find inspiration from its U.S. counterpart. Taiwan's FHCA is basically modeled after the U.S. model but selectively adopts parts of the E.U. model (e.g. "minimum capital requirement"), and in some cases, the relevant laws in Japan (e.g. "management anti-locking"). In Part II of this chapter, I intend to compare Taiwan's FHCA with the U.S. GLBA though a comparative study concerning certain key elements within both laws. To list them, they are (1) minimum capital requirements, (2) the umbrella regulator, (3) the functional regulator, (4) well-capitalized and well-management requirements etc., (5) competition policy (usually referred to as 'anti-trust' in the U.S.), (6) exempting financial holding company establishment as a result of smaller capital, (7) exempting foreign FHCs from additional local establishments, and (8) the management or employment interlock between the FHC and its affiliates or

[1] Gramm-Leach-Bliley Financial Modernization Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999).
[2] Directives EC, *Second Council Directive 89/646 of Dec. 15, 1989 on the Coordination of Laws, Regulations and Administrative Provisions Relating to the Taking Up and Pursuit of the Business of Credit Institutions and Amending Directive 77/780/EEC*, [1989] O. J. L 386. [hereinafter the Second Banking Directive].

subsidiaries (which is permitted by the U.S. GLBA but otherwise prohibited by Taiwan's FHCA).

In Part III of this chapter, Citigroup's recent break-up, announced in February, 2005 provides an opportunity for us to reassess the feasibility of synergies between the banking and insurance industries. As revenue increases from operational synergy is the ultimate goal for forming financial conglomerates, when these two objectives are not met, breaking up the conglomeration is a logical consequence. In the Citigroup merger circumstances, the financial conglomerate had "spent the past two decades buying up an array of financial services companies, putting together an ever bigger and ever more global network, offering more and more products to existing customers and using the one-stop shopping approach to lure new clients"[3]. If less-than-satisfactory profit is returned from such a large-scale buying spree, other alternatives must be sought in order to generate much anticipated profits and meet shareholder expectations. In this regard, the recent break-up of Citigroup provides us another perspective from which to analyze the appropriateness of the GLBA. Citing one commentary, "[e]conomic studies have generally found global diseconomies of scope in full service U.S. and foreign banks that are larger than [US$] 25 billion or that combine lending activities with nontraditional, fee-based activities such as derivatives, loan sales, and securities underwriting and trading. Investors appear to recognize the clear potential for scope inefficiencies when large banks diversify their operations....consumers have generally responded in a lukewarm or negative manner to 'one-stop shopping' programs established by diversified financial firms. Many consumers have instead shown a clear preference for specialized providers that offer better service at lower cost and avoid the conflicts of interest inherent in diversified financial institutions."[4] Ironically, the commentary pointed out that Citigroup is lone exception to this dismal finding, having so far "generated respectable profits from [an FHC] strategy, [but the commentary continued to warn that] its ambitious expansion program has not yet faced the test of a severe and prolonged

[3] Loren Steffy, "Breaking up isn't so hard when no one's profiting", The Houston Chronicle (4 February 2005) Business Section, pg.1. Available also through LexisNexus news search.
[4] Arthur E. Wilmarth, Jr., "The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation, and Increased Risks" (2002) 2002 U. Ill. L. Rev. 215 at 281-282.

economic downturn."[5] Despite the commentary's contrasting viewpoint, the FHC establishment does have its appeal in terms of its potential to reap synergistic benefits. One can fairly describe that the move to transition to an FHC has become an irreversible trend. Furthermore, the above-mentioned commentary is probably only seeing part of the truth, because Citigroup's competitors, such as Standard Chartered and HSBC, also have reported revenue increases (although both European-based financial giants may have been run as a "universal bank", which is similar to an FHC but not the same). Under this premise, the key is to focus on how to strike a balance between both the "cut-cost" rule and the "business of scale" rule, especially from the viewpoint of cross-selling, a capacity which is only enabled by the establishment of an FHC.

If Citigroup's break-up implies some failure of the FHC system, it is vital to evaluate both the pros and cons of FHCs and universal banks. Taiwan's FHCA emulates parts of the U.S. GLBA (which produces the FHCs) and also incorporates some principles from the European Union's *Second Banking Directive*. In juxtaposition with the U.S. model with the E. U. model, I intend to understand financial holding companies from an international law perspective. Although the advantages and disadvantages of FHCs when compared to universal banks have already been discussed (in "Introduction", the introductory chapter), most commentators suggest that there is no consensus yet as to whether one model is better than the other (i.e. whether or not FHCs are better than universal banks, or vice versa). To continue this discussion, in Part IV of this chapter, I will present another commentator's viewpoint which maintains that the E. U. model is quite "revolutionary", compared with the more "evolutionary" U.S. model. That being said, statistics put together by a research team in 1999 (that is ten years following the enactment of the *Second Banking Directive* in 1989) otherwise suggested that the level of integration has not improved significantly. In the same vein, a more recent report by 'The Economist' in 2005 also suggested there is not much breakthrough in cross-border banking convergence. This is quite alarming given the first and foremost goal for the *Second Banking Directive* was to create a single license for banking within the E.U. and to facilitate cross-border banking movement. A brief conclusion that contains

[5] *Ibid* at 284.

comparative analyses on the U.S. model, E. U. model, and their correlation with Taiwan's FHCA will follow.

II. Comparing Taiwan's Financial Holding Company Act ("FHCA") with the U.S. Gramm-Leach-Bliley Act ("GLBA")

1. Minimum Capital Requirement

Taiwan's FHCA, though closely modeled on the U.S. GLBA, otherwise sets out the "minimum capital requirements". Though this is not enforced in the U.S. for a single FHC, it is observed in the European Union following its adoption of the *Second Banking Directive*.

In juxtaposition to the financial holding company structure that prevails in the U.S. (the "U.S. model"), the universal banking system is predominant in the European Union (the "E.U. model"). As for the provision of safety nets, the U.S. model delegates such responsibility to the Federal Deposit Insurance Corporation (FDIC), while the E.U. model requires banking institutions within the region to self-insure its capital and financial soundness. The method, as prescribed in Article 4 of the *Second Banking Directive*, is equivalent to meeting "minimum capital requirements".

> Article 4 of the *Second Banking Directive* provides that:
> "1. The competent authorities shall not grant authorization in cases where initial capital is less than ECU 5 million.
> 2. The Member States shall, however, have the option of granting authorization to particular categories of credit institutions the initial capital of which is less than that prescribed in paragraph 1. In such cases: (a) the initial capital shall not be less than ECU 1 million; ..."

Variance between the U.S. and E.U. models makes one wonder why there is no minimum capital requirement provision in the GLBA, the governing law for U.S. financial holding companies (FHCs), as opposed to the *Second Banking Directive*, the governing law for E.U. universal banks. On the other hand, Article 12 of Taiwan's FHCA stipulates that "the FSC (Financial Supervisory Commission) shall prescribe the minimum paid-in capital of a Financial Holding Company." It then begs the question—does Taiwan take a two-pronged approach by selectively adopting both the U.S. and the E. U. models?

Taiwan emulated the U.S. model (the GLBA) and adopted a pure-holding company structure, umbrella regulator, functional supervision, and also exempted domestic establishment by foreign FHCs. Nonetheless, given that the Ministry of Finance in Taiwan prescribes that an FHC in Taiwan must meet a minimum capital requirement of NT$ 20 billion[6] (equivalent to approximately US$ 670 million), this mandate clearly reflects similar provisions in the E.U. model (the *Second Banking Directive*). Even so, the "Underlying Reason" (*li fa li you*, in Chinese) for Article 12 of Taiwan's FHCA does not explicitly characterize the "minimum capital requirement" as a cross-adoption of the E.U. model, except to refer to it as an inherence of Article 23 of the *Banking Act* in Taiwan.

Emphasis need be made that despite the legislative absence of "minimum capital requirements" in the GLBA, in practice, the Fed (Federal Reserve) otherwise has the authority to apply these requirements. According to the American Bankers Association summary on the GLBA, prepared by Covington & Burlington, it is said that "the Act does not affect the Federal Reserve's authority to establish consolidated capital requirements for an FHC, which would take into account at the holding company level the assets held by functionally regulated subsidiaries of the FHC."[7] It is fair to suggest

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[6] See Order of the Ministry of Justice (no. 0901000116), entitled "The Minimum Subscribed Capital for the Financial Holding Company".

[7] Covington & Burling, Financial Modernization: The Gramm-Leach-Bliley Act Summary, American Bankers Association, 1999 (See Executive Summary). Covington & Burling is a Washington law firm, which is credited, by Hjalma E. Johnson, then President of American Bankers Association, to have one of the foremost banking practices in the U.S..

that the "minimum capital requirement", thought not seen in the GLBA, still applies to a single FHC in the U.S., in a rather indirect fashion. That is because in the U.S., an FHC's financial strength and stability is weighted on a 'consolidated basis', and the minimum capital requirement for each FHC subsidiary is determined by its respective functional regulator (i.e. banks by OCC, securities firms by SEC, and insurance companies by State Insurance Commissioners).

2. Umbrella Regulator

As with the Board of Governors of the Federal Reserve System (also known as "the Federal Reserve Board"; "the Board"; "FRB") being an umbrella regulator to FHCs in the U.S., the Financial Supervisory Commission (FSC) acts similarly with respect to FHCs in Taiwan. To emulate the role and function successfully assumed by the FRB, the FSC was established in Taiwan in July 2004, with a view to promoting and integrating financial supervision.

In the U.S., the GLBA grants the FRB authority to supervise and impose restrictions or requirements on relationships or transactions between depository institutions and any affiliate. The GLBA, by making the Federal Reserve (the Fed) the umbrella regulator of a consolidated FHC, directs the Fed to be concerned with (i) the FHC's overall financial condition and its systems for monitoring and controlling financial and operating risks, (ii) transactions with depository institution subsidiaries, and (iii) compliance with legal restrictions on the FHC[8]. In so doing, the FRB acts as a watchdog to safeguard the federal deposit fund and meanwhile, to ward off moral hazard.

In the same vein, Article 3 of Taiwan's FHCA refers to the FSC as the "competent authority" (the term is defined in Taiwan's *Banking Act*), to oversee FHCs in Taiwan. According to the Taiwan Year Book 2004, the task of financial supervision was formerly split among three Ministry of Finance (MOF) agencies, namely the Bureau of

[8] PricewaterhouseCoopers, "An Executive's Guide to U.S. Financial Modernization", published by PricewaterhouseCoopers in January 2000, p.11.

Monetary Affairs (BOMA), Securities and Futures Commission (SFC), and Department of Insurance. It was not until July 1, 2004, the FSC under the Executive Yuan was formally established, marking the beginning of a new era in Taiwan's unitary financial monitoring system. It is suggested, with rapid changes in both domestic and overseas financial environments, the FSC's top priority would be to continually promote domestic financial reform so as to develop a system of laws and institutions that maintains long-term stability for Taiwan's financial markets[9]. Undeniably, the purpose of promoting the establishments of FHCs in Taiwan is to "emulate, at least to some degree, the power and success of multinational financial powerhouses such as Citigroup and HSBC", as suggested by the American Chamber of Commerce in Taipei[10].

Similarly to U.S. practice, where the FRB becomes the "umbrella regulator" for all FHCs in the U.S., the FSC in Taiwan is aimed towards consolidating the supervision of the banking, securities and insurance industries, as well as towards integrating the tasks of examining these financial industries.[11] As a functional regulatory power in the U.S., the FRB has overall supervisory power to identify and address potential risks to depository institutions associated with the securities and insurance activities in the organization (i.e. FHC). Following the FRB's footsteps, the Legislative Yuan (Taiwan's Parliament) passed the *Act Governing the Establishment and Organization of the Financial Supervisory Commission of the Executive Yuan* on July 10, 2003[12] and the FSC has been established accordingly almost one year after to provide such "umbrella supervision" similar to that of the FRB in the U.S..

Further, equally applicable to Taiwan's FHCs are the "best practice and the principles for corporate governance". These guidelines are otherwise set out by "relevant

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[9] See Taiwan Year Book 2004 on "Financial and Banking"—Money and Banking (released on June 27, 2005) Available at [http://english.www.gov.tw/Yearbook/index.jsp?categid=158&recordid=83310]

[10] Brian Asmus, "Financial Holding Companies Spur Consolidation Drive", in Vol. 33, No. 10 of AmCham's Local Circulation in Taiwan. The underlying purpose of AmCham's establishment in Taiwan, as noted in their website, is that "AmCham fosters the development of investment and trade between the United States and Taiwan, and it seeks to enhance Taiwan's economic environment by promoting the adoption of international business standards in the areas of legislation, regulation, and enforcement."

[11] "New Era", on-line information provided by Financial Supervisory Commission (FSC) in Taiwan: [http://www.banking.gov.tw/ct.asp?xItem=31503&CtNode=694]

[12] *Ibid.*

governing bodies", including the Securities & Futures Bureau of the Financial Supervisory Commission, the Taiwan Stock Exchange, the Bankers Association and the Taiwan Securities Association[13].

3. Functional Regulator

(3.1) The Interrelationship between the Umbrella Regulator and Functional Regulator(s)

In the U.S., functional regulation is premised on mutual cross-industry reliance and cooperation among the regulators[14]. Through Section 113 of the GLBA, the Act firmly establishes the Fed as the umbrella regulator for consolidated FHCs owning affiliates to engage in all-round financial activities (banking, insurance, and securities). Notwithstanding the Fed's far-reaching power, the GLBA also limits, to some extent, the Fed's authority over entities that are functionally regulated by other regulators. For instance, Section 114 of the GLBA mandates that banking should be functionally regulated by bank regulators (OCC, FRB, and FDIC)[15]; in parallel, Section 111(4) instructs securities to be functionally regulated by the Securities Exchange Commission (SEC), and insurance by the State Insurance Commissioners.

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[13] See [http://www.cdibh.com/en/governance-about.aspx]

[14] Covington & Burling, *supra*, note 7.

[15] For National banks, the *Gramm-Leach-Bliley Act* gives the Office of the Comptroller of the Currency (OCC) the authority to regulate transactions and relationships between national banks and their subsidiaries. For State banks, on the other hand, they can be further divided into two categories. For State *Member* Banks, the Federal Reserve Board (FRB) may impose regulations on relationships and transactions between State member banks and their subsidiary. For State *Non-Member* Banks, the power to regulate relationships and transactions between state non-member banks and their subsidiaries is vested in the Federal Deposit Insurance Corp. (FDIC). See K. R. Benson, K. M. Bianco & J. Hamilton, *Financial Services Modernization Gramm-Leach-Bliley Act of 1999 Law and Explanation* (Chicago: CCH Incorporated, 1999) at 43-44.

(3.2) The Umbrella Regulator Must Defer to Its Subordinated Functional Regulator(s)

The GLBA directs the Fed not to intrude on the supervision of FHC subsidiaries or activities which another agency functionally regulates[16]. To that end, the GLBA directs the Fed to rely to the "maximum extent possible" on examinations and reports prepared by functional regulators. These can include publicly reported information, and reports filed with other regulators, for instance the SEC or the State Insurance Commissioners. A report by PricewaterhouseCoopers[17] sums up an example of the deference in Section 111(1) & (2) of the GLBA, as follows—the Fed may require an FHC to file only the reports needed to respond to the concerns that the GLBA vests with the FRB. In case the Fed must obtain information it needs about a functionally regulated subsidiary, it must do so through reports made to that subsidiary's regulator. That basically means the Fed must rely on and trust the reports made to the functional regulators. Only in rare cases may the Fed itself require a report from a regulated subsidiary. The Fed must therefore defer to the assessment conducted by its subordinated functional regulators—they must rely and trust their fact-finding facility as delegated by the law.

Similar regulations with respect to limiting the Board's (FRB's) authority can also be found in Sections 112 and 113 of the GLBA. The former (Section 112) refers to the FRB's deference to functional regulators—the State insurance authority for the insurance company, or the SEC (or State securities regulator, as the case may be) for the registered broker, dealer, investment adviser or investment company. Worth noting is that the insurance company or a broker or dealer herein are registered under the *Securities Exchange Act of 1934*; the investment company, registered under the *Investment Company Act of 1940*; and investment adviser, registered by or on behalf of either the SEC or any State. Also, the insurance company thereof can either be a bank holding company or an affiliate of the depository institution. The latter (Section 113) refers to the GLBA's limitation on FRB's rule-making power.

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[16] PricewaterhouseCoopers, *supra*, note 8, at 11.
[17] *Ibid.*

Section 115 of the GLBA goes on to instruct that the examination authority of investment companies belongs to the SEC and the FDIC. Suffice it to say, a federal banking agency (as part of the Federal Reserve System) may not inspect or examine any registered investment company unless it is an affiliate[18] of a bank holding company or a savings and loan holding company.

Furthermore, through Section 111(3) of the GLBA, the Fed is also prohibited from applying any capital standard directly to any functionally regulated affiliate that is already in compliance with the capital requirements of its regulator[19]. The rationale that underlies this decision is based on the belief that each functional regulator knows best the business entities subject to its jurisdiction. It should be noted that the capital requirement in the U.S. is set for each individual financial subsidiary by its respective functional regulator, and not set for an FHC on a consolidated basis.

It should be noted that despite these legislative restrictions, for reasons of prudence, the GLBA does not prevent the FRB from exercising authority wherever necessary. Section 114 of the GLBA mandates that the FRB may exercise its authority as a watchdog, if doing so is consistent with the purpose of the GLBA, the *Bank Holding Company Act of 1956*, the *Federal Reserve Act*, and other federal law applicable to depository institution subsidiaries of bank holding companies or state member banks. As well, the FRB may exercise this authority if doing so is appropriate to avoid any significant risk to the safety and soundness of depository institutions or any Federal deposit insurance fund or in order to avoid any adverse effects, such as undue concentration of resources, decreased or unfair competition, conflict of interests, or unsound banking practices.

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[18] As can be seen from Section 112(c) of the GLBA with respect to definitions, the word "affiliate" is used interchangeably with "subsidiary" in this Act.
[19] Covington & Burling, *supra*, note 7.

(3.3) Functional Regulation Promotes Interagency Consultations

The purpose of functional regulation is to promote interagency consultations. Under this premise, Section 103(2) of the GLBA requires that the Fed (i.e. "the Board") consult with the Secretary of the Treasury to determine whether an activity is financial in nature or incidental to a financial activity. To make this decision, Section 103(3) instructs the Board to take into account (a) the purposes of the *Bank Holding Company Act* and the *Gramm-Leach-Bliley Act*; (b) changes or reasonably expected changes in the marketplace in which *financial holding companies* (emphasis added) compete; (c) changes or reasonably expected changes in the technology for delivering financial services; and (d) whether such activity is necessary or appropriate to allow a bank and the subsidiaries of a bank to (i) compete effectively with any company seeking to provide financial services in the U.S.; or (ii) efficiently deliver information and services that are financial in nature through the use of technological means, including any application necessary to protect the security or efficacy of systems for the transmission of data or financial transactions; and (iii) offer customers any available or emerging technological means for using financial services or for the document imaging of data. In a similar vein, though the Fed may add to the list of activities that are financial in nature or incidental to a financial activity, either by general regulation or by decision on a specific application, before doing so, Section 103(2) requires that the Fed must consult the Secretary, who may veto the addition of any new financial activity[20]. Conversely, Section 103(2) mandates that the Secretary of the Treasury may, at any time, recommend in writing that the Board (of Federal Reserve) find an activity to be financial in nature or incidental to a financial activity. Usually within 30 days upon receipt of a written recommendation from the Secretary of the Treasury, the Board shall determine whether to initiate a public rule-making proposing that the recommended activity be found to be financial in nature or incidental to a financial activity. Section 121(b) of GLBA basically restates the need for interagency consultation and this has been reflected in Section 103 of the same Act. In a similar spirit, the Secretary of the Treasury and the FRB shall notify and consult with each other concerning any request, proposal, or application under this section for a

[20] PricewaterhouseCoopers, *supra*, note 8, at 4.

determination of whether an activity is financial in nature or incidental to a financial activity. The FRB may, at any time, recommend in writing that the Secretary find an activity to be within this realm. Despite the similarities in legislative wording towards a determination of whether an activity is financial in nature or incidental to a financial activity, it should be noted that Section 121(b) of the GLBA applies directly to financial subsidiaries of *national banks* (emphasis added) while Section 103(4) applies to those of *financial holding companies* (emphasis added). Comparing Section 121(b) with Section 103(4), in regards to "newly authorized financial activities both by the Board and the Secretary of the Treasury", as a result of the GLBA, it is fair to say that permissible activities (i.e. those deemed 'financial in nature' or 'incidental' or 'complementary' to such financial activities) for financial holding companies are much broader than those for national banks. In fact, the difference in treatment encourages eligible financial institutions to apply and qualify to become FHCs in the U.S..

In a similar manner in Taiwan, Article 52 of Taiwan's FHCA indicates that "to ensure the sound operation of Financial Holding Companies and/or their Subsidiary(ies), the Financial Supervisory Commission may order a Financial Holding Company and its Subsidiary(ies) to provide relevant financial statements, transaction data and other relevant information within a prescribed period of time, and may at any time appoint an official or authorize an appropriate institution to investigate the business, finances, and other relevant affairs of such FHC and/or its Subsidiary(ies)". Such investigation must be conducted by professionals and technical experts, and must be based on the relevant facts. The results should also be reported to the Financial Supervisory Commission[21]. As for the investigation fees, the same article also prescribes that unless otherwise provided by law, the Financial Holding Company shall pay the fees arising from there. The legislative reason defines this as a "user fee".

[21] Paragraph 2, Article 52 of Taiwan's *Financial Holding Company Act*.

(3.4) The Structure of Umbrella Regulator vis-à-vis Functional Regulator(s)

Structurally speaking, in the U.S., the FRB is the single unified umbrella regulator that delegates its supervisory power, based on the principle of "functional supervision", to the OCC (Office of the Comptroller of the Currency), the FDIC (Federal Deposit Insurance Corporation), SEC (Securities Exchange Commission), and the SIC (State Insurance Commission) to be in charge of the banking (OCC and FDIC), securities (SEC), and insurance (SIC) industries. As mentioned before, "functional supervision" means that the regulator with the most experience and expertise in an industry will oversee each of the FHC's diverse activities. In Taiwan, the FSC is the single unified umbrella regulator that delegates its responsibility based on "functional supervision"—banking is supervised by the Banking Bureau; securities by the Securities and Futures Bureau; insurance by the Insurance Bureau; and law enforcement by the Examination Bureau.

Worth noting is that prior to the FSC becoming the umbrella regulator in July 2004, there existed two sets of powers with respect to Taiwan's financial system. One was an "administrative managerial power" that is wielded by the Ministry of Finance, and the other, a "financial supervisory power", shared among three governmental organs: the Ministry of Finance, the Central Bank of China, and the Central Deposit Insurance Corporation. Concerning the "administrative managerial power", the Ministry of Finance, being the "competent authority", was legally in charge of four financial industries: banking, securities, futures, and insurance. In practice, however, these four industries were not overseen by the Ministry of Finance itself, but the responsibility was delegated to the Ministry's four subordinated groups; each has the experience and expertise in its own area—banking by the Banking Bureau; securities and futures by the Securities and Futures *Commission* (emphasis added); and insurance by the Insurance Bureau. The establishment of the FHC, combined with at least two of three industries: banking, insurance, and securities, called for a consolidated financial supervisory power to oversee the 14 FHCs currently existing in Taiwan. To this end, the *Organic Act Establishing the Financial Supervisory Commission, Executive Yuan* was seen as "the

foundation of a single vertically integrated system to solidify the business operations of financial institutions, maintain financial stability, and facilitate the development of financial markets." The Act was passed by the Legislative Yuan (Taiwan's Parliament) and promulgated by the President on July 23rd, 2003. Accordingly, the Financial Supervisory Commission (FSC) was subsequently set up on July 1st, 2004 as a single financial regulator, like the Federal Reserve Board in the U.S., to consolidate the functions of monitoring and setting the rules for the banking, securities, futures, and insurance industries, as well as to carry out cross-sector financial examinations.[22]

Emphasis needs to be made that under the FSC, there are in fact four governmental organs subordinated to it. In addition to the previously-named three: the Banking Bureau, the Insurance Bureau, the Securities and Futures Bureau (renamed after the Securities and Futures Commission), the Examination Bureau is granted quasi-judicial power for stronger law enforcement, provided that appropriate procedures have been observed. With four arms of power working under one giant head, the FSC is believed to be well-equipped to carry out vigorous law enforcement and comprehensive supervision[23]. Worth noting is that the FSC is an independent authority sitting at the cabinet level.[24] Certain requirements that pertain to the organization of the commission can provide some explanation for this fact. For example, the FSC's chairperson and commissioners are nominated by the premier and appointed by the President. All the commissioners must possess expertise and experience pertaining to their particular financial field of expertise and serve a fixed tenure of four years. It is also required that the number of commissioners belonging to the same political party cannot exceed 1/3 of the total number of commissioners and are not allowed to participate any political activities during their tenures.[25]

One commentator suggested that compared to the E.U.'s single supervisory regulator, the U.S.'s "one head, three-pronged" functional regulation is unnecessarily

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[22] See on-line Introduction to Taiwan's Financial Supervisory Commission. [http://www.fscey.gov.tw/ct.asp?xItem=508412&CtNode=2225&mp=5]
[23] *Ibid.*
[24] *Ibid.*
[25] *Ibid.*

complicated[26]. "One head" refers to the Fed being the umbrella regulator, while "three pronged" functional regulation refers to banking as supervised by the Fed, the OCC, and the FDIC; securities by the SEC; and insurance by the State Insurance Commissioners. More details will follow in a later section entitled "Comparing the 'Evolutionary' U.S. Model with the 'Revolutionary' E.U. Model".

4. Well-Capitalized and Well-Managed Requirements

In the U.S., the GLBA necessitates[27] a financial holding company meet the following requirements (1) well-capitalized[28], (2) well-managed[29], (3) Section 23A and 23B of the Federal Reserve Act (which limits the exposure of a bank to a financial subsidiary to the amount of permissible exposure to an affiliate), (4) capital deduction principles and safeguards for the bank, and (5) subsidiaries (which are understood as 'affiliates' of a financial holding company) must conduct activities that are either "financial in nature" or "incidental", or "complimentary" to such financial activities. Of these requirements, the FHC's capital requirement is arguably the most complex as the GLBA does not tell us how—or even whether—the Fed is to set consolidated capital requirements for FHCs. After all, even the "well-capitalized" requirement under existing regulatory definitions only refers to that for a "depository" institution[30] and does not refer

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[26] J. M. Jeannot, "An International Perspective on Domestic Banking Reform: Could the European Union's Second Banking Directive Revolutionize the Way the United States Regulates its Own Financial Services Industry?", (1999) 14 Am. U. Int'l L. Rev. 1715..

[27] Section 121 of the *Gramm-Leach-Bliley Act* titled "Subsidiaries of National Banks". For the same regulations on state banks, see 12 USCS § 1831w.

[28] According to Section 121 of the *Gramm-Leach-Bliley Act*, the term "well-capitalized" has the meaning given the term in Section 38 of the Federal Deposit Insurance Act. Further, according to PricewaterhouseCooper's report, to be "well-capitalized" under existing regulatory definitions, a depository institution must have: (i) a Tier 1 risk-based capital ratio of at least 6%, (ii) a total risk-based ratio of at least 10%, (iii) a leverage ratio of at least 5%, and (iv) no outstanding regulatory agency enforcement action or order. PricewaterhouseCoopers, *supra*, note 8, at 7.

[29] Subject to Section 121 of the *Gramm-Leach-Bliley Act*, the term "well-managed" means (A) In the case of a depository institution that has been examined: (i) the achievement of a composite rating of 1 or 2 under the Uniform Financial Institutions Rating System (or an equivalent rating under an equivalent rating system) in connection with the most recent examination or subsequent review of the depository institution; and (ii) at least a rating of 2 for management, if such rating is given. (B) In the case of any depository institution that has NOT yet been examined, the existence and use of managerial resources that the appropriate Federal banking agency determines are satisfactory.

[30] PricewaterhouseCoopers, *supra*, note 8, at 7.

to an "FHC". It goes on to say, that the "well-capitalized" and "well-managed" standards of the GLBA apply not to the FHC, as a parent company, but to its subsidiary banks and thrifts[31].

The FHC must maintain the standards of being "well-capitalized" and being "well-managed" at all times, not just when it files a notice or application with the Fed for becoming an FHC. If an FHC fails to do so, it may face potential divestiture. Related to this, if just one bank (or thrift) subsidiary loses its "well-capitalized" or "well-managed" rating, the regulators may dismember the FHC. Procedurally speaking, whenever the Fed finds that one or more of an FHC's depository subsidiaries is not "well-capitalized" or "well-managed", the Fed "shall give notice" to the FHC of its finding. The FHC will then be given 45 days to agree with the Fed on a remedial action plan and 180 days for the subsidiary to restore its ratings and become "well-capitalized" and "well-managed" again[32]. Failure to do so empowers the Fed to order the FHC either to divest its banks (or thrifts), or to cease insurance activities, securities activities, or any other activities authorized under the GLBA. Conversely, if an FHC chooses to keep its banks, then its other activities will be limited to those permissible to a bank holding company before the GLBA was enacted[33]. In this case, the FHC will be dismembered, devolving into a regular bank holding company; henceforth, its governing law is no longer the GLBA but the *Bank Holding Company Act*.

In Taiwan, Article 9 of the *Financial Holding Company Act* emulates the U.S. GLBA by requiring the Financial Supervisory Commission (FSC), upon approving an application for establishing a financial holding company, to consider the following: (1) the soundness of the financial and operational status and management capacity; (2) capital adequacy; and (3) the impact on the competitive situation in the financial market and on the public interest. (This is adapted from Section 121 of the US GLBA: "changes or reasonably expected changes in the marketplace in which banks compete".)

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[31] *Ibid* at 15.
[32] *Ibid* at 10.
[33] *Ibid.*

5. Competition Policy (Usually referred to as 'Anti-trust' in the U.S.)

In regards to anti-trust, Section 132 of the U.S. GLBA commands that to "the extent not prohibited by other law, the Comptroller of the Currency, the Director of the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, and the Board of Governors of the Federal Reserve System shall make available to the Attorney General and the Federal Trade Commission any data in the possession of any such banking agency that the 'antitrust' agency deems necessary for an 'antitrust review' of any transaction requiring notice to any such antitrust agency or the approval of such agency under Section 3 or 4 of the *Bank Holding Company Act of 1956*, Section 18(c) of the *Federal Deposit Insurance Act*, the *National Bank Consolidation and Merger Act*, Section 10 of the *Home Owners' Loan Act*, or the antitrust laws."

In parallel, paragraph 2 of Article 9 of Taiwan's FHCA states that "[i]f the establishment of a Financial Holding Company constitutes a combination of enterprises under Article 6 of the *Fair Trade Law* (Taiwan's Competition Policy), the FSC approval shall be subject to the approval of the Fair Trade Commission (FTC)." Further, examination criteria for the FTC approval shall be prescribed by the FTC, in consultation with the financial holding companies' supervisory regulator, the Financial Supervisory Commission (FSC)[34].

6. Exempting Financial Holding Companies (Smaller Capital)

The U.S. GLBA provides banks with an alternative to using a "financial subsidiary" of the bank (both national and state) rather than an FHC as the vehicle for conducting new financial activities. The most important difference between the FHC and the bank's financial subsidiary is that the latter is prohibited from engaging in certain financial activities as "principal". The non-permissible activities include: insurance underwriting, real estate development or investment, merchant banking, and

[34] See paragraph 2 of Article 9 of Taiwan's *Financial Holding Company Act*.

"complementary (i.e. non-financial) activities"[35]. Nonetheless, a financial subsidiary may engage in the sale of any financial product as an "agent" (known as "agency activities") without geographic limitation[36]. It should be noted that the same regulatory conditions apply for establishing a financial subsidiary as for establishing an FHC[37]. Adapted from Section 121 of the GLBA, it is fair to conclude that if the consolidated assets of the national bank's financial subsidiaries are less than US$ 50 billion, the national bank could opt NOT to become a financial holding company, even though it will still be allowed to conduct some of the new financial activities under the GLBA.

In a similar vein, in Taiwan in Article 6 of the FHCA, it prescribes that "[a] same person or same affiliated person who has a controlling interest in a Bank, Insurance Company, and/or Securities House shall apply to the FSC for approval for the establishment of a Financial Holding Company", except that "[i]f the same person or same affiliated person does not concurrently hold shares or capital of a company from any two of the banking, insurance and securities industry, or the aggregate amount of assets of the Bank, Insurance Company or Securities House in which such same person or same affiliated person has a controlling interest does not exceed a 'Certain Amount', such same person or same affiliated person need NOT establish a Financial Holding Company". To this end, the actual amount has been determined as NT$ 300 billion (equivalent to approximately US$ 9.2 billion), through an order[38] issued by the Ministry of Finance, effective as of November 1st 2001.

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[35] Covington & Burling, *supra*, note 7, at 10.
[36] *Ibid* at 8.
[37] *Ibid*. According to the Executive Summary, the GLBA allows the bank to conduct new financial activities by amending the *National Bank Act* to authorize a national bank to own or invest in a new type of subsidiary called a "financial subsidiary". The Summary further points out that a state bank is equally permitted to establish such a financial subsidiary. See also section 121 of the U.S. *Gramm-Leach-Bliley Act*, under the subtitle "Sec. 5136A. Financial Subsidiaries of National Banks".
[38] See Order of the Ministry of Justice (no. 0901000118), entitled "The Aggregate Amount of Assets Referred to in Paragraph 2 of Article 6 of the *Financial Holding Company Act*".

7. Exempting Foreign FHCs from Additional Local Establishment

Taiwan follows the footsteps of both the U.S. and E.U. models by exempting, in principle, foreign FHCs from having to institute a local establishment, upon or prior to their entry to Taiwan's financial market (hereinafter "the exemption").

Article 23 of Taiwan's *Financial Holding Company Act* provides that:

> If a Foreign Financial Holding Company meets the following requirements and obtains FSC's approval, it may be exempted from establishing a new Financial Holding Company in the Republic of China ("R.O.C."[39])
> [In order to own a Controlling Interest in a Bank, Insurance Company and/or Securities House]:
> 1. [If the Foreign Financial Holding Company] has fulfilled the requirements under Article 9, Paragraph 1, for the establishment of a Financial Holding Company;
> 2. [If the Foreign Financial Holding Company] has sufficient experience in operating and managing a Financial Holding Company and has excellent credit;
> 3. The competent financial regulatory authority in such Foreign Financial Holding Company's home country has approved such Foreign Financial Holding Company investment in the R.O.C. by possessing Subsidiaries and agreed to cooperate with the R.O.C. government in sharing the responsibility to supervise such Foreign Financial Holding Company's activities on a consolidated basis.
> 4. The competent financial regulatory authority in such Foreign Financial Holding Company's home country and such Foreign Financial Holding Company's head office have the capacity to supervise the relevant Subsidiaries in the R.O.C. on a consolidated basis; and
> 5. The head office of such Foreign Financial Holding Company has appointed an agent for litigious and non-litigious matters in the R.O.C.
>
> The preceding paragraph also applies to foreign financial institutions which are "universal banks" in their home countries.

The rationale (*li fa li you*, in Chinese) underlying Article 23 of Taiwan's *Financial Holding Company Act* (hereinafter "the Rationale") suggests this exemption resonates with Section 141 of the U.S. GLBA. Based on the latter legislation, the

[39] The Republic of China ("R.O.C.") is commonly known as Taiwan.

exemption of a domestic establishment is conditional, only where the foreign holding company has declared its foreign holding company status within the 2 year prescribed period. It goes on to say, if the "status declaration condition" is not met yet, then, based on the "(WTO) national treatment principle" and "equality of competitive opportunity", such foreign FHCs are subject to the same restrictions or requirements of financial holding company activities as are applicable to the domestically-established U.S. FHCs.

Section 141 of the GLBA (where Foreign Banks that are Financial Holding Companies):

> ... (B) RESTRICTIONS AND REQUIREMENTS AUTHORIZED—If a foreign bank or company that engages, directly or through an affiliate pursuant to paragraph (1), in an activity that the Board has determined to be permissible for financial holding companies under section 4(k) of the Bank Holding Company Act of 1956 has not filed a declaration with the Board of its status as a financial holding company under such section by the end of the 2-year period beginning on the date of the enactment of the Gramm-Leach-Bliley, the Board, giving due regard to the principle of national treatment and equality of competitive opportunity, may impose such restrictions and requirements on the conduct of such activities by such foreign bank or company as are comparable to those imposed on a financial holding company organized under the laws of the United States, including a requirement to conduct such activities in compliance with any prudential safeguards established under section 114 of the Gramm-Leach-Bliley Act.

By drawing an analogy to Section 141 of the U.S. GLBA, the Rationale for exemption embodied in Article 23 of Taiwan's *Financial Holding Company Act* is that the "principle of national treatment" and "equality of competitive opportunity" should be used where the local (Taiwan) legislation is to apply to foreign FHCs, in whole or in part. The Rationale also refers to Article 52-20 of Japan's *Banking Act* and Section 225.124 of the U.S. *Regulation Y*, by concluding that based on the "Home Country Supervision" principle[40], the governing law for foreign FHCs is that of their home country. That is because first; such foreign FHCs were established based on their home country laws. Secondly, such foreign FHCs are usually multi-national companies, having global

[40] The Second Banking Directive refers to this principle as "Home State Member Control".

business operations and thus do not view Taiwan as their major market; under this circumstance, it is not without difficulty to require foreign FHCs to comply with domestic establishment requirements as is prescribed by Taiwan's *Financial Holding Company Act* for its local FHCs. To sum up, Article 23 of Taiwan's *Financial Holding Company Act* exempts, in principle, foreign FHCs from setting up a domestic establishment in Taiwan.

Legislators in Taiwan also pointed out that as a result of the U.S. GLBA's inheritance of the 1956 *Bank Holding Company Act*, the GLBA envisages financial holding companies as "holding companies" only and therefore entirely excludes E.U. universal "banks" from qualifying as an "equivalent" to U.S. FHCs.[41] It is their view that the U.S. GLBA dismisses the potential of E.U. universal "banks" to equally benefit from the exemption that it otherwise offers to "holding companies" in foreign jurisdictions following the U.S. system whereby there is a distinction between "holding companies" and "banks". For this reason, Taiwan's *Financial Holding Company Act* also grants, in principal, full exemption to E.U. universal banks, aside from other foreign FHCs. With a view to attracting potentially the most competitive foreign FHCs (particularly those from the U.S.) and their strongest rival "universal banks" from the E.U., to invest in or enter Taiwan's financial markets, this exemption is deemed important to developing a single financial market in a globalized economy.

8. Management or Employment Interlock between FHC and Affiliates/Subsidiaries (Permitted by U.S. GLBA, but still Prohibited by Taiwan's FHCA)

In the U.S., the GLBA, by repealing Section 32 of the *Glass-Steagall Act*, eliminates the prohibition on 'director, officer, and employee interlocks' between a bank and any affiliated or unaffiliated securities firm that is primarily engaged in securities underwriting activities that are not permissible for banks to engage in directly ("bank

[41] See the Rationale underlying Article 23 of Taiwan's *Financial Holding Company Act*.

ineligible" securities activities)[42]. The main purpose of this restriction was to prevent insider trading. Despite the relaxation by the GLBA and increasing the FHC's overall operational efficiency, in terms of granting the FHC the flexibility to mobilize their managerial/human resources, the GLBA still makes sure that elimination on interlocking would not go too far. After all, the GLBA remains true to upholding the underlying principle that separates banking from commerce. To this end the GLBA also provides both 'The Comptroller of the Currency' (Section 114 (a) of GLBA) and 'The Board of Governors of the Federal Reserve System' (Section 114 (b) of GLBA) with broad authority to impose 'prudential safeguards' on relationships or transactions between a bank and its affiliates, which could include 'interlock restrictions'. In parallel, both the Comptroller of the Currency ("OCC"; in Section 114 (a) of GLBA) and the Federal Deposit Insurance Corporation ("FDIC"; in Section 114 (c) of GLBA) are provided similar authority ("prudential safeguards") with respect to transactions between a national or state bank and its subsidiaries[43]. One of the main purposes in so doing is to avoid 'conflicts of interest'.

In Taiwan, the FHCA holds an outright ban on interlocking between a bank and its subsidiaries or between the bank's subsidiary and its invested company. Article 38 of Taiwan's FHCA stipulates that "[a] Subsidiary of a Financial Holding Company, or an enterprise in which the Subsidiary holds more than 20% of the total issued shares with voting rights or holds controlling interest, shall not hold shares of the Financial Holding Company." The underlying rationale for this absolute ban is said to have been Article 211-2 of the Japanese Commercial Act, which describes that interlocking would result in complicated shareholding structure.[44]

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[42] Covington & Burling, *supra*, note 7.
[43] *Ibid.*
[44] Wen-yu Wang, *Holding Company and Financial Holding Company Law* (*Kong Gu Gong Si Yu Jin Rong Kong Gu Gong Si Fa*, in Chinese) (Taipei: Yuan Zhao, 2001) at 394. (In Chinese)

III. Citigroup's Post-GLBA Development

1. The Recent Break-Up of Citigroup

As discussed before in Chapter Three, the underlying reason for lifting the Depression-era restrictions, which were exemplified by both the *Glass-Steagall Act 1933* and the *Bank Holding Company Act 1956*, was increasing competition from within and abroad. Therefore, when it came to unshackling the commercial banking, investment banking, insurance, and securities industries in the U.S. and allowing financial conglomerates to become financial-service providers across all fields of endeavor, there was now virtually universal agreement that the Great-Depression-era laws that built walls between these industries had long outlived their usefulness. Even so, the recent break-up of Citigroup indicated that the ideal of competition and revenue enhancement through cross-marketing had its problems. Citigroup first announced it would sell off its insurance business in February, 2005—Citi, the company that spawned the financial merger craze back in 1998, said it would sell most of its insurance and annuity business to Metlife for US$ 11.5 billon.[45] In a back to back announcement, just one day following Citi's announcement, American Express also announced plans to spin off its financial advisory unit, which oversees some US$ 400 billion in assets.[46] It seemed clear that breaking up is not so hard when no one is profiting, as was commented on by recent business news observers.

"Is bigger better or is bigger just badder"? This question has become an intensely-debated topic especially following the recent break-up of Citigroup. The 1998 Travelers-Citicorp merger was widely seen as the first of many mega-mergers to come that would capitalize on expected synergies between the insurance and banking industries. As it turned out, according to a recent report on Banks & Insurance, there were a few factors that undermined such dreams and led to Citigroup's breakup[47]. First, the merger

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[45] Steffy, *supra*, note 3.
[46] *Ibid.*
[47] "Merger Autopsy; What Killed The Citigroup Merger?", The National Underwriter Company, National

exposed vast cultural differences between the insurance and banking industries. Second, the two industries learned that there were more profitable ways to reap whatever synergies there might exist between the two disciplines, short of an outright acquisition or merger; examples include joint marketing agreements. Third, the exposure of numerous insurance lines to catastrophic risk beyond just natural disasters made the business too volatile for the more conservative tastes of bankers. Fourth, banks were frustrated by the lower returns on equity and slower growth produced by their insurance operations, consequently, widely anticipated cross-selling opportunities failed to materialize. Last and not least, banks found it was more productive to buy into the distribution system, acquiring brokerages, rather than bringing insurance companies in-house.[48]

Almost immediately after the merger, the new marriage of Citicorp and Travelers already concerned their observers, due to their very different corporate cultures. Citicorp's CEO, John Reed, when asked about the question, simply said that "the culture will take care of itself."[49] Reed referred to culture as "unwritten rules and values" and the benefit of having a strong culture is "it's binding", so there is no need to be explicit[50]. On the other hand, Travelers' CEO, Sanford Weill, admitted that the two companies did have very different cultures—"Travelers is more decision-oriented, Citi is more studied. More controls."[51] Reed also emphasized that with big corporations like Travelers and Citicorp, the fact is "Travelers wasn't one culture. And Citi wasn't really one culture. There was a big difference between the New York Citi and the Philippines Citi."[52] In the end, Reed concluded that both companies had made great success in bringing the culture

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Underwriter, Property & Casualty/Risk & Benefits Management Edition (14 March 2005) Banks & Insurance Section, pg. 12. Available also through LexisNexus news search.

[48] *Ibid.*

[49] Gary Silverman *et al.*, "Is This Marriage Working" *Business Week* (7 June 1999) 126.

[50] *Ibid.* Mr. Reed further explains the benefit of having common culture is "...you don't need to be explicit. It's automatic. If you have a culture that says you wear a tie to work you don't have to write a rule saying, hey guys, wear a tie. You know that people will. The benefit of having a strong culture is it's binding." Furthermore, when asked about corporate culture specifically, Mr. Reed explained that "if you can get a culture that is a healthy one, it makes people feel more comfortable because they are at ease with the environment, they feel like they fit in." From here, it seems clear that Mr. Reed had intended to avoid discussing a potential conflict in both Citicorp and Travelers corporate cultures. Even though he had recognized about the issue, Reed expected any resulted conflict to be naturally resolved by itself.

[51] *Ibid.*

[52] *Ibid.*

together, and should there be any difference, they could rely on the culture to take care of itself.[53] From here, it seems clear that Reed had intended to avoid discussing a potential conflict in both Citicorp and Travelers corporate cultures.

Banks are a highly leveraged business while insurance firms generally have to maintain a larger capital base because insurance returns are in the nature of long-term maturity. In this regard, it is clear that banks and insurance firms should, and often do, take very different approaches to structure and in how they utilize their capital.

The ideal of "one-stop shopping" and "cross-selling" is perceived by some as only a partly justified goal. As pointed out, "customers do want to conserve their energies when they shop; they like, for example, to be able to buy a pint of milk and a gallon of gas at the same service station. It is also true that what you learn about a customer in one selling context can sometimes be profitably exploited in another. A real estate broker, for example, can be ideally placed to help a house buyer with a mortgage and house insurance."[54] But here is the rub: cross-selling works only when what is being sold really is a collection of the best. In today's world of sophisticated, informed customers, even great products will not tug mediocre ones along with them.[55] And there is another rub: using customer information gained in one context to pitch products in another is likely to cause serious aggravation to customers.[56] Examples of these types of questions and doubts are—"How much does your banker or your life insurance agent really know about your overall financial situation and financial needs? The average bank teller cannot calculate what I'm worth to the bank as a customer, so what is the chance that he or she knows what I need from today's cornucopia of financial services"[57]? "It is not to say that bundling will not happen, it will", as emphasized by the same commentator. The bottom line, however, is "customers increasingly demand a subtle and

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[53] *Ibid.*
[54] Gary Hamel, "Wrong Merger, Wrong Logic" *Financial Times* [London, England] (15 April 1998) Comment & Analysis Section; pg. 22.
[55] *Ibid.*
[56] *Ibid.*
[57] *Ibid.*

diverse blend of financial services tailored to their needs."[58] In this light, the commentator observes that "the chances that a single company can offer any particular customer an ideal portfolio of products and services—even a company as big as the new Citigroup—is close to nil."[59] That is to say, customers want independent advice and expect to receive services that are not one-kind (or even one-brand) only. "You would not go to a travel agent that sold only P&O cruises. You would not go to a bookstore that sold only Simon & Schuster books—no matter how broad the Simon & Schuster catalogue."[60] This is all to say that customers may not feel as comfortable as taking advice from within the same financial conglomerate as the banks might perceive they should be. For example, within Citigroup, customers of Citibank who would need to purchase insurance products can only be referred to services by Citi's another arm, Travelers Insurance. Customers would inevitably fear being deprived of any better choice (better services or lower price) if they could have obtained otherwise from other independent insurers. In conclusion, as has been pointed out "cross-selling is a producer-driven strategy in an increasingly consumer-driven world. It is simply out of touch with the times."[61] Based on this observation, some observers in hindsight have openly decried the Citigroup merger as a "wrong merger", completed through "wrong logic". This perspective has profound value.

As this thought lingers on, it provides us another opportunity for further assessment of the feasibility of synergies between the insurance and banking industries. The recent break-up of Citigroup enables us to further analyze the appropriateness of the GLBA and more importantly to bridge into the next question of whether it would be better for Taiwan's FHCA to follow the U.S. FHC model or instead the German Universal Banking model.

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[58] *Ibid.*
[59] *Ibid.*
[60] *Ibid.*
[61] *Ibid.*

2. Revenue Enhancement & Ultimately Great Profits Back Up Merger Decisions

In face of the recent break-up of Citigroup, critics have raised a very good point—just because they de-merged, does not mean mergers should be prohibited.[62] Indeed, as the ultimate goal for mergers is revenue enhancement, following the recent break-up, should there be any merger opportunities coming along that are likely to boost profit and scale efficiency, there should be no reason not to merge. A case in point, subsequent to its sell-off of insurance business, Citigroup continued to aggressively buy out local banks in the Asian market with great expectations that in so doing it would garner for itself enormous profits (For details, please refer to Chapter Two of this dissertation.) Had 'profits' not been at the core of tabling or pulling through merger decisions, Citigroup would not even have offered to pay a "$1 billion *break-up fee* rather than follow through on commitments to [buy out] more than $37 billion in loans from [the Dallas-based TXU Corp., the state's largest utility]"[63]. "At issue is the difficult market for corporate debt, especially higher-risk debt."[64] Citigroup's reason for backing out may have to do with the ill performance of subprime mortgages of late. Citing the same report, "[t]he credit markets have been spooked in recent weeks. Rising losses in subprime lending led to a big sell-off on Wall Street in recent days. Rising interest rates have hit the bond market, and financing for many proposed buyouts has tightened up."[65]

3. Is Citigroup Too Big To Be Broken Up?

In juxtaposition with Citigroup's recent break-up, a more interesting question arises of whether Citigroup is too big to be broken up. Citigroup, being a financial conglomerate itself, has been described as "too unwieldy and complex"[66]. Reportedly,

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[62] The author would like to acknowledge Professor Robert Heinkel (at the Sauder School of Business, University of British Columbia) for bringing this issue to my attention.
[63] Jim Fuquay, "Banks May Be Jittery About TXU Deal", Fort Worth Star-Telegram (Texas), [distributed by] McClatchy-Tribune Business News, August 1, 2007. [Information is obtained from Lexis Nexus "News & Business" research database.]
[64] *Ibid.*
[65] *Ibid.*
[66] Grant Ringshaw, "Hedge Funds Put Citigroup In Their Sight", Sunday Times (London), May 6, 2007, p.

"Chuck Prince, Citigroup's chairman and chief executive since 2003, is on the ropes and urgently needs to address the underperforming share price. Critics say splitting [Citigroup] in four—wealth management, investment banking, consumer finance in America and international consumer finance—would unlock significant value. Citigroup fires back that there is more to be gained by keeping the group intact."[67] The regulatory hurdles, strategic problems, scandal of conflicts of interest, together with the loss created by giant deals, were ascribed to Citigroup's underperforming share price and the sell-off of its insurance business.

> "Supporters of Prince argue that in his first few years he was embroiled in regulatory and strategic problems—Citigroup was certainly hurt, like many others, by the scandal of conflicts of interest between investment banking and research. Still, today this is not a sufficient excuse and shareholders are understandably restless.
>
> Prince's big bet, after selling the insurance business, has been to concentrate the group broadly on consumer and investment banking. But progress has been limited. In one sense, Citigroup has suffered the handicaps of many behemoths created by giant deals—it has too many layers of middle management and bureaucratic back offices. Prince is belatedly taking an axe to the business, slashing 17,000 jobs and promising to make billions in cost savings."[68]

Citigroup's underperforming share price and slipping operational efficiency mirrors closely a commentator's view that the "financial conglomerate generally lacks scale efficiency."[69] Bluntly, the commentator has indicated that "[d]espite their growing frequency, big bank mergers have produced disappointing results....[m]ost large bank mergers do not improve the efficiency or profitability of the resulting institutions."[70] Ironically, the commentary, made in 2002, pointed out that Citigroup was an exception[71].

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14. [Information is obtained from Lexis Nexus "News & Business" research database.]
[67] *Ibid.*
[68] *Ibid.*
[69] Wilmarth, Jr., *supra*, note 4, at 272-273, 281.
[70] *Ibid* at 272-273.
[71] *Ibid* at 284.

That being said, Citigroup was reportedly very adamant about keeping the conglomerate together—"there is more to be gained by keeping the group intact."[72] Citigroup is not alone in believing in the conglomerate advantage and the proposition that bigger is better. Proponents for large conglomerate structures argue that they have "become important in terms of business strategy due to the significant improvements possible in terms of operational efficiency and effectiveness. These benefits arise from economies of scope and scale, which generate lower costs, reduced prices, and improved product and service innovation. At the same time, sector synergies can substantially increase the general competitiveness of the business. The stability of each of the structural components of a particular organization, as well as the business as a whole, can also be significantly improved through diversified revenues and risks. At the same time, product variety and innovation can increase customer loyalty as well as market penetration and market development."[73]

There are polar positions on this issue and they have clashed with each other, leaving many puzzled about whether the FHC is a good structure to encourage and improve overall operational efficiency. If Citigroup, the world's largest FHC, has struggled through the many issues described above (including but not limited to 'regulatory hurdles', 'strategic problems', 'conflicts of interest', 'back office problems', and 'losses from giant deals'), one could reasonably assume that many other FHCs are facing or will face the same obstacles to varying degrees. In other words the optimism often expressed for improved product and service innovation may just be overstated. One may recall that in Chapter Two and the interview with Fubon FHC's management, the executive interviewed clearly pointed out that (i) in terms of 'cross selling and marketing', collaboration among the three subsidiaries (banks, securities, and insurance arms) of the FHC would only be seen on certain occasions where joint efforts is sought for devising new financial service products, and (ii) in normal circumstances, each subsidiary of the FHC not only 'works independently' but 'keeps separate accounting books'. Obviously, this fact does not reflect a company that is aggressively seeking

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[72] Ringshaw, *supra*, note 66, "Hedge Funds Put Citigroup In Their Sight".
[73] George A. Walker, "The Law of Financial Conglomerates: The Next Generation" (1996) 30 Int'l Law. 57. [Part III. Conglomerate Advantage].

"sector synergies". In fact, going back to Citigroup discussion, its underperformance has direct ties to its inability to offset high costs from mergers with the marginal gain from revenue increases.

All that being said, if we consider that (i) FHC establishment is a relatively new development only beginning to evolve in recent years; and that (ii) the subsidiaries under the FHC, before they were pulled together to merge were already very competitive in their respective financial fields, one can reasonably assume that 'it is only a matter of time' before the FHC can manifest its potential in the U.S. and Taiwan.

IV. Comparing the 'Evolutionary' U.S. Model with the 'Revolutionary' E.U. Model

One commentator has pointed out, in discussing the U.S. *Gramm-Leach-Bliley Act* which evolved from its predecessor regulations, by removing legal barriers embodied in the previous *Glass-Steagall Act 1933* and the *Bank Holding Company Act 1956*, the E.U.'s *Second Banking Directive* is relatively revolutionary.[74] She goes on to say that it has provided the U.S. a chance to learn from its success. The *Second Banking Directive* of 1989 marked the beginning of a watershed change for financial liberalization. Specifically, it was aimed to create a single financial market in the European Union. Its preamble provides that "this Directive is to constitute the essential instrument for the achievement of an internal market, a course determined by the Single European Act and... from the point of view of both the freedom of establishment and the freedom to provide financial services, in the field of credit institutions." It was not until 10 years later, when the GLBA was promulgated in the U.S. (in 1999), that the reality of being able to create a financial conglomerate that provides comprehensive financial services, including banking, securities, and insurance businesses[75] in the U.S. manifested itself.

[74] Jeannot, *supra*, note 26, at 1715.
[75] *Ibid.*

The same commentator also points out that the European Union embraced three key concepts in its *Second Banking Directive* in order to achieve universal banking throughout the Union: (1) mutual recognition; (2) a single banking license; and (3) an agreed-upon list of banking activities. The consequences of the application of these three principles are significant. Essentially, one country's bank may gain a competitive advantage over another country's bank by providing domestic customers with products that domestic banks are prohibited from offering, but that are permitted by the *Second Banking Directive*. Thus, the regulatory body of the more restrictive country will have a strong incentive to level the playing field for its domestic banks by liberalizing its own regulations. The end result is that regulatory agencies of each country in the European Union engage in competitive deregulation of the financial services industry.[76]

The *Second Banking Directive* is currently the governing law on financial services in the European Union. In contrast to the U.S., where the GLBA is founded on a pure holding company system, the *Second Banking Directive* is based on a universal banking system. The former limits the FHC, as a parent company, to a pure holding company only whose job is to own, control, and manage its financial subsidiaries, whereas, the latter allows a bank to transact commercial and investment banking functions within the same corporate entity. In this regard, the commentator further suggests that the U.S. GLBA does not give the U.S. banking industry the flexibility to choose an appropriate corporate structure; while the E.U. gives banks the flexibility to choose.[77]

The U.S. GLBA and the E.U. *Second Banking Directive*, both enable cross-border banking services. It then begs the question of whether such deregulation has in practice increased the flow of cross-border banking activities. To correctly answer this question, one should first differentiate between retail and wholesale activities. While wholesale banking services are often supplied in an international competitive market, retail-banking services have been traditionally provided on a national basis. Therefore, for instance,

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[76] *Ibid* at 5, 33.
[77] *Ibid.*

within the European Union, the major gains from the integration of European banking systems should arise from the increase of competition in the retail segment[78].

1. Statistical Information in 1999

A research paper put together statistics in some E.U. countries concerning the increase in retail banking activity following *Second Banking Directive 1989*: Spain reports an increase of 34%, followed by Germany (33%), France (25%), and Netherlands (10%). Correlating the volume with prices, the researcher further stated that "if differences in prices for banking services are due to the existence of barriers that would isolate domestic banking systems from competition, the elimination of these barriers should lead to a reduction in price differentials for financial services across Europe. This was the main aim of the *Second Banking Directive* approved in [1989]."[79]

It may seem a bit counterintuitive, but by the time the U.S. GLBA came into place in 1999, it was ten years after the approval of the *Second Banking Directive*, and the level of integration of the European banking system does not seem to have changed much during this period of time. According to the same report, in 1998, cross-border offices within Europe represent less than 0.3% of the total banking offices (including representative offices, branches, and subsidiaries, which represent different levels of investment for the parent bank, offering a different range of banking services).[80] This fact indicates that cross-border banking movement had not occurred yet, even in the more revolutionary E.U. model.

[78] "Cross-Border Banking in Europe: An Empirical Investigation", research paper by Josep Garcia Blandón, Department of Economics and Business, University Pompeu Fabra.
[79] *Ibid.* (p. 4 and p. 17)
[80] *Ibid.*

2. Cross-Border Banking Mergers in the E. U. Countries (The Economist Report in 2005)

According to a more recent report by 'the Economist' in 2005, there was not much of a breakthrough in the number (compared with the research conclusion in 1999 as mentioned above) of cross-border banking transactions among the European Union countries, citing "European banking integration is slow and imperfect."[81] However, it must be stressed that integration, intended to be brought about by the *Second Banking Directive*, did occur with some success in the wholesale banking industry but not so in the retail banking sector.

> "On the wholesale side, the integration of European financial markets has been a resounding success. But on the retail side—bank accounts, payments, mortgages, insurance policies and personal investments—the process has hardly begun.
>
> One strong sign that there is little convergence is the scarcity of cross-border banking mergers. So far there has been only one significant one, the purchase of Abbey National, Britain's sixth-biggest bank, by Banco Santander Central Hispano of Spain. One medium-sized French bank, Crédit Commercial de France, was bought by Britain's HSBC in 2000, and in the same year Germany's HypoVereinsbank bought Bank Austria. In Italy, another Spanish bank, BBVA, looks likely to succeed in its bid for Banca Nazionale del Lavoro, and ABN Amro of the Netherlands has been battling to take over Banca Antonveneta. Apart from some cross-border bank consolidation in the Benelux and Scandinavian countries, that is as far as integration in western Europe has got.
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> In Central and Eastern Europe, it is a difficult story. Since the early 1990s, large swathes of the banking sector there have been privatized and ended up in foreign hands. That has brought immediate benefits in terms of safety and soundness, fresh capital, innovation and integrity, although some economists are alarmed by the long-term implications."[82]

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[81] (Headline) "A Blurred Euro-vision", The Economist, May 21, 2005. [Information is obtained from Lexis Nexus "News & Business" research database.]
[82] *Ibid.*

It is not difficult to fathom why there is varied degree of success of integration in wholesale and retail banking. Wholesale banking in the E.U. region has become more integrated, which is in large part due to the success of the Euro, a single unified currency circulated in this region. That is because in the realm of wholesale banking, "shares, bonds, loans and derivatives could be bought across the euro zone without additional currency or interest-rate risk."[83]

On the retail banking side, however, citing the same report "[c]ross-border mergers are likely to bring only a few savings from the eventual integration of IT systems, back offices and perhaps the design and marketing of some financial products...."[84] This departure from the U.S. model (which accredits FHCs for their ability to substantially reduce overall operational costs) is reportedly involved with the peculiar banking culture in E. U. countries where large merger costs can hardly be offset by the gains in new customers. The report in 2005 cited a couple of reasons as described below:

(i) First, customers in the E. U. countries seldom switch accounts, and even if they do, it is mostly because they are dissatisfied (with their original banks) rather than attracted by something better (such as cheaper deals or more financial services products available). "Much of the lack of cross-border action is explained by customers' general unwillingness to change banks. People over 40 in particular hardly ever move their bank accounts, however bad or expensive the service they are getting. They may be missing out on cheaper deals, but most of them have better things to do than shop around for banking bargains. And many customers are proud to bank where their parents and grandparents did. This inertia gives the established banks a comfortable cushion of steady earnings that is only slowly being

[83] *Ibid.*
[84] *Ibid.*

deflated by competition from internet alternatives, mortgage brokers and consumer-finance companies."[85]

(ii) Secondly, 'mutual recognition', one of the three pillar rules in the *Second Banking Directive* does not sufficiently remove the political and legal barriers set by the host country for its own market protection. "When it comes to retail banking, each national banking system, whether inside or outside the E. U., is still an island. Tax, ownership, consumer protection and conduct-of-business rules have not been harmonized. Despite the principle of mutual recognition, which is supposed to allow E.U. banks to operate branches in other E.U. countries under the supervision of their home regulator, simply opening branches in other countries does not win many retail customers."[86]

The "separate reality" phenomenon probably explains why cross-border banking integration is impeded in the region. Reportedly, "in general, even banks that have bought subsidiaries abroad tend to run them as separate banks. For example, Citigroup has not integrated its banking operations in various European countries, and nor have Nordea (the result of a merger of four Scandinavian banks), Deutsche Bank, HSBC or any of the smaller banks with subsidiaries in central and eastern Europe."[87] The Economist's 2005 report further ascribed this reason to the interesting fact that "[m]ost big European banks have preferred to look for growth in more dynamic markets, such as America and Asia."[88] Readers might recall that in Chapter Two of this dissertation, it is mentioned that both Standard Chartered and HSBC have invested in Asia by buying out local banks. Also mentioned in Chapter Two, Citigroup and its peers (Standard Chartered and HSBC), have all reported revenue increases in Taiwan's financial markets.

Legal barriers to entry not only act as a disincentive for cross-border banking, they openly defy the *Second Banking Directive*'s underlying intention. Under the

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[85] *Ibid.*
[86] *Ibid.*
[87] *Ibid.*
[88] *Ibid.*

proposed *Second Banking Directive*, announced on February 16, 1988, "a bank established as a legal entity in one Member State will in the future no longer need an authorization to offer a set of banking services as defined by the directive, either directly or through a branch, in any other Member State. Thus a bank duly established in one Member State would be entitled to offer a range of banking services in other Member States that might be wider than is permitted both under the law of the home Member State and under the law of other host Member States."[89] Under this design, every member state in the E.U. would strive to eliminate as many unnecessary legal barriers as possible, fearing that failure to do so would otherwise unfairly put their home country banks on a less level playing field. Hence, the competition would foster cross-border banking convergence. Contrary to this theory, legal barriers are also blamed for the inefficiency of the *Second Banking Directive* (which became effective on January 1st, 1993). According to The Economist's report in 2005,

> "The *Second Banking Directive* ....allows for branching under the European passport. A directive on funds that can be sold across Europe has tried to stimulate a market in pan-European investment vehicles. An investment-services directive allows the cross-border selling of insurance and other financial products. But there are snags: countries can still invoke their own consumer-protection laws, and the tax treatment of investments and the legal status of mortgages, even of the ownership of securities, can vary. It is as though foreign trademen had been invited into the bazaar, but told they could sell only goods that are identical to the home-produced variety."[90]

It is hard enough in itself having to overcome the legal barriers set by other member countries but above and beyond that there are more obstacles that stand in the way of the banking convergence in the E.U. region, such as pricing. The price for banking services is more divergent than other commodities sold across borders, such as cars, mobile phones, or fashion items and accessories[91]. The same report notes that

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[89] Karl M. Meessen, "Europe en Route to 1992: The Completion of the Internal Market and Its Impact on Non-Europeans" (1989) 23 Int'l Law. 359. [The citation is short-titled for 'The International Lawyer'.]
[90] *Supra* note 81 "A Blurred Euro-vision", The Economist, May 21, 2005.
[91] *Ibid.*

"comparing banking services from country to country is fiendishly difficult. A recent study by ING and Capgemini found huge variations in the price of core banking services, ranging from an average of euro 252 a year in Italy to euro 34 in the Netherlands. Another study, carried out by Mercer Oliver Wyman for the Italian banking Association, compared the average price of keeping a current account in various European countries: a current account costs euro 133 in Italy, euro 94 in France, euro 86 in Spain and euro 68 in Germany. At the same time over 50% of Italians share bank accounts, which brings down the cost per person, said the study.[92] Although it is beyond the scope of this dissertation to examine what the factors are that affect and further result in the variations of pricing for each and every banking service, it can be reasonably assumed that banks in different member countries have different operational strategies which in turn effects the prices for banking services. Likewise, consumers in different member countries have different expectations for their banks. The British and Germans are used to getting free current accounts, but simultaneously are accustomed to paying for cash withdrawals from other banks' ATMs. The French pay for their bank accounts but expect cash withdrawals across the euro zone to be free. Italians pay nothing for keeping a current account but are charged high fees for every transaction. Citigroup, which operates in most European countries, simply adopts the local price structure in each market.[93] In sum, there is a great deal of flexibility and far less unification than would be expected in banking pricing among members of the European Union. This, coupled with European customers' tenaciousness in abstaining from switching banks, might explain why the cross-border banking merger is harder to achieve than simply resorting to the *Second Banking Directive*.

In the face of the slow-paced improvement in cross-border banking convergence that defies the intention behind the *Second Banking Directive*, this 2005 report nonetheless tried to be optimistic by observing that 'it is only a matter of time'. Citing a study by Morgan Stanley and Mercer Oliver Wyman, published in February 2005, it "lays out the arguments in favor of cross-border mergers of European banks. It argues

[92] *Ibid.*
[93] *Ibid.*

that the banks which are well ahead on IT and on complying with Basle II capital rules would be in a good position to buy up those banks that are behind, because they could make the laggards more efficient. The study's authors assume that banking integration in Europe is only a matter of time, because institutions such as the European Commission and the European Central Bank are determined to make it happen."[94] The goal behind the E.U.'s banking supervision correlates with that in the U.S. where the bank regulators are usually quick to act on 'government interference', if doing so is deemed necessary to 'right the wrongs'. That is because the bank regulators believe that 'market rule is not always leading the market into the right direction'.

V. Conclusion

In the United States, the line between commercial banking and investment banking has been shifted a few times from being "completely undefined" (before 1900), to "strictly separated" (in 1933), to "increasingly blurred and relaxed" (in 1956) and "removed, if not entirely" (in 1999), following the enactment of the GLBA. As suggested by one commentator, "[b]efore 1900, although no formal law proscribed a commercial bank from engaging in securities activities, distinct and separate entities conducted investment banking activities in the United States."[95] The *McFadden Act* 1927 marked an era of liberalization that explicitly permitted commercial banks chartered by the federal government to conduct securities activities[96]. The fallout of the 1929 Crash and the ensuing Great Depression (1929-1933) has its legal ramifications (the *Glass-Steagall Act 1933,* a portion of the *Banking Act 1933*, i.e. Sections 16, 20, 21, and 32). The Great Depression began with the stock market crash in 1929, which led many to believe that the mix of commercial and investment banking activities was a primary cause for the biggest banking crisis and economic recession in American history. To rectify the situation, the remedial *Glass-Steagall Act 1933* drew a demarcation line which strictly separated commercial banking from investment banking. In actual effect, the

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[94] *Ibid.*
[95] Jeannot, *supra*, note 26, at 1716-1717.
[96] *Ibid* (original footnote 32). It refers to the *McFadden Act*, Pub. L. No. 639, 44 Stat. 1224 (1927). (codified as amended in scattered sections of 12 U.S.C.).

Glass-Steagall Act 1933 prohibited insurance companies, securities brokerages and banks from merging. To foster a healthy banking industry by providing federal deposit insurance, the Federal Deposit Insurance Corporation (FDIC) was established by mandate of the *Banking Act 1933*. However, a complete divorce of commercial and investment banking by the *Glass-Steagall Act 1933* did not last long. The wall created by the *Glass-Steagall Act 1933* that strictly separated commercial banking from investment banking was not impenetrable after all[97]. The first loosening of strictures came with commercial banks' attempts to affiliate with securities houses by forming entities known as bank holding companies, so that banks could conduct securities activities. Given that "bank holding companies" were not "banks", they did not fall into this definition and were thus not limited by the *Glass-Steagall Act 1933*.[98] To close the loophole, the *Bank Holding Company Act* came into place later in 1956. However, the firewalls established by the *Bank Holding Company Act 1956* were again taken down as a result of the Federal Reserve Board's raising the limit of 5% revenues from securities activities by a bank holding company (through its Section 20 Subsidiary) to 10% and later on to 25% in 1997, just two years prior to enactment of the GLBA. The *Bank Holding Company Act 1956* had been stretched so thin that it did not leave much substance at all. It made the U.S. industry believe that a general, if not complete, removal of the commercial and investment banking separation would eventually fall into place. The merger of Citigroup is believed by many to have prompted the promulgation of the GLBA in 1999.

The globalization of the international markets and the continuing success of deregulation elsewhere in the world, especially in the European Union following the adoption of the *Second Banking Directive*, inspired and necessitated the U.S. to revamp its then 66-year old *Glass-Steagall Act* and then 43-year-old *Bank Holding Company Act*. The E.U.'s *Second Banking Directive* provides an incentive for any member country in the Union to assimilate its domestic banking/financial laws for better integration with those in other member countries. The Directive necessitates that any member country

[97] *Ibid* at 1726.
[98] *Ibid* at 1727.

remove unnecessary legal barriers, fearing that failure to do so would otherwise deprive their financial industry of a level playing field. Theoretically speaking, the Directive would result in a single financial market within the E.U. and it is this envisioned success which inspired the U.S. government to revamp its financial system, after much arm twisting and political finagling by U.S. industry. Faced with their strongest rival from the E.U. member countries, the U.S. financial industry had lobbied vehemently for the GLBA, claiming that the trade barriers set by both the *Glass-Steagall Act 1933* and *Bank Holding Company 1956* have long placed them at a disadvantage.

The U.S. GLBA inspired Taiwan's enactment of its *Financial Holding Company Act*, with the same vision of providing a level playing field for its financial services industry as well as maintaining their global competitiveness. Taiwan's economic figures show rapid growth in key sectors. It is considered a mature economy, diverse and deep. Some of the nation's companies are transnational corporations. Simply on the basis that some of the banking sector's largest customers are sophisticated world-class conglomerates, one would imagine that Taiwan's financial institutions have an opportunity to also be internationally competitive.

However aspects of Taiwan's macroeconomy remain in a historical and cultural backwater, and this includes the banking sector. As with many nations its impressive growth has at times juxtaposed and painfully exposed dubious institutional practices across all economic and political fields. This is particularly so in the field of finance where, despite the enormous amount of capital available, the country's financial institutions have often failed the needs of its entrepreneurial class. Banks in Taiwan remain too numerous for economic efficiencies to result. At worst they remain in some cases the personal holding companies for a few wealthy individuals, and at best they simply cannot serve their most prominent corporate clients. Consequently companies outgrow their account managers, corruption survives and occasional institutional financial scandals threaten the banking infrastructure.

But capital is still spread out and diluted among the numerous lenders in Taiwan, presumably because Taiwan's top lenders do not sufficiently distinguish themselves from the majority of financial institutions that are smaller in size and scale. Taiwan's top lenders are not necessarily more efficient and they do not necessarily represent the majority of capital in Taiwan. They are therefore not in a position to grow even domestically, let alone internationally. The top five lenders in Taiwan only account for 35% of the market. In sharp contrast, in most developed nations, the top financial institutions account for 60-80% of the market as exemplified by companies like HSBC and Citibank. In the latter situation, the market is healthier and represented by market leaders which are rewarded for their efficiency and innovation by obtaining a significantly large share of the financial services market.

As has been mentioned in Chapter One, a study by the *Economist* pinpoints a critical problem existing in Taiwan's banking industry – Taiwan's lack of global competitiveness within the banking sector. Put in a macro context, Taiwanese banks possess only a relatively small market share, compared to other more vibrant international banks. Beyond this, recent financial reform in Taiwan also highlights the problem with Taiwan's banking/financial institutions being relatively small in size and thus lacking the ability to be globally competitive.

Why then did Taiwan adopt the U.S. model, rather than the E.U. model? Commentary has suggested that "[l]ately, universal banking [which is prevalent in the E. U. model] is considered to be old fashioned, [although] it is not practical or desirable to attempt to conclude which system is the better. Both have their advantages and flaws, and both evolved within their own unique cultural, social, and historical circumstances. Given these differences, it is surprising to witness the current 'Americanization' of [the universal banking system]. The pressure to stay competitive drives banks to mergers and to specialization."[99]

[99] Susan-Jacqueline Butler, "Models of Modern Corporations: A Comparative Analysis of German and U.S. Corporate Structures" (2000) 17 Ariz. J. Int'l & Comp. Law 555 at 603.

Generally speaking, there are both 'pros' and 'cons' to Taiwan's FHCA adopting the U.S. model (the GLBA):

(1) The adoption of the U.S. model ensures *better fire-wall protection*[100] for Taiwan's financial holding companies (FHCs). The U.S. model requires its FHCs be pure holding companies only, as opposed to the E.U. model where the parent companies (universal banks) are also operating holding companies. This further means that, in the U.S. model, the parent FHC's *functionary role* requires it to ensure that the financial conglomerate must be 'well-managed' and 'well-capitalized' at all times. The former term ('well-managed') refers to the parent FHC's management ability to increase the entire FHC's revenue and the value of its assets through proper reinvestment. The latter term ('well-capitalized') otherwise refers to the parent FHC's *fiduciary duty* to ensure that all subsidiaries (the banking, insurance and securities arms) within the FHC must meet the regulatory requirements by maintaining a satisfactory 'capital adequacy ratio'.

(2) Taiwan can benefit from making its FHC system comparable with that of the U.S.. Certainly the U.S. experience speaks for itself - the top FHCs in the U.S. (such as Citigroup) are among the world's biggest foreign investors in the global capital and financial markets. In fact, as indicated in Chapter Two of this dissertation, Citigroup has become the biggest investor and the most profitable international bank in Taiwan. This fact, coupled with Taiwan's ongoing need and desire to attract foreign investment to invest in this country, has provided an incentive for Taiwan to try to bring its banking system more in line with that in the U.S. and

[100] Worth noting is that while the phrase "one-stop shopping financial services" was coined to depict the economic scope of U.S. Financial Holding Companies, the phrase "all finance" is generally associated with the German Universal Banking System, both denoting their capacity to provide all comprehensive financial services. The difference, however, is that the U.S. system is built on the pure holding company model, while the German system, is built on the operating holding company premise. Though both are holding companies, the U.S. FHC tends to only and exclusively (i) invest in its subsidiaries, (ii) manage the entire FHC, and (iii) form internal supervision and auditing systems; in sharp contrast, the German Universal Bank operates the actual day-to-day banking and securities businesses, even though it still maintains control over its subsidiaries' other financial services. It is exactly this 'all-comprehensive, cross-sector, direct operation by one single universal bank' that arouses the concerns by many that, compared to FHCs in the U.S. model, universal banks in the E. U. model amass too much power and hence may be more susceptible to adverse effects resulting from potentially inherent conflicts of interests that directly link to the more easily-penetrable firewalls.

meanwhile make sure that there is enough or even better comparability existing in both systems.

Moreover, there are other merits to the U.S. model:

(3) According to a commentary[101] that was mentioned above, many believe that the U.S. model is more *modern and progressive*.
(4) From the U.S. Congress's perspective, the financial holding company (FHC) structure in the U.S. model is based on the familiar "bank holding company" structure. This *regulatory design* may have provided some comfort for those hard-nosed legislators that were still in favour of the 1933 *Glass-Steagall Act* restrictions that completely separated banking from commerce. In fact the 1999 GLBA has reaffirmed the 1933 principle of *separating banking from commerce*.
(5) By the time the U.S. GLBA (which represents the U.S. model) was promulgated in 1999, it was poised to learn from the lessons through its predecessor law, the 1956 *Bank Holding Company Act et seq.*. Such a *conservative approach*, built on the solid experience of 43 years, may have its own appeal.
(6) The E. U. model's "mutual recognition" principle is an obstacle to Taiwan's wholesale adoption of it because it may open the door to an *unsustainable* amount of *deference* (that necessitates its own financial regulators to relinquish their normal exercise of regulatory control). This reason alone may be sufficient for Taiwan to reject (although not completely) the E.U. model.

Critics who opposed the adoption of the U.S. model point out the disparities in the institutional structures and environment in which FHCs exist in both countries, and the large difference in size between the capital bases in both Taiwan and the U.S.. The former refers to the U.S.'s banking system being two-tiered (federal and state banks), as opposed to Taiwan which is a complex one–tiered system. Taiwan's one-tiered banking system makes provision for not only traditionally defined banks, but also a fringe and satellite banking system (such as all three types of Bank Co-ops), a vestige from

[101] Butler, *supra*, note 99, at 603.

Japanese colonization. The latter refers to the capital base gap as exemplified by the fact that even the largest FHC in Taiwan (the Cathay FHC) only accounted for 1/10 of Citigroup's 'capital base' and 'market share' when Citicorp and Travelers' first merged in 1998 to become the largest FHC not only in the U.S. but in the world. It is not unimaginable that gap has now widened even more over the last 9 years.

The fundamental difference in capital bases prompts another question in regards to the legislative history of recent financial reform. In the U.S., "the Congress's primary purpose in enacting the *Bank Holding Company Act of 1956* (BHCA) was to keep banking activities separate from non-banking activities, and to prevent concentration in the banking industry."[102] Quite unlike this fundamental concern, one of the major problems in Taiwan's banking system over the past decade has been that of non-performing loans (NPLs). This issue has largely shaped the drive to financial reform in Taiwan. The relatively small and fragile capital base in Taiwan has been exposed by the NPL issue. Structurally, Taiwan banks' average capital base is not strong enough to contain the damage from any large banking crisis. Taiwan's recent banking law reform has been more focused on eliminating bad loans, and consequently, the taking over of under-performing banks, by using special funds apportioned by the government ("The Executive Yuan Restoration Fund"). It is fair to say that the principles underlying the U.S. BHCA in "preventing excessive competition" does not necessarily provide an analogous reference for Taiwan to look to for its banking reform needs. The U.S. GLBA derives from and further expands the definition of permissible non-banking activities under the BHCA. The same focus and purpose under the BHCA is not necessarily relevant to Taiwan's current banking needs.

Despite the critiques concerning Taiwan's adoption of the U.S. approach, empirical research as discussed in the introductory chapter indicates that Taiwan has already experienced some moderate success in regards to the increased number of amalgamations and increased operational efficiencies of its banking institutions. Hence the experience

[102] J. F. Groth, "Can Regulators Force Bank Holding Companies to Bail Out Their Failing Subsidiaries?—An Analysis of the Federal Reserve Board's Source-of-Strength Doctrine" (1991) 86 Northwestern University Law Review 112 at 123.

in Taiwan might be a good lesson for China to follow. However, to go further in analyzing the pros and cons of adopting the U.S. model is beyond the scope of this dissertation.

Given Taiwan's long-standing comprehensive banking practice and its relatively small capital base, it would make sense to suggest that given Taiwan's current economic circumstances the E.U. model (esp. featured by the German Universal Banking System) represents a more comparable and adaptable model for Taiwan. As for the comparability of the U.S. and Taiwan systems, and with particular attention to critics' concerns about the structural differences between these two countries' *banking system*s (i.e. the U.S.'s banking system being two-tiered while Taiwan's remaining one-tiered) and thereby whether Taiwan could effectively adopt the U.S. model, two points must be made—

(1) The comparative analysis is unavoidable because Taiwan's FHCA presently adopts a majority of the U.S. model.

(2) We can see elements of similarities and differences in both models. Such similarities and differences form the basis of reviewing the implementation of the U.S. model. By doing so, it offers an opportunity for researchers to further assess whether the U.S. experience can provide a lesson for Taiwan. Similarities include a relatively open market while differences include the different size of each country's financial holding companies.

Ultimately Taiwan adopted the majority of the U.S. model in the FHCA. The legislative debates over the adoption of this structure have been closed and academics, practitioners and policy makers have weighed in already. The question now is not whether Taiwan should or should not adopt the GLBA but rather how well and how effectively it will meld to Taiwan's existing institutional financial systems and structures. Furthermore whether the FHCA will really work in forcing financial institutions to reach for efficiencies and ultimately global standards is still an open question. With respect to the latter, enough passage of time will likely provide us with sufficient economic data to

help determine the efficacy of the FHCA. The numbers and data have yet to be fully counted. Initial observations suggest some moderate success so far but to go further in the analysis is beyond the scope of this dissertation. As to the former question of how efficacious the implementation of the FHCA will be, given its foreign origins (referring to Taiwan FHCA's adoption of the U.S. GLBA), this researcher, for one, has reason to be optimistic. (A case in point is Citigroup's formidable global success which attests to the efficacy of the GLBA.) Although such a discussion is also beyond the scope of the dissertation, I nonetheless believe that given the preliminary research and data, the U.S. GLBA is still compatible with Taiwan's banking system. Both the U.S. and Taiwan have relatively open market systems, competitive banking systems and numerous financial service providers. The main difference, however, is the difference in market capitalization. Taiwan's financial institutions have a relatively small market capitalization compared to those in the U.S.. Whether this difference in scale between both countries' systems can ultimately prevent the efficacious implementation of a sophisticated piece of legislation, which in part and in spirit was originally designed for the banking system in the U.S., is unlikely.

Despite the comparability concern, Taiwan has recently followed the international trend of forming financial holding companies (FHCs). Once Taiwan's FHCs have transitioned completely through SME capitalism and a domestically-contained financial system, their potential to grow with the assistance of foreign injected capital investment is very promising. After Taiwan officially joined the WTO in 2001, under the WTO/GATS guidelines, Taiwan is now forced to open its market to its international business partners as of January 1, 2002. This mandate also includes the opening of Taiwan's financial markets. For the future development of Taiwan's financial holding companies, the U.S. FHC model, compared to the German Universal System, still possesses more power and greater potential to maintain their global competitiveness. One factor that contributes to the U.S. model's success is that it restricts the financial holding company, as a parent company, to an exclusively pure-holding company structure. To this end, the U.S. FHC's only job is to invest, manage, and oversee its various subsidiaries' activities, including commercial banking, investment banking,

securities brokerage, property casualty and life insurance, consumer finance, credit cards, asset management, and investment trust and consulting businesses etc.. Compared to the German Universal Banking System where the commercial bank (as a holding company) not only directly controls and manages the day-to-day banking and securities businesses, without delegating it to a subsidiary (except as is the case with the universal bank's other financial services, including insurance, investment trust and consulting, lease, and credit card businesses etc.), the U.S. model is poised to promote a higher level of professionalism. The U.S. model hence has a greater potential to increase revenue for the entire FHC.

Although Taiwan's *Financial Holding Company Act* (FHCA) is basically modeled after the U.S. GLBA, the international trend toward financial services liberalization under the WTO and GATS has ensured a positive environment and impetus in Taiwan within which the FHCA has been legislated. The WTO/GATS have become additional influences beyond the FHCA's application of the U.S. model. However a fuller discussion on the role of WTO/GATS in the opening up of Taiwan's financial market is beyond the scope of the dissertation.

Banking deregulation in the U.S. has been a response to domestic and international pressures. The U.S. financial sector has lobbied Congress to permit cross-marketing among commercial banking, securities brokerages and underwriting, and insurance brokerages. Internationally deregulation has been manifestly successful and has assisted U.S. banking leaders in making their case for fewer restrictions on their business activities. The European Union has been a successful example of deregulation following the adoption of the *Second Banking Directive*[103] and there has been consistent and ongoing pressure for many years now in the context of financial services liberalization under the WTO/GATS.[104]

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[103] R. B. Walker III, "The U.S. Financial Services Modernization Act of 1999: New Financial Order, or Financial Chaos?" (2000-2001) 16 Banking & Finance Law Review 47 at 69 (original footnote# 5), quoted as, "EC, Second Council Directive 89/646/EEC of 15 December 1989 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions and amending Directive 77/780/EEC, [1989] O.J.L. 386/1."
[104] *Ibid* at 49.

In Taiwan, the ongoing pressure for financial services sector liberation under the WTO/GATS negotiations has affirmed the direction of financial liberalization in the U.S.. Taiwan has followed many other countries by calling for financial reform that has resulted in synergies across financial institutions and their products. This turnover is predictable as Taiwan has been striving to develop itself as Asia's financial operations center. As an island highly dependant on foreign trade, it is critical for Taiwan to ensure its access to international markets is not blocked by unnecessary regulatory restraints. Almost unequivocally, the best way to achieve that goal is to make sure Taiwan's financial regulatory regime conforms to international standards.

The GATS (General Agreement on Trade in Services) is a treaty of the WTO (World Trade Organization) that came into force in January 1995 as a result of the Uruguay Round negotiations. The GATS was created to "extend the multilateral trading system to services, in the same way the GATT (General Agreement on Tariffs and Trade) provides such as system for merchandise trade."[105] With WTO/GATS guidelines in place, the global economic system not only requires a freer flow of capital but also creates a more competitive environment for global investment activities. This phenomenon also means that business entities in any given country draw much-needed operational or investment capital from the international community instead of purely domestic sources. Business enterprises are inclined to pursue mergers and acquisitions in order to further their chances for survival (by cross-marketing banking, securities, and insurance deals); considerations include obtaining market priority and technology, lowering cost, and tax planning[106].

Practically speaking, implementation of Taiwan's Financial Holding Company Act (FHCA) by its umbrella regulator (Financial Supervisory Committee; FSC) has met with some modest initial success. With respect to enforcement of the FHCA and other complementary functional regulations (such as the *Banking Act*, the *Insurance Act*, etc.),

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[105] On-line encyclopedia, [http://en.wikipedia.org/wiki/GATS]

[106] Wen-yu Wang, "The Review of and Suggestions to Taiwan's Company Law in Respect of Mergers and Acquisition" (2001) 68 Yueh Dan Journal of Law 24 at 24. (In Chinese)

according to the FSC's government website, its measures undertaken to ensure a full compliance of such laws include, but not limited to, imposing fines, restricting services, displacing the president of a problematic financial institution, and the issuance of warnings.

For example in 2005, Fubon Securities (a subsidiary of the Fubon FHC) reportedly received a warning by FSC pursuant to subparagraph 1, Article 66 of the *Securities & Exchange Act* for defective internal control. The irregularity, as indicated by the FSC, involved Fubon Securities' acceptance of "the orders of Merrill Lynch International to buy stocks on June 27, 2005 and made a huge-sum trading error."[107] FSC's investigation found that there were "several deficiencies in the internal control system of Fubon Securities, including inadequate credit checking of customers, failure to set up tiered responsibility system for the accounts of foreign investors or fund companies involving a custodian bank, and failure to establish safety control mechanism for its order placement system."[108] In light of those deficiencies, the FSC thereby issued a warning against Fubon Securities based on the latter's violation of certain provisions in securities laws and regulations, inclusive of subparagraph 1, Article 66 of *Securities & Exchange Act*. As part of the remedial procedure in order to ensure full compliance of the law in the future, the FSC further ordered Fubon Securities to "submit an internal control improvement plan and a report on the implementation of the plan in one month pursuant to Article 28 of the *Guidelines for Establishing Internal Control System by Service Enterprises in Securities and Futures Market*."[109]

With respect to monitoring insurance activities, the FSC reportedly imposed a fine on Cathay Insurance (the insurance arm of the Cathay FHC) in 2006, after the latter "commenced the sale of an insurance policy without first applying for approval of changes to the policy (including a change of name, format, and declarations), as required in Article 12 of the *Regulations Governing Pre-sale Procedures for Insurance*

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[107] "Fubon Securities is Given Warning by FSC Pursuant to Subparagraph 1, Article 66 of Securities & Exchange Act for Defective Internal Control", see Financial Supervisory Commission (FSC)'s website at [http://www.fscey.gov.tw/news_detail5.aspx?icuitem=862627]
[108] *Ibid.*
[109] *Ibid.*

Products."[110] On a legal basis, relevant provisions were cited to explain for its imposition of such punishment, as the FSC indicated that "[f]ailure to apply for approval constituted a violation of Article 144-1 of the *Insurance Act*, for which the company was fined NT$ 600,000 pursuant to Article 171 of the same Act."[111]

In addition to the 'fines' and 'warnings' as indicated above, a recent FSC's enforcement report[112] indicated that 'deposing and/or suspension' of management team can also apply in the realm of punishment. A case in point, on June 2006, FSC sanctioned Fubon Futures whereby these punishments ('suspending internal auditor' and 'removing positions held by departmental supervisors') were meted out pursuant to Article 101, paragraph 1 of the *Futures Trading Act*[113].

Besides, more radical punishment such as 'restricting (banking) services' and even 'revoking business permit' were also resorted by the FSC to hold against defiant financial institutions, such as the Taitung Business Bank and Sheng Bao Wei Lian Investment Consulting Co. Ltd. The former (the Taitung Bank), in May 2005, was held against by the FSC as in violation of Article 10, Paragraph 3, Subparagraph 1 of the *Regulations Governing Bank Capital Adequacy Ratio*, which were issued under the provisions of Article 44 of Taiwan's *Banking Act*[114]. On top of that, the Taitung bank was also imposed a fine by FSC for NT$ 2 million for providing a flawed banking report for the fiscal year of 2004[115]. The latter (the Sheng Bao Wei Lian Investment Consulting Co. Ltd.)'s business permit was revoked in May 2006, pursuant to provisions of Article 103, subparagraph 5 of the *Securities Investment Trust and Consulting Act* as well as Articles 3 and 5 of the *Regulations Governing Securities Investment Consulting*

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[110] "FSC Hands Cathay Insurance NT$ 600,000 Fine", see FSC's official website in regards to "Laws and Regulations Enforcement". [On-line information, available at http://www.fscey.gov.tw/news_detail5.aspx?icuitem=1781993]
[111] *Ibid.*
[112] See FSC's various enforcement reports. [On-line information http://www.fscey.gov.tw/news5.aspx?ctunit=610]
[113] "FSC Sanctions Fubon Futures Co., Ltd.", see FSC's government website at [http://www.fscey.gov.tw/news_detail5.aspx?icuitem=1739885].
[114] "Taitung Business Bank Was Fined NT$ 2 Million, Restricted Services and Displaced the President by FSC", see FSC's government website at [http://www.fscey.gov.tw/news_detail5.aspx?icuitem=900569]
[115] *Ibid.*

Enterprises[116]. The FSC had the company's business permit revoked as it "[moved] into an unknown location and failing to account for the whereabouts of certain funds; [and that] the company had registered persons as directors and supervisors without their permission, and its managers and associated persons had all departed the company, which was thus clearly incapable of safe and sound operations."[117]

With respect to foreign financial institutions' branch(es) in Taiwan, it should be noted that the FSC has oversight over them as it does the domestic financial institutions in Taiwan. Thereby the FSC can impose fines (or other forms of punishment) on such foreign institutions' branches in Taiwan, as a result of applying the WTO's 'national treatment principle'. The corollary is that foreign financial institutions can be held responsible if they violated the financial laws and/or regulations in a host country where they operate. A case in point, according to an FSC's enforcement report in July 2006, the FSC's found that "Zurich Insurance (Taiwan) had launched a new product without properly observing file-and-use procedures as required by the *Regulations Governing Pre-sale Procedures for Insurance Products*."[118] The FSC held that this practice constituted a violation of Article 144 of the *Insurance Act*; thereby the FSC "fined the company NT$ 600,000 pursuant to Article 171 of the same Act."[119] The FSC further found that "the investments of Zurich Insurance (Taiwan) in stocks and bonds were equivalent to 38.1% of the company's funds, while Article 146-1 of the *Insurance Act* provides that such investments shall not exceed 35% of an insurance enterprise's funds."[120] For this violation, "the FSC fined the company an additional NT$ 900,000."[121] In aggregation, the FSC handed Zurich Insurance (Taiwan) fines totalling NT$ 1.5 million.

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[116] "FSC Revokes Business Permit of Sheng Bao Wei Lian Investment Consulting", see FSC's government website at [http://www.fscey.gov.tw/news_detail5.aspx?icuitem=1688243]
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[118] "FSC Hands Zurich Insurance (Taiwan) Fines Totaling NT$ 1.5 Million", see FSC's government website at [http://www.fscey.gov.tw/news_detail5.aspx?icuitem=1781991].
[119] *Ibid.*
[120] *Ibid.*
[121] *Ibid.*

Based on the evidence cited above, it appears that regulation in Taiwan is not without teeth. It is imperative to recognize the importance of the regulator (FSC's) behaviour and the design of the law in the emergence of irregularities and scandals. Whether such regulation has ultimately acted as a deterrent to misbehaviour and assisted indirectly in promoting a stronger banking system as judged by international standards is yet to be determined, and is outside the scope of this dissertation. Further research in this regard will be of interest to both academics and practitioners that observe or work in the banking and financial sector, within or outside Taiwan. This is because Taiwan's moderate success in its implementation of FHCA may as well serve a lesson for any country with a comparatively small financial market similar to Taiwan.

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Appendix One

No. 741. Mergers and Acquisitions—Summary: 1990 to 2003

[206 represents $206,000,000,000. Covers transactions valued at $5 million or more. Values based on transactions for which price data revealed. *All activity* includes mergers, acquisitions, acquisitions of partial interest that involve a 40 percent stake in the target or an investment of at least $100 million, divestitures, and leveraged transactions that result in a change in ownership. *Divestiture:* sale of a business, division, or subsidiary by corporate owner to another party. *Leveraged buyout:* acquisition of a business in which buyers use mostly borrowed money to finance purchase price and incorporate debt into capital structure of business after change in ownership]

Item	Unit	1990	1995	1997	1998	1999	2000	2001	2002	2003
All activity: Number	Number	4,239	4,981	8,770	9,634	9,599	11,169	7,713	7,032	7,743
Value	Bil. dol.	206	896	1,610	2,480	3,402	3,440	1,688	1,185	1,318
Divestitures: Number	Number	1,907	2,227	3,189	3,304	3,184	3,497	2,816	2,631	3,090
Value	Bil. dol.	91	365	616	555	678	892	644	473	501
Leveraged buyouts: Number	Number	177	206	198	238	344	476	329	303	366
Value	Bil. dol.	18	24	24	27	58	86	60	83	86
Foreign acquisitions of U.S. companies:										
Number	Number	773	80	441	483	560	741	448	336	321
Value	Bil. dol.	56	4	65	233	297	335	125	68	58
U.S. acquisitions overseas:										
Number	Number	392	317	539	746	698	746	470	378	398
Value	Bil. dol.	21	63	88	128	158	136	108	56	106
US companies acquiring US companies:										
Number	Number	(NA)	2,250	3,753	3,882	3,353	3,119	2,079	1,994	2,070
Value	Bil. dol.	(NA)	462	834	1,379	1,259	1,400	638	370	463

NA Not available.

No. 742. Mergers and Acquisitions by Industry: 2003

[462,808 represents $462,808,000,000. See headnote Table 741]

Industry	U.S. company acquiring U.S. company		Foreign company acquiring U.S. company		U.S. company acquiring foreign company	
	Number	Value (mil. dol.)	Number	Value (mil. dol.)	Number	Value (mil. dol.)
Total activity [1]	2,070	462,808	321	58,371	398	106,423
Aerospace and aircraft	7	2,038	1	14	2	1,820
Agriculture, forestry, and fishing	10	628	3	322	3	1,136
Amusement and recreation services	15	1,070	-	-	5	304
Business services	209	33,417	33	1,562	56	5,391
Chemicals and allied products	31	9,192	15	1,739	13	4,409
Commercial banks, bank holding companies	130	65,995	3	227	13	7,154
Communications equipment	35	2,093	7	427	2	13
Computer and office equipment	25	2,407	3	72	4	300
Construction firms	27	3,028	3	149	3	757
Credit institutions	23	11,423	7	961	6	720
Drugs	70	15,914	14	7,502	19	11,548
Educational services	12	1,815	1	30	3	109
Electric, gas, water distribution	75	26,240	16	1,386	4	246
Electronic and electrical equipment	72	9,577	16	1,827	17	932
Food and kindred products	36	7,033	10	1,339	8	5,999
Health services	54	10,935	2	217	1	10
Hotels and casinos	44	5,819	10	286	6	994
Insurance	56	54,893	4	13,366	5	3,095
Investment & commodity firms, dealers, exchanges	59	18,522	10	910	28	3,563
Machinery	24	896	6	296	10	1,391
Measuring, medical, photo equip; clocks	69	12,239	11	997	21	5,394
Metal and metal products	46	6,542	8	669	8	856
Mining	16	1,112	6	233	5	1,357
Motion picture production and distribution	15	14,584	3	335	-	-
Oil and gas; petroleum refining	111	20,742	19	1,585	12	3,827
Other financial	7	7,615	1	11	2	292
Paper and allied products	12	1,384	4	451	3	327
Prepackaged software	134	11,884	19	1,261	38	982
Printing, publishing, and allied services	17	2,612	7	1,650	3	4,099
Radio & television broadcasting stations	71	13,132	-	-	11	5,420
Real estate, mortgage bankers and brokers	123	26,559	21	3,005	13	16,378
Retail trade-food stores	19	2,115	3	889	2	19
Retail trade—general merchandise and apparel	18	1,960	-	-	5	348
Rubber & misc plastic products	17	1,159	2	106	5	488
Savings and loans, mutual savings banks	40	7,430	-	-	1	24
Soaps, cosmetics, & personal-care products	7	425	2	3,089	3	6,951
Telecommunications	49	5,973	5	8,237	11	2,789
Textile and apparel products	27	7,416	2	27	3	94
Tobacco products	4	3,103	-	-	-	-
Transportation and shipping (except air)	31	5,129	5	469	8	2,188
Transportation equipment	17	2,471	5	162	4	227
Wholesale trade—durable goods	31	2,405	5	115	10	558
Wholesale trade-nondurable goods	26	2,864	2	23	3	2,622
Wood products, furniture, and fixtures	18	5,607	4	545	2	84

- Represents zero. [1] Includes other industries not shown separately.

Source of Tables 741 and 742: Thomson Financial, Newark, NJ, Merger & Corporate Transactions Database (copyright).