

BANKING REFORMS IN GLOBAL MARKET -CHINA AND TAIWAN

by

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ABSTRACT

As a result of innovations in financial technology and financial liberalization, financial sectors have operated more globally in the past decades. It is clear that the process of globalization highlights the importance of international standards. In the area of international banking, GATS and Basel Principles are the most influential standards because no countries can conduct their banking activities in global market without the consideration of these two regimes.

Both China and Taiwan are seeking to join the WTO and have committed a lot of efforts in their banking reforms by reference to GATS. However, the eruption and contagion of Asian Financial Crisis in 1997 demonstrates that most Asian countries, including China and Taiwan, fail to develop a prudential and comprehensive banking regulatory regime in consistent with the Basel Principles before, or, at a minimum, no later than financial liberalization. Thus, in recommending financial liberalization and globalization through a safe and sound banking supervisory system, this thesis introduces a comparative study of the banking supervisory regimes in China and Taiwan under the impact of the international banking regime constructed by the GATS and the Basel Principles.

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Chapter 1 Introduction

Economic globalization has not only vitalized developed countries, it is now influencing developing countries as well. During the past decades, the "Chinese Economic Area" (CEA)¹, referring to a de facto economic relationship among China, Hong Kong and Taiwan, has become one of the largest emerging markets.

Although political tension² between China and Taiwan might inhibit the creation of a formal CEA, private sectors within the CEA have sought profit through economic integration and have already propelled the formation of an unofficial CEA. If all three entities are considered to be one economic entity, the integrated CEA would have a Gross National Product (GNP) in 1998 of \$1.4 trillion U.S dollars, the largest foreign exchange

¹ The Chinese Economic Area is also known as "Great China", "Chinese Triangle," and "South China Economic Community." However, these different terms all describe the same geographic area. See Sally Stewart et al, "The South China Economic Community" (1992) Colum J. World Buss 30, at 32; Lawrence L.C. Lee, "Adoption and Application of a "Soft Law" Banking Supervisory Framework Based on The Current Basle Accords To The Chinese Economic Area" 16 (1998) Wisconsin Int'l L. J. ,691

While the CEA is not a formal economic union governed by treaty, these three entities are often referred to as a group since Hong Kong was returned to China in 1997, and Taiwan, in spite of a de facto sovereign, is recognized internationally as a renegade province of China.

The label "Chinese Economic Area"¹, coined in 1979, summarizes the economic relationship amongst Hong Kong, China, and Taiwan. Current economic integration in the CEA differs significantly from the other existing regional trading blocs. For instance, the EU and the North American Free Trade Agreement created, by written agreement, free trade markets for the mutual advantages of their members. In contrast, the political tensions between Taiwan and China prevent the execution of a formal written agreement. Thus, the success of the CEA's integrated economy results mainly from private transactions.

² Historically, the government of China, Hong Kong and Taiwan has had tension-filled relationship. In July of 1997, Hong Kong's survival as a political body became dependent on China. Although China considers Taiwan to be part of China and a regional province, Taiwan is a de facto sovereign. Taiwan and China's anomalous relationship manifests itself in both China's "One Country, Two System" proposal and Taiwan's contrasting view of "One Country, Two Governments".

The political relationship between Taiwan and China detrimentally affects the economic relationships among all three CEA entities. Taiwan adopted the "Three Nos" policy--"no contact, no negotiations, and no compromise" with the Chinese Communist Party--to prohibit trade with China "directly." China also adopted a Sino-Japanese trade policy--one that encourages trade between China and Japan--in response to political tension with Taiwan. The purpose of the Sino-Japanese trade policy is to replace the position of Taiwan in trading with Japan, hence indirectly, encourage Taiwanese investors to trade with China and make

reserves, and the third largest turnover based on 1998 figures (See Table 1.1). In addition to CEA's dynamic performance in global economy, the growing interdependence within the CEA is even more remarkable. According to Taiwan's statistics, Taiwan's indirect trade with China through Hong Kong amounted to approximately \$21 billion U.S. dollars in 1996, and has drawn Taiwan and China closer economically. Taiwan is the largest investor in China's Fujian province, making Taiwan the second largest investor in China as a whole; Taiwanese investments in China totalled between \$25 and \$30 billion U.S. dollars in 1996 (See Table 1.2).

In spite of CEA's regional and global economic dynamism, the banking services in China and Taiwan remain relatively protected by government policies, and are thus less able to compete with foreign banking institutions. Once China's and Taiwan's bids for WTO membership are accepted, their domestic financial markets will become more integrated into the global market, increasingly deregulated and competitive than their current status. It is critical to examine whether the current banking supervisory regimes in China and Taiwan are capable of fighting off potential financial crises while simultaneously enjoying the prosperity brought by globalization.

Thus, in recommending financial liberalization and globalization through a safe and sound banking supervisory system, this thesis introduces a comparative study of the banking supervisory regimes in China and Taiwan under the impact of the international banking regime constructed by the GATS and the Basel Principles.

Table 1.1 Foreign Trade & Economic Statistics Data of Important Countries
(All in billion U.S. dollars)

	(1) <i>Foreign reserve (1998)</i>	<i>exchange</i>	(2) <i>GNP (1998)</i>	(3) <i>Total Trade (1998)</i>
U.S.	62.3		8750	1628(14.9 %)
Japan	272.4		3887	669 (6.1%)
German	62.4		2138.2	1006(9.2%)
U.K	29.4		1397.6*	576 (5.4%)
Canada	25.1		598.8*	419 (3.8%)
China	151.3		963.2*	324 (3.0%)
Hong Kong	89.2		163.7	359 (3.3%)
Taiwan	102.7		268.6	214 (2.0%)

Source: Taiwan's Council for Economic Planning and Development

Table 1.2 Trade between Taiwan and China
(All in million U.S dollars)

Year	(1) Taiwan's export to China	(2) Taiwan's import from China	(3) Total trade with China	(4) Taiwan's world trade total	(5) Taiwan's trade dependence on China
1986	811.3	144.4	955.5	64,043.0	1.49%
1987	1,226.5	288.9	1,705.2	88,662.1	1.92%
1988	2,242.2	478.7	2,720.9	110,340.2	2.47%
1989	3,331.9	586.9	3,918.8	118,569.3	3.31%
1990	4,394.6	765.4	5,160.0	121,930.4	4.23%
1991	7,493.5	1,125.9	8,619.4	139,038.3	6.20%
1992	10,574.6	1,119.0	11,666.6	153,477.1	7.60%
1993	13,933.1	1,103.6	15,096.7	162,022.1	9.32%
1994	14,653.0	1,858.7	16,511.7	176,000.0	9.38%
1995	17,800.0	3,100.0	20,900.0	215,200.0	9.71%

Source: World Trade Organization & Taiwan's Council for Economic Planning and Development

Financial Globalization and Potential Risk: The Implication of Asian Financial Crisis

Every age has its defining terms. One of the most powerful and persuasive images of today's world is "globalization"³, which conveys the widely held belief that we are living in an increasingly interconnected, interdependent and borderless world. The image of globalization becomes more vivid when it comes to economic sectors. By the late 1980s, for example, the US-based multinational enterprises were responsible for 65 percent of total US merchandise exports, while the US subsidiaries of foreign-based firms may have been accounting for another 25 percent of US merchandise exports.⁴

No sector in the economy, however, is more global in its orientation and operation than finance. The following data illustrate financial globalization operating outside the framework of nation-states. International bank lending grew from \$40 billion in 1975 to well over \$300 billion by 1990, while bond lending rose almost tenfold, from \$19 billion to over \$170 billion during the same period.⁵ Banks have placed branches worldwide, and many now accumulate the bulk of their earnings outside their home country.

The phenomenon of financial globalization is to a great extent shaped by the trend of financial liberalization.⁶ In the last two decades, financial liberalization in developed countries has been propelled by advocates of market-oriented, or "neo-liberal" thought.⁷

³ There is no universally accepted definition of "globalization." For some recent efforts to delineate important aspects of this concepts, See Ethan B. Kapsten, "Governing The Global Economy-International Finance and the State" (Harvard University Press 1994) at 1 ; George Soros, "Toward a Global Open Society" (Atlantic Monthly: January 1997) at 101-102; Michael Veseth, "Selling Globalization: The Myth of Global Economy" 3th ed, (Lynne Rienner Publisher,1998)

⁴ See Raymond Vernon & Ethan Kapstein, "Defence and Dependence in a Global Economy," (Washington DC:CQ Press, 1992), at 15

⁵ See Andrew Walter, "World Power and World Money," 2d ed, (Herfordshire, England:Harvester Wheatsheaf, 1991), at 12

⁶ See A.T. Aburachis , "International Financial Markets Integration: An Overview" (Stanley R..Stansell ed.1993) at 3

⁷ The neo-liberal model is market-led. Private capital, operating through efficient market, is seen as the driving force for the achievement of the policy goals. State only acts as a facilitator, creating the conditions that will enable markets to flourish. See Richard Mc Kenzie & Dwight Lee, "Quicksilver Capital:How the Rapid

Neo-liberal advocates favour the elimination of capital controls partly on efficiency grounds, arguing that capital would be able to move across borders to find its most productive employment. In addition to the trend of financial liberalization, technological revolution has also played a remarkable role in promoting financial globalization.⁸ Technological innovation, particularly the revolution in telecommunications and information processing, not only facilitates the capitalists' and investors' access to information but also makes possible for them to operate on a global scale.⁹ It is often assumed that the globalization of the financial markets is irreversible because the process is thought to be a result of technological developments, which cannot easily be turned back.

Financial liberalization and globalization bring a myriad of benefits. They not only make the financial sector more efficient and stable, but also increase the incentive for better macroeconomic policies and regulation under international competition.¹⁰ Despite the benefits praised by neo-liberal advocates, one risk arising from the growth of financial globalization is the potential for international financial crises.¹¹ Although financial liberalization and globalization will not necessarily lead to international financial crises, it is true that most financial crises erupt from regions where financial liberalization and globalization are conducted rapidly and imprudently. For example, the Asian Financial Crisis that originated from Thailand in 1997 took us by surprise, in terms of its scope, severity, and duration.¹²

Movement of Wealth Has Changed the World" (New York: Free Press, 1991)

⁸ See, for example, Walter Wriston, "The Twilight of Sovereignty : How the Information Revolution is Transforming Our World" 2d ed. (New York : Scribners, 1992)

⁹ See, Andrew Walter, *World Power and World Money*, (Hertfordshire, England : Harvester Wheatsheaf, 1991), at 201

¹⁰ See Masamichi Kono, Patrick Low, Mukela Luanga, Anditya Mattoo, Mailka Oshikawa & Ludger Schuknecht, "Opening Markets in Financial Services and The Role of The GATS," (World Trade Organization, 1997) at 17-21

¹¹ See Wendy Dobson & Pierre Jacquet, "Financial Services Liberalization in the WTO," (Institute for International Economics, Washington D.C, June 1998) at 8

¹² The Asian Financial Crisis that originated in Thailand in July 1997, and then quickly spread to Malaysia,

The devaluation of the Thai baht in July 1997 is generally recognized as the Crisis' genesis. Under the trend of globalization, Thailand deregulated its capital controls and established an offshore banking center in 1993. However, Thailand's deteriorating macroeconomic conditions was inconsistent with the tremendous wealth and rapid growth brought by the laissez-faire policy of Thai authority. Thailand's exchange rate had been pegged to the dollar for 13 years. But the appreciation of the dollar against the yen in 1996 and 1997, together with the cyclical weakness within the semiconductor industry and the appearance of new competitor in labor-intensive export industries, had begun to cause competitive problems in the economic sector.¹³ By 1996, the current account deficit had reached 8 percent of Thai's GDP. At the same time, the Thai market had become heavily reliant on foreign capital, and the banks and corporations had accumulated large, short-term, and unhedged foreign debt liabilities. By 1997, degenerating competitive problems in the real economic sector combined with the heavy liabilities forced many Thai companies into bankruptcy. Thereafter, the banking system in Thailand also faced a financial dilemma because of high levels of foreign liabilities together with non-performing loan problems caused by the bankruptcy of domestic companies. Moreover, when markets became worried about exchange rate policy in Thailand, capital inflows became outflows, and the Thai baht sharply devaluated by 20%, dropping from 25: \$1 to 30: \$1.¹⁴ The dramatic devaluation of the Thai baht sent shockwaves across the region and was immediately followed by currency plunge in the Philippine (July 11), Indonesia and many other economies in East Asia and

Indonesia, Philippines, South Korea, Japan, and other Asia countries. Besides the contagion effect in Asia, the crisis has also spread to Latin America, Europe and United States. More discussions related to the Asian Financial Crisis, see *supra* note 1, George Soros, *Toward a Global Open Society*, especially chapter 7; Fai-nan Perng, "The Asian Financial Crisis Policy Options," (The Central Bank of China, Taipei, May, 28, 1999) (Chin)

¹³ See IMF, Timothy Lane Et Al. "IMF-Supported Program in Indonesia, Korea, and Thailand: A Preliminary Assessment" 17 (1999), at 8

¹⁴ See The World Banks, "East Asia: The Road to Recovery," (Washington D.C., 1998) at 3

Southeast Asia. Table 1.3 lists the dramatic devaluation of currencies in East and Southeast Asian countries between 1997-98. In addition to its contagion to adjacent Asian countries, Asian Financial Crisis also “infected” the global financial system.¹⁵

Table 1.3 Currency Devaluation in Major Asian Economies, 1997-98
(Exchange Rate to US \$1)

Currency	July 1 1997	July 2 1998	Devaluation (%)
Indonesia rupiah	2432	14650	83.10
Malaysia ringgit	2.5247	4.1550	39.21
Thai Baht	25.880	42.070	38.48
Philippine pesos	26.373	41.310	36.15
South Korea won	887.80	1366	35.00
New Taiwanese dollars	27.812	34.342	19.01
Japanese yen	114.91	139.18	17.44
Singapore dollars	1.4300	1.6857	15.17

Source: Fai-nan Perng, The Central Bank of China, Taipei, May 28, 1999

The culprit in the Asian Financial Crisis was not only the traditional combination of rising current account deficits, lax monetary and fiscal policies.¹⁶ Other offenders such as structural weakness in the banking system, including inadequate banking supervision, especially with respect to indebtedness dominated in foreign currencies; inadequate risk assessment; a tradition of bank bailouts, and the interaction amongst these weaknesses. The

¹⁵ George Soros, Toward a Global Open Society ,especially chapter 7 ; Fai-nan Perng, The Asian Financial Crisis Policy Options, at1-3

¹⁶ Other causes of the Asian Financial Crisis see, Cheng-Chin Liang, “The Implication of Asian Financial Crisis” (The Central Bank of China, Taipei, July, 1998) (Chin) ; supra note 1, George Soros ,Toward a Global Open Society ,especially chapter 7 ; supra note 12, Fai-nan Perng, The Asian Financial Crisis Policy Options

banks' participation in the Asian local market further exposed them to a number of risks, notably credit risk. Most businesses in Asian economies were family owned, and in accordance with Confucian tradition, the families wanted to retain control. Therefore, they preferred to rely on credit rather than risk losing control through securities markets. At the same time, the prevalence of government-directed loans and connected lending also produced systemic risk. The combination of these factors resulted in very high debt to equity ratios and a financial sector that was neither transparent nor sound.¹⁷ Additionally, the history of Asian economies managing their growth contributed to the belief that implicit government guarantees existed on particularly banking sectors. Therefore, the creditor banks, in many cases, failed to assess the creditworthiness of borrowers. Pre-Crisis increases in capital flows fuelled rapid expansion of credit in domestic banks. That coupled with poor regulation in implicit/explicit government guarantees of bank and corporate debt, government-directed loans, and connected lending, failed to minimize excessive risk-taking. This left many banks vulnerable to market and credit risk, and therefore caused a severe adverse impact on economic activities.¹⁸ The Asian Financial Crisis thus illustrates that strengthening prudential banking supervision and improving its efficiency are prerequisites to capital account liberalization. In other words, the transition from a protected financial system with a closed or highly restricted capital account to an internationalized system that is open to capital flows (short-term flows in particular) should be carefully managed through an adequate and prudential banking supervisory system.

¹⁷ See supra note 1, George Soros, *Toward a Global Open Society*, at 138

¹⁸ Basel Committee on Banking Supervision, Working Papers No2, June 1999, "Supervisory Lessons To Be Drawn From The Asian Crisis" (June 1999), at 9

Government Policies in the Global Market: The Impact of International Standards

Under the trend of internationalization and globalization, governments can formulate hardly any policies or regulations without considering the international standards. The international standards not only eliminate the regulatory fragmentation among national jurisdictions but also streamline policies to avert unpredictable policy reversal of individual governments.¹⁹ Another reason in support of government's proposition is to resist the declining authority of nation state following the trend of globalization²⁰. This is because that financial liberalization and technological innovation led to financial market operation beyond government control. It has become scarcely possible for one national government to regulate the market or to pursue economic policies seen by market operators as wrong. Governments find themselves impotent when facing global market tides and look for cooperation with other countries as a partial solution²¹.

Nevertheless, the promotion of international standards is not without challenges. The principal argument against international standards is the problem of implementation²². Any existence of international standards requires the national governments to surrender some degree of their sovereignty, which contravenes the government's intention to maintain authority. In other words, governments support the establishment of international standards on the one hand, but are unwilling to sacrifice their sovereignty on the other hand. The conflicting roles played by national governments hinder the implementation of international standards and climax in the international banking area because of governments' protective

¹⁹ See supra note 3 Ethan B. Kapstein, "Governing the Global Economy- International Finance and the State," Yair Atharoni, "Changing Role of State Intervention in Services in an Era of Open International Markets, State" (University of New York Press, 1997) at 20

²⁰ See Enrico Colombatto & Jonathan, A Public Choice Model of International Economic Cooperation and the Decline of Nation State, (1996), 18, Cardozo Law Review, 925

²¹ See supra note 3, Ethan B. Kapstein, chapter one; Yair Atharoni, Introduction.

attitude towards their domestic banking sectors. This is one of the arguments used in Europe when it was decided that banking supervision would stay at national level rather than migrating to the European Central Bank²³.

However, international agreements appear to be an irresistible general trend in the area of international finance since the World Trade Organization came into being in 1995. International cooperation in financial matters is hardly new, but the General Agreement on Trade in Services (GATS), which emerged from the Uruguay Round, represents the first multinational effort to establish rules governing trade in services, including financial services, and to provide a framework for multilateral negotiations on improved market access for foreign services.²⁴ Nowadays, more than 95 percent of world trade in banking, insurance, securities, and financial information now comes under the WTO's jurisdiction, on the basis of broad MFN²⁵ and under the auspices of the dispute settlement mechanism.

Another influential area of international cooperation in the banking system is the Basel Principles. In December 1974, Central Bank Governors of leading industrialized countries met at the Banking for International Settlements²⁶ in Basel, Switzerland, to set up a committee to improve collaboration between bank supervisors in light of the experiences drawn from the failure of Bankhaus Herstatt in Germany and Franklin National Bank in

²² See *supra* note 20 at 925

²³ See *supra* note 3, Ethan B. Kapstein, Chapter 6

²⁴ See *supra* note 10, "Opening Markets in Financial Services and The Role of The GATS" at 1

²⁵ MFN treatment refers to the most-favoured-nation treatment, which means that one member should treat other members equally. Under the GATS, if a country allows foreign competition in one sector, equal opportunities in that sector should be given to services providers from all other WTO members. See, Jeffrey S. Thomas & Michael A. Meyer, "The New Rules of Global Trade: A guide to the World Trade Organization," (Careswell 1997) at 214

²⁶ The Bank for International Settlement (hereinafter BIS) provides technical assistance to central banks of eastern Europe, the former Soviet Union and some Asian nations in transition and coordinates technical assistance and training provided by the central banks of more than twenty industrial countries. The stability of international monetary and financial systems has long been a primary concern of central bankers' meeting at the BIS.

New York. The committee, known as the Basel Committee on Banking Supervision²⁷, has focused its attention on the prudential supervision of international banks. Although Basel Committee appears to avoid any characterization of itself as a legal-based institution or of its various accords as legal documents, it has spawned significant and widespread national legislation and regulatory instruments within its member countries. Furthermore, the influence of the Committee appears to be more global through its cooperation with other international groups.

Although China and Taiwan are not members of the WTO and the Basel Committee, their past banking reforms have been deeply affected by these two areas of international cooperation. For instance, to follow the trend of financial globalization and their bids for WTO membership, China and Taiwan have deregulated their market access to foreign banks, as well as their domestic banking operation. Moreover, to minimize the potential for financial crisis and to maintain financial stability, they also seek to develop a safe and sound banking supervisory regime that is consistent with the Basel Principles.

Organization of the Thesis

The thesis is constructed as follows:

Chapter one elaborates the motive, purpose, and scope of the thesis.

Chapter two assesses two international standards that have substantial impact on government's policy on banking supervision. First, it examines the relevant provisions of financial services in the General Agreement on Trade in Services (GATS), evaluates the

²⁷ The following introduction of Basel Committee, see Basel Committee on Banking Supervision,

significance of the GATS as the first multilateral effort to governing financial services, and analyzes the government intervention within / without the scope of the GATS. Second, a series of Basel Principles pertaining to the cross-border banking are explored in pursuit of the soundness and stability of the banking system and its role in preventing the reoccurrence of the international financial crises. However, with the non-legal binding nature of the Basel Principles, the advantages and possibility of the implementation of the Basel Principles are considered as well.

Chapter three delineates a preliminary framework of the banking supervisory regime in China via reviewing the Commercial Bank Law, as well as other crucial banking regulations. This chapter examines the licensing processes and the prudential regulations²⁸ for banking operation in China, incorporating the domestic and the foreign banking branches in China. It concludes with the vulnerability of the banking supervision in China by comparing it with the supervision in the international level.

Chapter four constructs the infrastructure of the banking supervisory regime in Taiwan through consideration of its Banking Law, as well as other banking regulations. Four types of banking branches are incorporated: the domestic and the foreign banking branches in Taiwan; Taiwan's overseas banking branches; the cross-strait banking operation (with China); and offshore banking operation. Taiwan has conducted a series of banking law reform in the past decade in order to fulfil its intention to the establishment of Asian Pacific Regional Operation Center. This chapter will assess the banking supervisory regime in Taiwan by reviewing the supervision in the international level.

Chapter five concludes the thesis.

Compendium of documents, Volume One, at10-16, April 1997, at <http://www.bis.org/about/index.htm>

²⁸ Prudential regulation, a term used in the area of international banking, refers to the requirement which is essential to a safe and sound banking supervisory regime

Chapter 2 International Cooperation in Banking Services

As a result of innovations in financial technology, and financial liberalization, financial sectors have operated more globally in the past decades. Although this phenomenon creates a period of wealth and prosperity, it simultaneously exposes the banking institutions to unsafe and unsound circumstances. Thus, a prudential and comprehensive financial regulatory structure should be developed before, or, at a minimum, no later than financial liberalization.²⁹

This chapter introduces two important international standards: General Agreement on Trade in Services (GATS) and the Basel Principles. GATS marks the first time that financial services liberalization would be covered by a global trade agreement and ensures that governmental policies to encourage financial liberalization and globalization will not be easily reversed. Basel Principles refer to a series of banking supervisory principles whose main objectives are to close supervisory gaps in international banking activities and to foster a safe and sound banking environments. After providing an overview of the GATS and Basel Principles, the incentives for China and Taiwan to adopt these two international standards will be highlighted.

²⁹ See, 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 529; also see Charles R. Irish, Speech, "The East Asian Financial Crises and American Trade Laws and Policies," presented to the East China Political & Law University, Shanghai, China, (March 9, 1998)

I General Agreement on Trade in Services (GATS)

A Tension surfaced during the GATS financial negotiations

The GATS negotiations in the financial services sector have always been difficult and set by conflict. During the protracted negotiations, the GATS negotiating countries did not reach any consensus until the last minute. The uncertainty involved should come as no surprise, because the negotiations addressed difficult issues that had not previously been dealt with in multilateral negotiations. Not only are temporary deadlocks a constant, normal, and sometimes even tactical and strategic feature of negotiations, but also the actual results are often achieved through brinkmanship or compromises between conflicts. To better comprehend the outcome of the multilateral agreement, it is essential to identify the tension surfaced during the negotiation.

First, the tension between government and market³⁰ plays a momentous role in negotiations. Services are a heterogeneous group of products, but with one common thread: many services are subject to widespread government intervention through regulation and other measures. Therefore, governments seek to maintain the possibility to intervene in the market and are extremely reluctant to release their authority more than the status quo. However, the combination of financial deregulation and technological innovation- in short, the globalization of the world economy- poses a major challenge to the sovereignty of national government. As mentioned earlier, governments deem the promotion of international agreements as a part of solutions to resist their declining authority, and governments will not sacrifice their sovereignty unless they can profit more. Therefore,

³⁰ See supra note 3, Ethan B. Kapstein, "Governing the Global Economy- International Finance and the State" chapter 1

GATS can scarcely escape from this dilemma, since the governments predominate the entire negotiating process and attempt to preserve as much autonomy as possible.

The second tension is between developed and developing countries³¹. Developing countries have dramatically changed their trade policy to fit in to the trend towards trade liberalization over the last 15 years, and have generally recognized that openness to the world economy is necessary for successful development³². Nevertheless, there has been considerable hesitation about financial opening, and that stance seems vindicated by the rather negative experience with financial reform in Latin American countries in the 1970s³³, Mexican peso crisis in 1994³⁴, and more recently by the 1997 Asian financial crisis³⁵. Moreover, developing countries are not primarily interested in access to developed countries' markets, because few of their financial institutions have reached the size and efficiency that could make them competitive in the developed countries' financial markets. Instead, many developing countries were concerned that GATS would make their domestic markets overwhelmed by foreign supplier from developed countries³⁶. Hence, they lean toward a defensive and protective posture, rather than an aggressive stance aimed at opening others' markets via a give-and-take negotiating process.

Of course, the circumstance is different in developed countries³⁷, where domestic financial institutions have more comparative advantages than those in developing countries.

³¹ See, Jeffrey S. Thomas & Michael A. Meyer, "The New Rules of Global Trade: A Guide to the World Trade Organization" (Carswell, 1997), at 205-209

³² See supra note 10, Masamichi Kono, Patrick Low, Mukela Luanga, Anditya Mattoo, Mailka Oshilkawa, & Ludger Schuknecht, at 17-21

³³ An account and impact on the currency crisis in Latin American, see, for example, Zanny Minton-Beddoes, "A Survey of Latin American Finance", *The Economist*, (December 9, 1995)

³⁴ For an account and impact on the Mexican peso crisis, see, for example, Michael Veseth, "Selling the Globalization: The Myth of the Global Economy" (Lynne Rienner Publishers, 1998.) at 76-80

³⁵ More discussions related to the Asian Financial Crisis, see George Soros, "Toward a Global Open Society", at 135-175; Fai-nan Perng, "The Asian Financial Crisis Policy Options," (The Central Bank of China, Taipei, May 28, 1999)

³⁶ See supra note 31, Jeffrey S. Thomas & Michael A. Meyer, at 211

³⁷ See supra note 11, Wendy Dobson & Pierre Jacquet, *Financial Services Liberalization in the WTO*, at 78-79

They play a crucial role in global finance and have a definite interest in market access abroad, particular to the emerging markets. Thus, the clear asymmetry of objectives between developing and developed countries often leads to the necessity for mutual concessions.

For instance, some developed countries are reluctant to further commit themselves under GATS because they are unwilling to allow developing countries to become so-called free riders³⁸ The free rider problem arises because the GATS is based on the most-favoured-nation (MFN) principle, which precludes discrimination among all WTO members. This makes it possible for developing countries that do not offer strong commitments to market access to become free riders. That is, without opening their domestic markets, their service providers have the opportunity to benefit from the market access provided by other countries. In response, the U.S government took the position that, unless the developing countries improve their commitments, the U.S would only make limited commitments for banking and securities in GATS. Therefore, the U.S government advocated a MFN exemption approach that would leave the possibility to discriminate among countries. In other words, without violating the GATS, the United States could prohibit future entry into U.S. market for financial institutions whose home countries were not sufficiently open to U.S financial institutions.

The third tension, for financial services in specific, is between financial liberalization and financial stability.³⁹ Striking the balance between the two foregoing perceptions is scarcely facile. The eruption and contagion of Asian Financial Crisis provide a fresh impetus to a slow-moving negotiating process, while simultaneously, provide these negotiating

³⁸ See Sydney J. Key, "Financial Services in the Uruguay Round and the WTO", (Group of Thirty, Washington D.C, 1997), at 3-4

³⁹ See supra note 11, Wendy Dobson & Pierre Jacquet, Financial Services Liberalization in the WTO, at 71

countries, particularly Southeast Asian countries, with further pretexts not to make more liberal commitments.

B. GATS: The Architecture

GATS proved to be a complex arrangement, reflecting the tensions that surfaced during the negotiations. Architecturally, GATS is comprised of three elements⁴⁰:

- 1 The framework of the agreement, which incorporates a preamble and twenty-eight articles, specifies the obligations of signatories. It was, to a great extent, directly modelled on the General Agreement on Tariffs and Trade (GATT)⁴¹ and relies on many same principles. Just as GATT, the underlying belief of GATS is non-discrimination. This not only means non-discrimination between trading partners (most-favoured-nations principle⁴²) but also means non-discrimination between foreign and domestic companies (national treatment principle). For this broad concept of non-discrimination to prevail, governments' policies and the measures they take to implement them need to be transparent. Consequently, MFN, national treatment, and transparency construct the three major principles in GATS.
- 2 A set of attachments embodies eight Annexes, eight Ministerial Declarations, and an

⁴⁰ See supra note 31, Jeffrey S. Thomas & Michael A. Meyer, "The New Rules of Global Trade: A Guide to the World Trade Organization;" also see WTO, The Brief Introduction of GATS, at <http://www.wto.org/wto/inbrief/inbr00.htm>

⁴¹ GATT is both an international organization located in Geneva, Switzerland, and a multilateral treaty conferring rights and obligations to more than 100 countries (known as "Contracting Parties" which have chosen to join it. Countries that are part of GATT account for about 90 percent of world merchandise trade (i.e. trade in "goods" as distinct from "services"). The tariff barriers were successfully dismantled and trade liberalization was pursued in eight successive rounds of multilateral negotiations under the auspices of GATT.

⁴² hereinafter MFN

understanding commitment in financial services. The first Annex specifies the conditions under which countries may claim exemptions from the MFN obligation. Other Annexes establish special or different rules for specific types of services. The Ministerial Declarations deal with general institutional matters such as establishment of working groups on various issues.

- 3 National schedules set out each member's specific commitment to national treatment and market access. To be more specific, WTO members' obligations to observe national treatment and market access are bound only in those sectors for which they have provided schedules and only to the extent of the commitments undertaken on those schedules.

In examining the GATS agreement, as well as at the significance of the specific services commitments undertaken by WTO members, one must bear in mind that the GATS is only a beginning. The fact that the GATS rules are still largely untested, and that the services schedules are much more complex than those of goods, adds to the difficulty of assessing exactly what rights and obligations WTO members have assumed under the purview of the GATS.

C Financial Services Agreement-Highlights of the financial services in GATS

<p>Table 2.1 Highlights of the GATS: Financial Services</p>
<p>Framework agreement</p> <p>Modes of supply</p> <p>Cross-border provision of services Consumption abroad Establishment of a commercial presence Temporary presence of natural persons</p> <p>General obligations</p> <p>Most-favoured-nation treatment Transparency Progressive liberalization</p> <p>Specific commitments</p> <p>Market access National treatment</p>
<p>Annex on Financial Services</p> <p>Coverage and definition on financial services Prudential carve-out Financial services expertise in dispute settlement Recognition of prudential measures</p>
<p>Schedules of commitments</p> <p>Hybrid list approach Negative list approach for countries using the Understanding on Commitments In Financial Services Scheduling by mode of supply</p>
<p>An alternative approach to scheduling</p> <p>Commitments used by most of the OECD Countries</p>

Rather than delineating the full view of the GATS, this section simply highlights some principal features of the GATS that are substantially relevant to financial services (See Table 2.1). Owing to the special characteristics and sensitivity of the financial sectors, the GATS contracting parties contended that financial services negotiations required financial expertise and should be separated from other negotiations. Accordingly, while the GATS framework agreement and the structure of the schedules of commitments were negotiated by trade officials, the attachments pertaining to financial services were negotiated primarily by finance officials⁴³. These pertinent attachments incorporate the Annex on Financial Services, the

Understanding on Commitments in Financial Services. This is the reason why the expression of "financial services agreement" is widely used to refer to the GATS as it

applies to financial services, although in fact, a separate agreement for financial services does not exist.

1 Framework Agreement

(a) Methods of Providing Services Internationally: Modes of Supply

The GATS avoids any theoretical definition of services. Instead, it is expressed in terms of four modes of supply⁴⁴: (i) the cross-border supply of services, which does not require the physical movement of supplier/consumer but refers only to the service that crosses the border. (e.g. reinsurance provided by a company in another country) (ii) consumption abroad, which typically involves the movement of consumers to the location of suppliers. (e.g. a German tourist visit Disneyland in U.S) (iii) establishment of commercial presence such as a branch or a subsidiary- that is, foreign direct investment (e.g. the Canadian subsidiary of a British Bank) ; and (iv) the temporary presence of natural persons, which means that service-suppliers or persons employed by service-suppliers provide services outside their home countries (e.g. the non-local staff of a branch of a foreign bank).

(b) General Obligations and Disciplines

Obligations accepted by GATS signatories are of two sorts: general obligations and disciplines applicable immediately to all members in all services sectors, and commitment-specific obligations. With regard to the latter, countries are bound only in those sectors for

⁴³ See supra note 38, Sydney J. Key, "Financial Services in the Uruguay Round and the WTO", p12-13

which they have provided schedules and only to the extent of the commitments undertaken in those schedules. The main general obligations and disciplines are the MFN obligation (Article 2), transparency (Article 3) and progressive liberalization (Article 20, 21).

(i) Most-favoured-nation Treatment (MFN)

Most-favoured nation treatment that is set out in Article 2 is the core general obligation under the GATS. MFN treatment requires each member to “accord immediately and unconditionally to services and service-suppliers of any other member treatment no less favorable than it accords to like services and service-suppliers of any other country.”⁴⁵

However, partly motivated by developed countries’ concerns over free riders,⁴⁶ Members are permitted to schedule exemptions from MFN application in GATS. That is, Members are allowed to discriminate between services and services-suppliers of other Members, once they reserve the relevant discriminatory measures in their MFN exemption list. In order not to disintegrate the general MFN principles, such exemptions must be filed prior to entry into force of the WTO Agreement. Any exemption filed after this date shall be processed under Paragraph 3 of Article 9 of WTO Agreement, which requires a qualified majority of three-fourths of WTO Members⁴⁷. The exemptions are subject to review every five years⁴⁸. “In principle,” such exemptions shall not exceed ten years⁴⁹. The words “in principle” would appear to allow the possibility of extending exemptions beyond ten years, although whether the Council for Trade in Services would allow this to happen remains to

⁴⁴ GATS, Article 1.2

⁴⁵ GATS, Article 2.1

⁴⁶ the discussion of free-riders see, see p 17

⁴⁷ GATS, Annex on Article 2 Exemption of the GATS, paragraph 2

⁴⁸ GATS, Annex on Article 2 Exemption of the GATS, paragraph 3

⁴⁹ GATS, Annex on Article 2 Exemption of the GATS, paragraph 6

be seen.⁵⁰

(ii) Transparency

GATS Article 3 and Article 3.1 require Members to generally comply with the transparency obligations. Trade in foreign countries will be badly handicapped unless the investors know what laws, regulations, and administrative guidelines they are confronted with. This problem is particularly serious in developing countries, which traditionally employ considerable government regulations to protect their domestic sectors. GATS requires each Member to promptly publish all measures of general application that are covered by or that may bear on the operation of the Agreement.⁵¹ Any related international agreement shall be published as well.⁵² Each Member must also notify the Council for Trade in Services of new or amended laws, regulations, or administrative guidelines that significantly affect trade in services covered by its specific commitments under the Agreement.⁵³

By January 1, 1997, each Member shall establish an "inquiry point", which can be contacted by other Members and which can provide information on Member's services-related measures.⁵⁴ Member must respond promptly to any information requests from other Members.

Finally, Members have no obligations to provide confidential information if the disclosure would "impede law enforcement," or would "be contrary to the public interest,"

⁵⁰ See Chia-Chi Jackie Lin, "Foreign Access to Banking Markets in China and Taiwan", (The University of British Columbia, 1996), at 36-38

⁵¹ GATS, Article 3.1

⁵² GATS, Article 3.2

⁵³ GATS, Article 3.3

⁵⁴ GATS, Article 3.4

or would “prejudice legitimate commercial interest of particular enterprise, whether public or private.”⁵⁵

(iii) Progressive Liberalization

Part IV of the Agreement provides for progressive liberalization through further negotiations and for the modification of Members’ schedules under certain other circumstances. The most significant element in Part IV is Article 19, which provides that, starting no later than January 2000, WTO Members shall enter into successive rounds of negotiations with to the intention of achieving a progressively higher level of liberalization. It offers a guarantee that the current GATS package is only the first step of an ongoing enterprise, jointly undertaken by all WTO members, to raise the level of their service commitments towards one another.

(c) Specific Commitment: Market Access and National Treatment

The commitment-specific GATS obligations are contained in the schedules of commitments notified by Members individually. That is, in sectors not scheduled, Members make no commitment to liberalize beyond the general obligations previously discussed; in scheduled sectors, broad obligations of market access and national treatment apply except where Member have formulated reserves individually. These schedules incorporate, for each member, a “positive” list of sectors in which the members are willing to make commitments and a “negative” list of derogation from the broad principles of market access and national

⁵⁵ GATS, Article 3 bis

treatment set out in Articles 16 and 17.

(i) Market Access

All Members have a schedule of market access commitments, which assures that each Member is to give no less favorable treatment to the services and service suppliers of other Members than is provided in its schedule of commitments.⁵⁶

GATS also specifies six measures which may be forbidden unless their use is clearly accorded in the schedule. They are:⁵⁷

- limitations on the number of service-suppliers;
- limitations on the total value of services transactions or assets;
- limitations on the total number of service operations or the total quantity of service output;
- limitations on the number of persons that may be employed in a particular sector or by a particular supplier;
- measures that restrict or require supply of the service through specific types of legal entity or joint venture;
- percentage limitations on the participation of foreign capital, or limitations on the total value of foreign investment.

⁵⁶ GATS, Article 16, paragraph 1

(ii) National Treatment

Article 17 is essentially constructed to ensure that, in those sectors covered by each Member's schedule and subject to any conditions and qualifications set out in the schedule, a Member cannot discriminate between its own services and service-suppliers and those of other Members. It is important to note two additional aspects to the national treatment obligation in GATS. First, it extends broadly, not just to measures directly relating to the relevant services, but to all measures affecting the supply of that service.⁵⁸ Second, the national treatment obligation in GATS is *de facto* as opposed to *de jure* national treatment.⁵⁹ This has two implications. First, a Member need not formally extend identical treatment to both domestic and foreign services and service-suppliers to meet the national treatment obligation. It is sufficient if the conditions of competition between the two are equal. Second, and perhaps more importantly, formally identical treatment may not meet this national treatment. That is, if a measure applied to foreign services/service-suppliers is formally identical to that applied to domestic services/service-suppliers but still modifies the conditions of competition in favor of domestic services/service-suppliers, the measure will likely to run afoul of Article 17.

(iii) Additional Commitment

Members are able to negotiate on measures, regarding qualification, standards or licensing matters, that reach beyond the purview of the market access and national treatment

⁵⁷ GATS, Article 16, paragraph 2

⁵⁸ "Measures by Members affecting trade in services" is then defined broadly in Article 28 to include among other things, measures respecting purchase, payment and use of a service, and the presence of the persons in the territory of a Member.

⁵⁹ GATS, Article 17, paragraph 2 and 3

in GATS.⁶⁰ Such commitment shall be inscribed in a Member's schedule.

2 Annex on Financial Services

In negotiating the GATS, governments were reluctant to sacrifice their control over financial sectors and contended that the key issues of financial services would need some special treatment. One reason is that a country's economic growth and development are linked to the stability of its financial institutions. The other is that users of financial services need protection against providers of services, who lack sufficient financial backing, or are badly managed or dishonest. The Annex on Financial Services is designed to meet these needs.

(a) Coverage and Definition of Financial Services

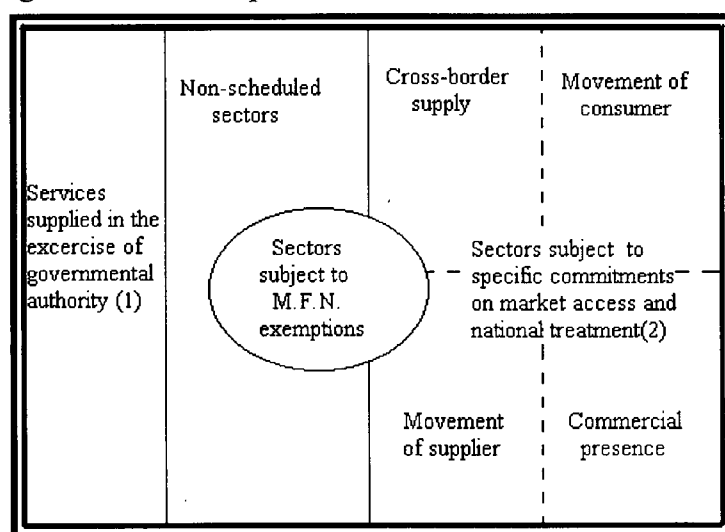
The Annex defines financial services as any services of a financial nature offered by a financial service supplier of a WTO Member, and then provides a nonexclusive list of financial services.⁶¹ The list is product-based, including insurance and insurance-related services, all forms of banking, lending and financial leasing, securities, settlement and clearing services, and financial advice. If a firm supplies any one of the listed services, it falls within the GATS definition of financial services, and can benefit from the GATS regime for financial services.

Moreover, the exclusion from coverage under the GATS Article 1.3 for "services supplied in the exercise of governmental authority" has been specifically defined for financial services

⁶⁰ GATS, Article 18

in paragraph 1 (b) of the Annex to exclude monetary and exchange rate policies. (See Figure 2.1) Based on the non-competitive and non-commercial nature of those services, the exclusion of financial services also extends to activities which form part of statutory social assistance, public retirement plans, and other activities carried out by a public entity which is on behalf of, or using the financial resources of the government.⁶²

Figure 2.1: The Scope of the GATS



Note:

(1) Excluded from GATS coverage

This general exclusion has been specifically identified for financial services in paragraph 1 (b) of the Annex to exclude monetary and exchange rate policies.

(2) Subject to terms, limitations, conditions and qualifications as inscribed in Members' schedules.

Source: B. Hoekman & P. Sauve, *Liberalizing Trade in Services* (Washington, D.C : World Bank, 1994) at 41

⁶¹ GATS, Annex on Financial Services, paragraph 6

⁶² GATS, Annex on Financial Services, paragraph 1

(b) Prudential Carve-out

When the idea of including financial services in the Uruguay Round was first proposed, financial regulators were concerned about the possibility of a trade agreement interfering with their ability to regulate and supervise financial institutions. They made it clear that inclusion of financial services in the GATS would be unacceptable without a specific exception for prudential regulation and supervision.⁶³ As a result, the GATS contains a so-called prudential carve-out to ensure that the opening of markets that the agreement is intended to achieve, will not jeopardize prudential regulation and supervision.

The prudential carve-out for domestic regulations permits a country to take prudential measures “for the protection of investors, depositors, policy holder or persons to whom a fiduciary duty is owed” or “to ensure the integrity and stability of financial system” regardless of any other provisions of the GATS.⁶⁴ The significance and ambit of prudential regulations in the context of broader policy affecting financial sectors will be explored later in the chapter.

Any disagreement over whether a particular national measure falls within the prudential carve-out is subject to WTO dispute settlement procedures and thus, if necessary, to a determination by a dispute settlement panel.⁶⁵ However, this provision cannot be used to avoid a Member’s obligation and commitments under the agreement.

⁶³ See Rachel McCulloch, “Services and Uruguay Round” (1990) 13 World Econ 329, 33

⁶⁴ GATS, Annex on Financial Services, paragraph 2

⁶⁵ GATS, Annex on Financial Services, paragraph 4

(c) Dispute Settlement

While financial officials from the major industrial countries were pushing the idea of a separate body for dispute settlement involving financial services, trade officials found this idea unacceptable. Ultimately, the concerns of financial official were addressed by inserting a requirement in the Annex, that dispute settlement panels on prudential issues and other financial matters must have the expertise necessary to deal with “the specific financial service under dispute.”⁶⁶ This standard is more narrow than the general standard applicable to the GATS, which requires panel to have the “necessary expertise relevant to the specific services sectors which the dispute concerns.”⁶⁷

(d) Recognition of Prudential Measures

Paragraph 3 of the Annex, which partly replaces Article 7 of GATS, permits a Member to recognize the prudential measures of other Members either unilaterally or mutually.⁶⁸ Such recognition of prudential measures is not subject to the MFN obligation of GATS, and is excluded from the prior notification to the Council on Trade in Services.⁶⁹

⁶⁶ GATS, Annex on Financial Services, paragraph 4

⁶⁷ See *supra* note 31, Jeffrey S. Thomas & Michael A. Meyer, “The New Rules of Global Trade: A Guide to the World Trade Organization”, at 313

⁶⁸ GATS, Annex on Financial Services, paragraph 3(a)

3 National Schedules

It is only by reference to a Member's schedule, as well as its MFN exemption list, that it can be seen to which services sectors and under what conditions the basic principles of the GATS -market access, national treatment and MFN treatment - apply within that country's jurisdiction. On the other hand, when making a commitment, a government binds the specified level of market access and national treatment and guarantees not to impose any new measures that would restrict entry into the market or the operation of the service. Commitments can only be withdrawn or modified after the agreement of compensatory adjustments with affected countries⁷⁰, and no withdrawals or modifications may be made until three years after entry into force of the Agreement.⁷¹

(a) Schedules of Specific Commitments

The national schedules all conform to a standard format, which is intended to facilitate comparative analysis. These schedules include, for each member, a "positive" list of sectors in which the member is willing to make commitments and a "negative" list of derogations from the broad principles of market access and national treatment. Some commentators have underlined the limitation on the liberalizing dynamic implied by the positive listing of sectors. This approach establishes a bias toward the status quo: it presents further opening as a positive and optional undertaking and it may also lead to a conclusion that opening is likely

⁶⁹ GATS, Annex on Financial Services, paragraph 3(b)

⁷⁰ GATS, Article 21 (2)(a)

⁷¹ GATS, Article 21 (1)

to be undertaken only when and where it hurts least.⁷² Moreover, the positive-list approach not only leaves important sectors untouched by liberalization, but also implies that as new sectors emerge they will automatically stand outside the market-opening framework until explicitly brought into it.⁷³

The choice of positive-list approach owes much to the effort of developing countries to deflect the demand put on them and to keep their option open. The United States initially advocated a more demanding negative-list approach, but the positive-list approach emerged as the only mutually acceptable negotiating platform that parties are willing to consider. To provide for more opening in financial services, the OECD countries introduced an optional variant to scheduling: countries adopting this variant commit themselves to broad market opening principles and list their limited reserves therefrom. This alternative negative-list approach, embodied in the memorandum of agreement on financial services in GATS, is "The Understanding on Commitments in Financial Services."

(b) Alternative Approach: The Understanding on Commitments in Financial Services

Like Part III of GATS, the Understanding on Commitments in Financial Services focuses on two areas: market access and national treatment. The Understanding forms an alternative basis for the specific commitments on market access and national treatment outlined in Part III of GATS. Members are free to choose to schedule specific commitments in financial sector, either in accordance with Part III of GATS or in accordance with the Understanding.⁷⁴ Albeit the Understanding is not formally part of the GATS, most OECD countries, but only OECD countries, have made their specific financial services

⁷² See supra note 11, Wendy Dobson & Pierre Jacquet, *Financial Services Liberalization in the WTO*, at 74

⁷³ See supra note 11, Wendy Dobson & Pierre Jacquet, *Financial Services Liberalization in the WTO*, at 96

commitment on the basis of the Understanding, with the exception of South Korea, Mexico, and Poland.⁷⁵

Those countries, which made commitments under the Understanding, followed an approach that extend beyond the liberalization requirements of GATS Part III in a number of respects.⁷⁶ They adopted a “standstill” principle, whereby their commitments were at least as liberal as the measures they actually applied.⁷⁷ They also consented to opening government procurement of financial services and thus endeavor to reduce the scope of monopoly right affecting the sector.⁷⁸ They also permit cross-border trade, without the need for commercial presence, in the areas of insurance and insurance-related services, as well as in financial information and auxiliary services.⁷⁹ Other financial service commitments under this approach concerned commercial presence, the provision of new services by established suppliers, the transfers of information, temporary entry of personnel, non-discrimination and national treatment.

(c) Current Status of Member's Commitments in Financial Services

For the most part, a Member's commitments in financial services, especially banking services, simply formalize the status quo.⁸⁰ Commitments made by countries that are members of the Organization for Economic Cooperation and Development (OECD) do little to further open the market because their current financial markets were already relatively

⁷⁴ See E. McGovern, “International Trade Regulation”, (Exeter: Globefield Press, 1995), at 31-32

⁷⁵ See supra note 31, Jeffrey S. Thomas & Michael A. Meyer, “The New Rules of Global Trade: A Guide to the World Trade Organization”, at 236

⁷⁶ See M.J. Trebilcock & R. Howse, “The Regulation of International Trade”, (New York: Poutledge, 1995) at 242

⁷⁷ GATS, The Understanding on Commitments in Financial Services, section A

⁷⁸ GATS, The Understanding on Commitments in Financial Services, section B paragraph 2

⁷⁹ GATS, The Understanding on Commitments in Financial Services, section B, paragraph 4

open. The United States provide access to its markets on an existing reciprocal basis by not allowing the developing countries to become free-riders. Moreover, with few exceptions, the significant emerging-market economies offer little new access to their often-undeveloped banking sectors, while they offer significant new access to their insurance sectors. (See Table 2.2)

Table 2.2. WTO Financial Services Agreement: Market Access in selected Countries, 1997

	Banking	Insurance	Securities
Status quo plus	Malaysia Mexico Japan South Korea Philippines Mexico	Brazil Indonesia South Korea Malaysia Philippines	Brazil Indonesia
Status quo	Argentina Brazil Chile India Indonesia Japan South Korea Thailand	Chile India Thailand	Argentina Thailand
Less than status quo	Philippines	Malaysia India	Chile

Source: Wendy Dobson & Pierre Jacquet, Financial Services Liberalization in the WTO, Institute for International Economics, Washington D.C, June 1998, at 93

There may be good reasons why there was so little movement beyond the status quo. From the stance of developing countries, they are concerned about the competitiveness of their domestic banks, which used to be the protected or infant industry. Moreover, the Asian Financial Crisis in 1997-1998 and the experience of southern-cone countries of Latin

⁸⁰ See supra note 11, Wendy Dobson & Pierre Jacquet, Financial Services Liberalization in the WTO, at 89-94

America in the 1980s demonstrated that financial integration with the rest of the world holds dangers if the process is not planned and managed with great care. For the developed countries, besides the free-rider concern, they were also concerned about a future loss of negotiation leverage and therefore were reluctant to expand their commitments. Negotiators in developed countries want to leave themselves weapons to future negotiations and were unwilling to grant too many concessions up front.⁸¹

D Government Intervention and Financial Services in GATS

As described earlier in this chapter, one common characteristic of heterogeneous services is the intervening government policy. In financial services, policy intervention is a more widespread phenomenon under the pursuit of macroeconomic and financial stability. Therefore, after providing the ambit of Member's obligations under the GATS, this section will further explore how these obligations fit into the broader policy framework relevant to the financial services. (See Table 2.3)

Table 2.3 Policy Intervention and the Scope of GATS

Four-fold Distinction of Policy Intervention	Subject to the Scope of GATS
1 Macroeconomic policy management	<i>No</i> (paragraph 1 (b) of the Annex on financial Services)
2 Prudential regulation	<i>No</i> (paragraph 2 (a) of the Annex on Financial Services)
3 Measures not prudential per se but also Affecting the financial market	Depends on whether they constitute limitation on market access or national treatment
Measures inhibiting the establishment and operation of foreign service-suppliers	<i>Yes</i>

* Compiled by author

⁸¹ See supra note 19, Yair Atharoni, "Changing Role of State Intervention in Services in an Era of Open International Markets", at 18-20

A four-fold distinction can be made between different types of government policy intervention that could have impact on the financial services.⁸² First, there is macroeconomic policy management in general. For example, when a central bank conducts open market operations, the impact of such interventions on the money supply, interest rates or exchange rates could affect conditions in the financial sector .. These types of intervention fall entirely outside the ambit of the GATS.⁸³

Second, governments maintain prudential regulations in order to protect the financial sector, and ultimately the stability of the economy and the welfare of the consumers. The rationale for this consideration traditionally has been based on the concept that financial institutions are "special" corporate entities to be regulated mostly by government.⁸⁴ These institutions are the main intermediaries for the productive mobilization and disbursement of capital in free economy, the primary vehicles for the implementation of national monetary policy, and the mechanism for ensuring an effective and reliable payment system upon which business and economy depend.⁸⁵

Typical prudential measures might include capital adequacy ratios and solvency margin requirements, restrictions on credit concentration or portfolio allocation, requirements for preserving asset quality, liquidity ratios, controls on market risk, management controls, and disclosure and reporting requirements.⁸⁶ As with macroeconomic policy management, GATS commitments do not in any way curtail the purview of prudential regulation. This

⁸² Government measures to protect public morals or to maintain public order as well as national security measures may also have an impact, but are not discussed here because they are treated as general exceptions in GATS. See *supra* note 10, *Opening Markets in Financial Services and The Role of The GATS*, at 3-6

⁸³ GATS, Annex on Financial Services, paragraph 1 (b)

⁸⁴ See e.g., Corrigan, "Are Banks special?", Fed. Res. Bank of Minn, Annual Report (1982). For different opinions on whether the financial is special, see, e.g., *supra* note 11, Wendy Dobson & Pierre Jacquet, at 44-46

⁸⁵ See *supra* note 83, Corrigan, "Are Banks special?" at 32-38

⁸⁶ See White, L.J., "Competition versus Harmonization- An Overview of International Regulation of Financial Services," (Washington, D.C., American Enterprise Institute Press 1996) ; White, W.R., "International Agreement in the Area of Banking and Finance: Accomplishments and Outstanding Issues", BIS Working Paper No.38

principle, so-called prudential carve-out, is set out in paragraph 2(a) of the Annex on Financial Services. However, it must not be used as a means of avoiding commitments or obligations under the GATS.

Generally speaking, prudential regulations need not be inscribed in Members' schedules of specific commitments, because they are not regarded as limitations on market access or national treatment. Nevertheless, if a Member is concerned that a particular measure might not be generally accepted as prudential in the future, it could list the measure as an exception in its initial schedule of commitments. Indeed, some Members may have been so far too cautious in this regard. That is, they may have taken exceptions for measures that are clearly prudential, for example, requirements for applications by foreign financial firms to set up host-country offices.

Third, governments may maintain other regulations, which are not prudential in nature, but which nevertheless can affect the conditions of operation and competition in a market. Such measures could include, for example, a requirement to lend to certain sectors or individuals. Such lending might also be mandated on the basis of preferential interest rates. The use of financial system in this fashion- as a political instrument or a tool of industry policy- has been criticized by many economists as a relatively inefficient means of achieving particular objectives, as well as a risk to financial stability if pursued to excess. However, it is important to notice that these policies are not necessary subject to commitment made under the GATS. Whether they are or not depends on the judgment as to whether they constitute limitations on market access or national treatment. If they are neither discriminatory, nor intended to restrict the access of suppliers to a market, then such non-prudential domestic regulatory measures fall within the ambit of GATS Article 6 disciplines.

Article 6 seeks to ensure that domestic regulations involving qualification requirements and procedures, technical standards and licensing requirement do not constitute unnecessary barriers to trade. It requires that these domestic regulations be based on transparency and objective criteria, and not be more burdensome than necessary to ensure the quality of the service..

The fourth area of policy intervention aims at measures that prevent or inhibit the domestic establishment of foreign service-suppliers or the foreign supply of services on a cross-border basis. It is the reduction and elimination of these measures that constitute the primary focus on the trade liberalization efforts of the GATS. Therefore, it falls entirely within the ambit of the GATS.

In conclusion, GATS touches upon some but not all policy intervention affecting the financial services. Due to the paramount importance of maintaining the stability and security of the financial services system, governments are not subject to any restriction when conducting macroeconomic policy management, as well as the prudential regulation. Moreover, even if the measures are not prudential per se, the prohibition of taking these measures still depends on whether they constitute the limitation on market access or national treatment. And, only when the measures taken by governments in any way restrict the entry or the operation of foreign services or foreign service-suppliers, shall they be subject to the ambit of GATS and the specific commitments of each Member. However, the distinction of the four modes of policy intervention is somewhat ambiguous, and thus leaves the legitimacy of policy intervention uncertain. For example, GATS simply defines the prudential regulation as the measures taking to protect investors and to ensure the integrity and stability of the domestic financial systems⁸⁷, but scarcely provides any further

⁸⁷ GATS, Annex on Financial Services, paragraph 2 (a)

information to practically identify whether it is prudential. Therefore, it poses the major challenge for scholars to limit the exception of GATS by restricting purview of prudential regulations. In response to the challenge, one efficient way is through the cooperation with other international organizations, for example, Basel Committee on Banking Supervision. These international organizations have served for a long time as an ongoing forum for discussing and encouraging financial globalization, and have framed some general principles to maintain the financial stability during the process of globalization. Moreover, because the WTO is originally to be devised as a contractual trade institution, its role vis-à-vis developing countries is very different from that of other international financial institutions that provide funding and risk management. However, as the WTO becomes more involved with financial services, opportunities for creative interaction with other international organizations need to be fully explored.⁸⁸

E Conclusion

GATS represents a significant breakthrough because it brought the broad range of services into the multilateral negotiations for the first time, within a framework of principles on which multilateral trade in goods had long been based in GATT. Nevertheless, some of the built-in features of GATS suggest that it suffers from architectural limitations that cast doubt on its ability to create a liberalization-enhancing regime for trade in services.

First, the failure to use general obligations for market access and national treatment, as well as the adoption of MFN exception, is always considered as the structure weakness. Part of the genius of GATT was its success in turning reciprocity-based mercantilism into an instrument of give-and-take multilateral liberalization. Unfortunately, it is generally

⁸⁸ See *supra* note 38, Sydney J. Key, "Financial Services in the Uruguay Round and the WTO", at 48

believed that this approach will ruin the multilateral framework created by the broad MFN obligation and will pull it back to the bilateral basis. Second, the positive-list approach of scheduling skills combined with the tension-stretched negotiating process makes Member's substantial obligation fewer than expectation. Especially owing to the haze of Asian Financial Crisis, many developing countries considered the stability of their domestic financial market as a priority and were not willing to offer substantial commitments in their banking services sectors. Finally, for financial services only, insufficient judgement of whether the measures are prudential makes the ambit of prudential carve-out unpredictable. This may require WTO to develop some relevant standards itself or to establish procedures for cooperation and sharing some information with other international organizations, such as the IMF, or the Basle Committee on Banking Supervision.

Despite of the above vulnerabilities, the achievement of GATS is still an encouraging first step to extend legally binding international agreement on financial services. Although the GATS rules are still largely untested and incomplete, and the process of filling these gaps will require continuing negotiations, it does provide an opportunity for most of the main players to bind the status quo in an international agreement and provide a mechanism for settling disputes. These are not insignificant accomplishments because financial services are too important to be left the vagaries of political U-turn, bilateral deals, and unregulated markets.

II Basel Principles

A The Basel Committee on Banking Supervision

In 1974, the collapse of major banks in three nations triggered the attention of the international banking community in enhancing international banking supervision. In June 1974, West Germany closed the Bankhaus Herstatt following the bank losses from foreign exchange dealings and Britain closed the British-Israel Bank of London for insolvency problems.⁸⁹ Later in October 1974, the Franklin National Bank in the United States was shut down because of the combined weight of bad management in the volatile domestic wholesale deposit, excessive speculation in international foreign exchange markets, and over-ambitious efforts to expand.⁹⁰ In response to the serious disturbances in international currency and banking markets, the central bank governors of the leading industrialized countries met in Basel at the end of 1974, to establish the Basel Committee on Banking Supervision (Basel Committee).⁹¹ The members of this Committee comprise Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, United Kingdom, United States, Switzerland, and Luxembourg. In most cases, each member has two representatives, one from the central bank and another from other authorities with formal responsibility for the prudential supervision of banking institutions.

Since the Basel Committee was born in the crisis atmosphere of 1974 bank failures, its initial target was to improve banks' "early warning" systems to discover the potential risk of

⁸⁹ See Ethan B. Kapstein, "Supervising International Banks: Origins and Implications of the Basel Principles," (Princeton, N.J.: International Finance Section, Dept. of Economics, Princeton University, 1991) at 4

⁹⁰ See *supra* note 1, Lawrence L.C. Lee, "The Basel Principles as Soft Law: Strengthening International Banking Supervision" at 16

⁹¹ The Basel Committee was originally named as the Committee on Banking Regulations and Supervisory Practices, and later changed to the Basel Committee on Banking Supervision. The following introduction of Basel Committee, see Basel Committee on Banking Supervision, *Compendium of documents*, Vol 1, at 10-16, April 1997, at <http://www.bis.org/about/index.htm>

financial crisis, as well as to enhance the international cooperation in order to close gaps in supervisory net and to improve supervisory understanding and the quality of banking supervision worldwide. As listed in Table 2.4, its myriad of recommendations and guidance can be grouped into three. (p 42)

In order to intensify its role in promoting sound supervisory standards worldwide, the Basel Committee issued a comprehensive set of “*Core Principles for Effective Banking Supervision*” (*Core Principles*) in September 1997. The *Core Principles* comprise twenty-five basic principles, which conclude by reference to former Basel pronouncements, and have already been endorsed by the Basel members as well as by many non-Basel members.⁹²

⁹² See Basel Committee on Banking Supervision, *Compendium of documents*, Vol 1, at 17, February 2000, at <http://www.bis.org/publ/index.htm>

Table 2.4 The Summary of the Basel Principles

I Basel Concordat and its successors⁹³
<ul style="list-style-type: none"> • In 1975, "<i>Basel Concordat</i>" first came into being. It sets up the principles for sharing supervisory responsibility for banks' foreign establishment, subsidiaries, and joint ventures between host and parent (home) countries. • In May 1983, "<i>Principles for the Supervision of Bank's Foreign Establishment</i>" was finalised to accommodate the changes in markets and to incorporate the principle of consolidated supervision. • In April 1990, "<i>Supplement to the 1983 Concordat</i>" was issued to improve the flows of prudential information between supervisory authorities in different national jurisdictions. • In June 1992, certain principles set up in the Concordat and relevant documents were reformulated as "<i>Minimum Standards</i>." • In October 1996, the Committee released "<i>The Supervision of Cross-border Banking</i>" jointly with the Offshore Group of Banking Supervisors to conduct effective consolidated supervision of the cross-border operations of international banks. This report was endorsed by supervisors from one hundred and forty countries, who attended the International Conference of Banking Supervisors (ICBS) in June 1996.
II Capital Adequacy⁹⁴
<ul style="list-style-type: none"> • In July 1988, "<i>Basel Capital Accord</i>" was issued to require the minimum capital adequacy standard (8%) in international banks. • In January 1996, the Committee issued a formal Amendment to the Capital Accord, which is designed to incorporate within the Accord the market risks arising from banks' open positions in foreign exchange, traded debt securities, equities, commodities and options • In June 1999, the Committee issued a proposal for a new capital adequacy framework to replace the 1988 Capital Accord and to formally incorporate the concept of market risk. However, the exact date for the implementation of the new Accord will depend on the comment received and the work that need to be undertaken in the meantime.
III Others
The supervision of banks' foreign exchange positions; the management of banks' international lending (i.e country risk); the management of banks' off-balance-sheet exposures; the prevention of the criminal use of the banking system; the supervision of the large exposures and risk management guidelines for derivatives; and credit risk, including the management of credit risk, principles for credit risk exposures, and current practices and applications of credit risk modelling.

* Compiled by author

Although the Basel Committee is dedicated to improving international banking supervision by issuing various pronouncements, it does not possess any formal supervisory authority, and is never intended to have legal enforce. Rather, it formulates and recommends broad supervisory principles and guidelines of best practices in the hope and expectation that individual authority will take steps to implement them through detailed arrangement

⁹³ The following by reference to Compendium of documents produced by the Basel Committee on Banking Supervision, Volume Three, p10-16, April 1997, at <http://www.bis.org/about/index.htm>

⁹⁴ The following by reference to Compendium of documents produced by the Basel Committee on Banking Supervision, Volume One, January 2000, at <http://www.bis.org/publ/bcbasc11/pdf>

that are best suited to their own national systems.⁹⁵

Due to this gradual convergence methodology encouraged by the Committee, application of the Basel Principles to the national banking operation should facilitate more efficient and stable financial transactions, and harmonize the divergence among different regulatory jurisdictions. Moreover, because the Basel Principles are non-legal binding per se, they allow the government to be flexible in the way it implements the Basel Principles, and to take into account a different regulatory system and social consideration. The Basel Principles also overcome at least part of the political obstacles to economic success, and offer the possibility to reach the goal of strengthening international banking supervision without the imposition of a new legal framework or interference with national sovereignty⁹⁶.

Despite the merits above, the Basel Principles did not attract attention in international finance until the Basel Committee sought to expand its role to non-Basel countries recently. This was because the Basel Committee does not possess any formal supranational supervisory authority; does not, nor will ever have legal force. Thus, banking supervision remains the province of national authorities and may be weak because different countries have different capacity. That is, the Committee is only as effective as its member states want it to be⁹⁷. The gap between talk and action was bridged only when the Basel members, United States in particular⁹⁸, provided the planks.

⁹⁵ See discussion of the role of Committee by W.P. Cooke, the Chair of the Committee, in Basel Supervisors Committee(Committee document for external distribution) (June 21,1984)

⁹⁶ See supra note 1, Lawrence L.C. Lee, "The Basel Principles as Soft Law-Strengthening International Banking Supervision" at 6-7

⁹⁷ See supra note 3, Ethan B. Kapstein, "Governing the Global Economy- International Finance and the State" at 127-128

⁹⁸ See Alejandro Bendana, "Power Lines-U.S. Domination in the New Global Order," (New York, Interlink Publishing, 1996) Chapter three

B Implementation of the Basel Principles: Through International Community

Although the Basel Committee's contributions to developing prudential supervision for international banks are highly esteemed, the most controversial issue is still the implementation. Unlike the GATS, the Basel Principles are neither legally enforced per se nor subject to an effective dispute settlement mechanism. Accordingly, the Basel Committee has resolved to extend its "influence" to non-Basel members by routinely exchanging information and coordinating with other international groups (See Figure 2.2).

1 Cooperation with Regional/ International Supervisory Groups:

In order to enable a wider group of countries to be associated with the work being pursued in Basel, the Committee always maintains close relationships with a number of regional⁹⁹ as well as international groups¹⁰⁰ (Figure 2.2).

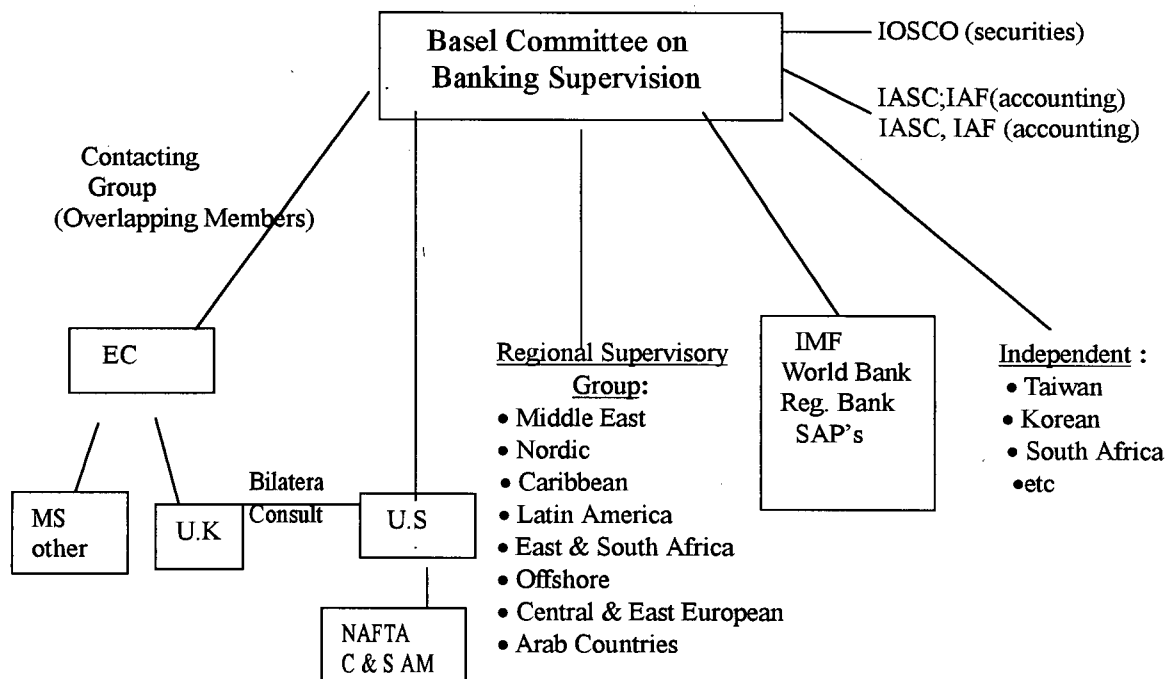
Through the cooperation with foregoing regional/international supervisory groups, the Basel Committee has successfully extended its influence to both Basel and non-Basel members on a near global basis. However, similar to the Basel Committee, these regional supervisory groups have no formal legal authority. The cooperation between Basel Committee and regional/international supervisory groups will simply make the Basel

⁹⁹ See Hayward, "Prospects for International cooperation by Bank Supervisors," (1992) 24 Int'l Law 787, at 792 Joseph Jude North, "Devising International Bank Supervisory Standards," (Members of the Kluwer Academic Publishers Group, 1995,) at 229-233

¹⁰⁰ Such as: (1)International Organisation of Securities Commission (IOSCO), which currently comprises securities regulators from over 400 countries. Its primary objectives are regulatory coordination, mutual exchange of information, establishment of standards, effective surveillance mechanisms and provision of mutual assistance for ensuring the integrity of securities markets worldwide. See J.Norton, "Banking Regulation and Supervision in 1990s", at 77-79 (2) the International Accounting Standards Committee (IASC) which comprises representatives from the accounting associations in the most major countries and the International Auditing Practices Committee (IAPC) of the International Federation of Accountants (IFA), See at <http://www.bis.org/publ/bcbsc/01.pdf>

Principles internationally comprehensive rather than construct an effective implementation mechanism.

Figure 2.2



Notes

EC =European Community

MS =Member States

U.S =United States

U.K =United Kingdom

NAFTA =North American Free Trade Agreement

C & S AM=Central and South American

IOSOC =International Organization of Securities

IASC =International Accounting Standards Committee

IAF =International Accounting Federation

IMF =International Money Fund

Reg =Regional

SAP =Structural Adjustment Program

(Compiled by author: by reference to Joseph Jude Norton, Devising International Bank Supervisory Standards, 1995, p33)

2 Cooperation with IMF

The International Money Fund (IMF) has become the world's economic "fireman" by providing bailout package to assist countries in economic and financial distress¹⁰¹. It helped to contain the third-world debt crisis of the 1980s and restored confidence in the Mexican economy in 1995.¹⁰² The success of the IMF's past achievements has led to its important role in stabilizing the world's economic and financial system.¹⁰³ As seen by the aftermath of the Mexican and Asian crises, the IMF recognizes the importance of international banking activities because banks form the core of a country's financial system. In consideration, the group of seven industrialized countries and several international organizations, encompassing the IMF and Basel Committee, gathered in Lyon in June 1996 to develop a strategy for fostering international financial stability.¹⁰⁴ By participating in the Lyon Summit, the IMF and the Basel Committee have jointly promised to promote financial stability in emerging markets.¹⁰⁵

Moreover, IMF has facilitated the expansion of influence of the Basel Principles through loan agreements and bailout packages. For example, the IMF convinced the Korean authorities that the rescue policy requires the restructuring and recapitalizing of all banks that fail to meet the Basel Capital Standards.¹⁰⁶ Therefore, through cooperation with the Basel Committee, the IMF can complement the Basel Principles' lack of legal

¹⁰¹ The IMF was established in 1944 to promote international monetary cooperation, exchange rate stability, and provide short-term lending to members that experience balance-of-sheet difficulties. See Richard Lacayo, "IMF to Rescue", *TIME*, (Dec.8 1997) at 30

¹⁰² See Marin Feldstein, "Refocusing the IMF," (Mar/Apr, 1998) 77 *FOR. AFF.* 20, at 32

¹⁰³ Although the IMF's rescue programs to the Mexican crisis were successful in 1994-95, the IMF's plan to assist Asian countries in 1997 were subject to hard criticism. See "The IMF and Its Critics", *FIN, TIME*, (Dec 17, 1997) at 17

¹⁰⁴ See Mario Draghi, "Financial Stability in Emerging Market", *Economies* 5 (April 1997)

¹⁰⁵ See *supra* note, Mario Draghi, "Financial Stability in Emerging Market"

¹⁰⁶ See "IMF Approves Three-Year Stand-By Credit to Support Korea's Economic and Financial Program", 26 *IMF Survey*, (December 15, 1997) at 389

force, and promote the application of the Basel Principles via IMF's near-universal membership among the countries in the world.

3 Cooperation with WTO

Although the GATS and the Basel Principles are independent standards in international level, and have no explicit clauses to further cooperate, they can still reinforce each other's function. Given the non-legal binding nature of the Basel Principles, the legally binding enforcement of the GATS under the WTO, to some extent, provides a vehicle to implement the Basle Accords. For example, the major members of the WTO have adopted the Basel Principles and, thus, a country which is a WTO member but a non-Basel member, will inevitably adopt the Basle Accords' cross border banking recommendations¹⁰⁷. If not, a WTO member who has also adopted the Basel Principles has the right to discriminate the WTO member who has yet to adopt the Basel Principles for prudential reasons.

4 Regional Models

(a) The Case of Europe

The law-generating influences of the Basel Principles within Europe should not be underestimated. For example, the European Economic Area Agreement ("EEA Agreement")¹⁰⁸ between the EC¹⁰⁹ member states and the EFTA¹¹⁰ countries allows an

¹⁰⁷ See supra note 1, Lawrence L.C. Lee, at 32

¹⁰⁸ See Agreement on the European Economic Area, signed on 2 May 1992 in Opporto by the nineteen EC

EFTA member to take advantage of the EC's internal market in banking, investment services and insurance if it implements nationally the supervisory requirements of the Second Banking Directive and related prudential directives. As such, the practical realities create pressure on the EFTA member states to align their supervisory standards in the financial service areas in alignment with those of EC¹¹¹, whose prudential standards roughly approximate the Basel Principles and were formulated in consultation with the Basel Committee.

Moreover, of growing importance are those countries of Central and Eastern Europe who seek eventual membership or association (or other economic linkage) with the EC and are in the process of formulating banking law regime and who, therefore, seek alignment with the EC/Basel regimes.¹¹²

(b) The Case of NAFTA

The North American Free Trade Agreement (NAFTA), representing the world's largest trade bloc, came into being on 1st January 1994 amongst its Contracting parties (i.e., Canada, Mexico, and the United States).¹¹³ NAFTA is constructed on three general principles, including MFN, national treatment, and transparency, although each principle

and EFTA Member States and the European Community.

¹⁰⁹ ie European Community. The EC comprises France, Germany, Italy, Holland, Belgium, Luxembourg, U.K., Denmark, Ireland, Greece, Spain and Portugal.

¹¹⁰ ie European Free Trade Association. The EFTA comprises Austria, Finland, Island, Liechtenstein, Norway, Sweden, and Switzerland.

¹¹¹ On general impact of EEA on EFTA countries, see M. Sheridan, *EFTA Legal System: An Introductory Guide* (L.W. Gormley, 1993)

¹¹² Cf. Generally the theme of Mcgoldrick, "A New International Economic Order for the Europe?" (1992) 12 Ybk. Eur.L. 433

¹¹³ Generally on NAFTA, see, Bello, Holmer and Norton, "The North American Free Trade Agreement: A New Frontier in International Trade and Investment in the American" (Washington, D.C.: The American Bar Association and the International Lawyer 1994)

is subject to voluminous exceptions. NAFTA embraces trade in goods, trade in services, environmental and labour issues, and as well as intellectual property arena.

Chapter 14 of the NAFTA and the Chapter's relevant annexes mainly focus on the financial services within the NAFTA territory. It sets up a general principle: NAFTA provides a legal, regulatory and functional framework for the bridges among three rather disparate financial services systems, and promotes a greater compatibility (though perhaps not full convergence) within the Contracting Parties. In addition, NAFTA will probably foster internationally-oriented and compatible standards in the supervision of financial institutions (i.e., the Basel Principles).¹¹⁴

More specifically, Basel Principles will to a great extent become the common reference by which the respective bank regulators will evaluate the qualification for foreign bank entry and will use or refrain from using the prudential carve-out under NAFTA Chapter 14. Therefore, the Basel Principles have taken, and will continue to take on additional international significance through the NAFTA Treaty framework.

(c) Other Independent Case

Other countries have also come to embrace the Basel Standards within their national banking structures for other reasons. For example, Taiwan has amended its banking laws to incorporate directly a number of the Basel prudential standards because Taiwan wishes to be viewed internationally as a mature economy with a developed banking system and has aspirations of becoming a viable international financial centre in the Pacific Rim

¹¹⁴ NAFTA, Article 1401(1). For a more detailed discussion of the financial services provisions of the NAFTA, see Bachman, Financial Services Under the North American Free Trade Agreement: An

area.¹¹⁵ Similar observations can be made concerning the recent banking reforms in South Korea¹¹⁶ and the Republic of South Africa.¹¹⁷

C The Architecture of Basel Effective Banking Supervision: Core Principles

The “Core Principles for Effective Banking Supervision,”¹¹⁸ developed by Basel Committee in cooperation with supervisors from non-Basel countries in 1997, has to some extent provided an trans-national benchmark of safe and sound banking supervisory regimes. They are considered prominent and typical in two respects. First, it concludes with twenty-five comprehensive principles by reference to prior Basel Principles. The principles relate to:

Preconditions for effective banking supervision -- Principle 1

Licensing and structure -- Principle 2 to 5

Prudential regulations and requirements -- Principles 6 to 15

Methods of ongoing banking supervision -- Principles 16 to 20

Information requirements -- Principle 21

Formal power of supervisors -- Principle 22

Cross-border banking -- Principle 23 to 25

Overview, 28 Int'l Law (Spring 1994); and Norton, “NAFTA: A New Framework for Regulation and Supervision of Financial Services in the American,” (1994) J. of Bus. L. 394

¹¹⁵ See Gary Klintworth, “Taiwan in the Asia-Pacific in the 1990s”, (Department of International Relation, Australia 1994) at 124

¹¹⁶ See IMF,, “Transition to Market: Studies in Fiscal Reform” Press Release (IMF 1993)

¹¹⁷ See Pienaar, “The Prudential Requirements of the Deposit-Taking Institutions Act 94 of 1990,” (1992-93) J. of So. African L. 475

¹¹⁸ Hereinafter “Core Principles.”

Second, Core Principles are prevalent not only among the Basel members but also among non-Basel countries to strengthen prudential supervision of banking activities.¹¹⁹ In the earlier stage of developing the principles, the Basel Committee has worked closely with non-Basel supervisory authorities, covering many countries in Asia¹²⁰, mid-Europe¹²¹ and Latin America¹²². Later during the annual meeting of the IMF and World Bank in Hong Kong in October 1997, the Core Principles are widely endorsed by the international financial community. The common consensus reached in the meeting is that national authorities should apply the Core Principles in the supervision of all banking organizations within their jurisdictions, and the IMF and the World Bank should play a critical role in the implementation.¹²³

Although already widely endorsed, it should always be born in mind that the Core Principles, like any other Basel Principles, are not directly enforceable. It serves as a minimum "reference" and in many cases may need to be supplemented by other measures designed to address particular conditions and risks in the financial systems of individual countries. Any substantive changes in national legislative framework still depend on the inclinations of supervisory authorities in different jurisdictions.

¹¹⁹ The following materials relevant to the endorsement of the Core Principles by international Community, see Basel Committee on Banking Supervision, Core Principles for Effective Banking Supervision, September 1997, No 30; Basel Committee on Banking Supervision, Core Principles Methodology, October 1999, NO 61

¹²⁰ such as China, Hong Kong, India, Indonesia, Korea, Malaysia, Russia, and Singapore, Thailand

¹²¹ such as the Czech Republic, Hungary, and Poland

¹²² such as Argentina, Brazil, Chile, and Mexico

¹²³ Other endorsement of Core Principles: (1) In October 1998, the Group of 22 endorsed several sets of internationally accepted principles including the Core Principles and underscored the importance of their timely implementation. (2) The International Conference of Banking Supervision in Sydney once again endorsed the Core Principles and pledged to actively contribute to the implementation while requesting the Basel Committee to develop more comprehensive guidance. See *supra* note 119, Core Principles Methodology, at 3

1 Preconditions for Effective Banking Supervision

The Core Principles recognises that effective banking supervision requires a set of preconditions to be in place because banking supervision is only part of wider arrangements that are needed to promote stability in financial markets. Although these preconditions are largely beyond the control of the banking supervisory authorities, weaknesses or shortcomings in these areas may acutely impair the ability of the supervisory authority and eventually bring about irretrievable damages. This perception has been fully demonstrated in the case of Thailand, Indonesia, and Korea during the Asian Financial Crisis.¹²⁴

The first Core Principles concludes with the following preconditions necessary for effective banking supervision¹²⁵:

Sound macroeconomic policies

A well-developed public infrastructure in order to protect financial system stability, including business laws sufficient to establishment solid contract and property rights, well-defined accounting standards, and a system of independent audits to validate financial statements;

A system of effective market discipline based on good standards of corporate governance and adequate transparency in respect of financial activities;

A consistent framework of responsibilities, with operational independence and adequate resources (including staff, funding, and technology). Operational

¹²⁴ For the detail of how unsound macro-economic policies caused the failures of Thai banks during the crisis, see p.5; or other discussion of the case of Indonesia and Korea, see Michael E. Burke, "Improving China's Bank Regulation to Avoid the Asian Bank Contagion", (1999), 19, UCLA Pacific Basin Law Journal, 32

independence means that the supervisors should be free from political pressures to both decision-making and rule-making;

A legal protection from personal and institutional liability for supervisory actions taken in good faith in the course of performing supervisory duties;

Arrangements for sharing information between supervisor (within the same jurisdiction as well as among different jurisdictions) and for protecting confidentiality of supervisory information.

2 Licensing Process and Approval for Changes in Structure

In order to maintain a healthy financial system, and to accurately identify the population of institutions to be supervised, the arrangements for licensing banking organizations and the scope of permissible activities should be clearly defined. In particular, accepting proper bank deposits from the public is typically reserved for institutions that are licensed and subject to supervision as banks. The use of the word “bank” should also be clearly defined and be controlled as far as possible to avoid any circumstance that may mislead the public.¹²⁶

Even with the strict definition of banks, the licensing process and requirement are no less paramount. Without the guarantee that a bank will operate well after it opens, the licensing process can be applied as an effective method to reduce the number of unstable financial institutions that enter the banking system. It is important that the criteria for issuing license are consistent with those applied in ongoing supervision so that they can provide the same bases for withdrawing authorization when a bank no longer meets the

¹²⁵ See supra note 119, Core Principles , Section II

qualification.¹²⁷ Where the licensing and supervisory authorities are different, it is essential that they cooperate closely in the licensing process and that the supervisory authority has a legal right to have its views considered by the licensing authority. To reduce the potential for political interference in the licensing process, the criteria shall be as clear and objective as possible. In either licensing or supervisory, if the authority determines that the license was knowingly based on false information, the license can be revoked. The licensing process, giving consideration to both issuing and withdrawing the license, should consist of the following assessments, at a minimum.¹²⁸

- (a) Ownership Structure¹²⁹-Ownership includes the bank's major¹³⁰ direct/indirect controlling shareholders. The assessment should review the controlling shareholders' past banking and non-banking business ventures and their integrity and standing in the business community, as well as the financial strength of all major shareholders and their ability to provide further support if necessary.
- (b) Fit and Proper Test for Directors and Senior Management¹³¹- The licensing authority evaluates proposed directors and senior management as to expertise and integrity (fit and proper test). The fit and proper criteria encompass: (i) skills and experience in relevant financial operations commensurate with the intended activities of the bank and (ii) no record of criminal activities or adverse regulatory judgements that makes people unfit to uphold important positions in a bank.

¹²⁶ Core Principles, Principle 2

¹²⁷ Core Principles, Principle 3

¹²⁸ Core Principles, Principle 3-5

¹²⁹ Core Principles, Principle 3

¹³⁰ In many countries, a "major" shareholder is defined as holding 10 % or more of a bank's equity capital. See Core Principles, at 16

¹³¹ Core Principles, Principle 3

- (c) Operating Plan and Internal Controls¹³²- The licensing authority should review the proposed strategic and operating plans of the bank, as well as determine whether adequate internal policies and procedures have been developed. These are to include the establishment of an appropriate system of corporate governance and the implementation of the “four eyes” principles (segregation of various functions, cross-checking, dual control of assets, double signature, etc).
- (d) Financial Projections Including Capital¹³³- The licensing authority should review pro forma financial statements and projections for the proposed bank. It should incorporate an assessment of the adequacy of the financial strength to support the proposed strategic plan, especially in light of start-up costs and possible operational loss in the early stages.
- (e) Prior Approval from the Home Country Supervisor When the Proposed Owner Is a Foreign Bank¹³⁴-In the case of foreign banks establishing a branch or subsidiary, prior consent (or a statement of “no objection”) of the home country supervisor need to be obtained.
- (f) Transfer of a Bank’s Shares¹³⁵- The supervisor has the authority to review or reject any proposal for a change in significant ownership or controlling interest, if the change does not meet criteria comparable to that applied to approving new banks. Supervisory approval, either explicit prior approval or non-objection to a prior notification, is always required.
- (g) Major Acquisitions or Investment by a Bank¹³⁶- Laws or regulations should clearly

¹³² See supra note 131

¹³³ See supra note 131

¹³⁴ See supra note 131, and also Basel Committee, Minimum Standards for the Supervision of International Banking Groups and Their cross-border Establishments”, Compendium Vol III

¹³⁵ Core Principles, Principle 4

¹³⁶ Core Principles, Principle 5

define the types and amount of acquisitions and investments that need prior approval and the cases in which notification is sufficient. The criteria required in new acquisitions and investments should be consistent with the licensing requirements.

3 Arrangements for Ongoing Banking Supervision

(a) Development and Implementation of Prudential Regulations and Requirement

The risks inherent in banking must be recognized, monitored and controlled. Many Asian supervisory authorities failed to detect and manage risks, which led to the collapse of the banking sectors during the crisis. Therefore, an important part of the supervisory process is to develop and utilize prudential regulations and requirements to limit the imprudent risks in banking operation.

(i) Capital Adequacy¹³⁷

To ensure that the capital is available to bear risk and absorb losses, laws or regulations should require all banks to calculate and consistently maintain a minimum capital adequacy ratio, as well as define the components of the capital. At least for internationally active banks, the requirements must not be lower than those established in the Basel Capital Accord.

The Basel Capital Accord sets minimum capital ratio requirements for international banks of 4 % tier one capital and 8 % total capital (tier one plus tier two) in relation to

¹³⁷ Core Principles, Principle 6

risk-weighted assets. Tier one capital refers to core capital, consisting of permanent shareholders' equity and disclosed reserves that are created or maintained by appropriations of retained earnings or other surplus (e.g. share premiums). Tier two capital refers to supplementary capital, including other forms of reserved and hybrid capital instruments that should be included within a system of capital measurement.¹³⁸

(ii) Credit Risk Management

The Asian Financial Crisis has underlined the importance of credit risk management. The government-directed loans (policy lending) and connected lending was clearly the problems in a number of Asian countries. Related to this is the problem of guarantees and collateral. It is important that banks should never assume the existence of implicit government guarantee when making the judgements on granting the loans. Bank should look through to the global aggregate and the nature of risks undertaken by their borrowers, even if the facilities they have provided appear to be fully collateralized.

(iia) Credit-granting standards and credit monitoring process

The extension of loans is the primary activity of most banks. Lending activities require banks to make judgements related to the creditworthiness of borrowers. These judgements are not always accurate and the creditworthiness may decline over time. Therefore, the credit risk, applying not only to loans but also to guarantee,

¹³⁸ More detail of Basel Capital Adequacy, by reference to Basel Committee, International Convergence of Capital Measurement and Capital Standards, July 1988, update to April 1998, at

acceptances, collateral, and securities investments, need to be managed with care. At a minimum, the factors to be considered and documented in approving credits must include:¹³⁹

The purpose of the credit and source of payment;

The integrity and reputation of the borrower or counterparty;

The current risk profile (including the nature and aggregate amounts of risks) of the borrower or counterparty and its sensitivity to economic and market developments;

A forward-looking analysis of the capacity to repay based on various scenarios;

The legal capacity of the borrower or counterparty to assume the capacity;

For commercial credits, the borrower's business enterprise and the status of the borrower's economic sector and its position within the sector;

The proposed terms and conditions of the credit, including covenants designed to limit the changes in the future risk profile of the borrower; and

Where applicable, the adequacy and enforceability of the collateral or guarantees, including under various scenario.

The supervisor requires and periodically verifies that prudent credit-granting and investment criteria, policies, practices and procedures are approved, implemented and reviewed by the bank management and boards of directors.¹⁴⁰ Banks must also have a well-developed process for ongoing monitoring of credit relationship, including the

<http://www.bis.org/publ/bcbasc111.pdf>

¹³⁹ Basel Committee, Principles For The Management of Credit Risk, July 1999, Principle 4

¹⁴⁰ Core Principles, Principle 7

financial condition of borrowers.¹⁴¹

(iib) Assessment of asset quality and adequacy of loan loss provisioned and reserves

Supervisors should set rules for the periodic review by banks of their individual credits, asset classification and provisioning. A general framework will also be required to formulate specific policies for dealing with problem credits.¹⁴²

(iic) Concentrations of risk and large exposures

Banking supervisory should set prudential limits on large exposures to a single borrower or closely related group of borrowers¹⁴³ to avoid credit risk concentration. A “closely related group” should be explicitly defined to reflect actual risk exposure. This definition can include not only legally related companies but also financially related companies (e.g. with common ownership).

Although not necessary, banks are expected to adhere to the following definitions:

- 10 percent or more of a bank’s capital is defined as a large exposure;
- 25 percent of a bank’s capital is the limit for an individual large exposure to a private sector non-bank borrower or a closely related group of borrowers.

Minor deviations from these limits may be acceptable, especially if they explicitly

¹⁴¹ Reference document: Basel Committee, Principles for the Management of Credit Risk, July 1999

¹⁴² Core Principles, Principle 8

¹⁴³ Core Principles, Principle 9

temporary or are related to very small or specialized banks.¹⁴⁴

(iid) Connected lending

Laws and regulations shall assure that exposures to connected or related parties may not be extended on more favourable terms (i.e., for credit assessment, interest rates, amortization schedules, requirement for collateralisation) than corresponding loans to non-related counterparties. Transactions with connected or related parties exceeding specified amounts or otherwise posing special risks are subject to approval by the bank's board of directors.¹⁴⁵ The ground to confine the connected lending is that, if not properly controlled, it can lead to significant problems because determinations regarding the creditworthiness of the borrower are not always made objectively.

The term "connected or related parties" should be defined specifically in law or regulations to include affiliated companies, significant shareholders, board members, senior management, key staff as well as close family members, corresponding persons in affiliated companies, and companies controlled by insiders and shareholders.¹⁴⁶ Supervisors should also have the authority to make discretionary judgements about the existence of connections between the bank and other parties. This is especially necessary in those instances where the bank and related parties have taken measures to conceal such connections.

¹⁴⁴ More detail, by reference to Basel Committee, Measuring and Controlling Large Credit Exposures, January 1991

¹⁴⁵ Core Principles, Principle 10

¹⁴⁶ See *supra* note 119, Core Principles Methodology p26

(*ii*) Country and transfer risk

Country and transfer risk refers to risk associated with the economic, social, and political environments of the borrower's home countries. It may be most apparent when lending to foreign governments or their agencies. In Asian markets, some creditor banks assumed that their exposure to foreign private borrowers would be protected by an implicit government guarantee of debtor's home countries. This assumption may induce them to take on larger exposures at a lower spread than warranted by normal credit standards and, therefore, accelerates the contagion in the course of Asian Financial Crisis.

Principle 11 enjoins banks to be "satisfied that banks have adequate policies and procedures for identifying, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining appropriate reserves against such risk". Specific guidance applicable to Principle 11 is currently built on the Basel Committee's 1982 paper "management of banks' international lending". These include:

- The supervisor decides on appropriate minimum provisioning by setting fixed percentages for exposures to each country;
- The supervisor sets percentage intervals for each country, and the banks may decide, within these intervals, which provisioning to apply for the individual exposures;
- The bank itself sets percentage or guidelines or even decides for each individual loan on appropriate provisioning. The provisioning will then be judged by the

external auditor or by the supervisor.

(iii) Market Risk Management

The supervisor requires that a bank has suitable policies and procedures related to the identification, measurement, monitoring and control of market risk, which refers to a risk of loss in on- and off-balance sheet positions arising from variations in market prices. Laws or regulations to appropriately limit the risk of foreign exchange business are always essential to market risk management.¹⁴⁷

(iv) Other Risk Management

The supervisor requires individual banks to have in place comprehensive risk management processes to identify, measure, monitor and control liquidity risk, interest rate risk, and operational risk as well as all other risks.¹⁴⁸

(v) Internal Controls

The supervisor requires that “banks have in place internal controls that are adequate for the nature and the scale of their business”.¹⁴⁹ These controls, at a minimum, encompass¹⁵⁰:

- Organisational structure: definitions of duties and responsibilities including clear

¹⁴⁷ Core Principles, Principle 12; Reference document: Basel Committee, Amendment to the Capital Accord to incorporate Market risks, January 1996

¹⁴⁸ Core Principles, Principle 13

¹⁴⁹ Core Principles, Principle 14

delegation of authority (e.g. clear loan approval limits), decision-making procedures, separation of critical functions (e.g. payments, accounting, and audit)

- Accounting procedures: reconciliation of accounts, control lists, information for management
- Checks and balance (or “four eyes principles”): segregation of duties, cross-checking, dual control of assets, double signature
- Safeguarding assets and investments: including physical control

These controls may be supplemented by an effective audit function that independently evaluates the adequacy, operational effectiveness and efficiency of the internal control system. In addition, in reference to public confidence, banks should have policies and procedures, including strict “know-your customer”, to avoid being used intentionally or unintentionally by criminal elements.¹⁵¹

(b) Methods of Ongoing Banking Supervision

Banking supervision requires an in-depth understanding, periodic analysis and evaluation of individual banks, focussing on safety and soundness, based on meetings with management and a combination of both on-site and off-site work.¹⁵² Due to the divergent extent of on-site and off-site supervision (See Table 2.5), it is assumed that only the appropriate mix of both can maximize the supervisory function and avoid supervisory gaps.

¹⁵⁰ Basel Committee, Framework for Internal Control Systems in Banking Organisations, September 1998

¹⁵¹ Core Principles, Principle 15

¹⁵² Core Principles, Principle 16, 17

Moreover, the supervisor has the legal authority to require banking organizations to submit information, on both a solo and consolidated basis, on their financial condition and performance at regular intervals.¹⁵³ This includes the ability to review both banking and non-banking activities conducted by banks, either directly or indirectly (through subsidiaries and affiliates), and activities conducted at both domestic and foreign establishments.

Table 2.5 Off-Site Supervision versus On-Site Supervision

	Off-Site Supervision	On-Site Supervision
Meaning	Supervisors regularly collect and review the reports from banks, particularly in the interval between on-site inspections.	Supervisors can practically conduct the supervision either by it own staff or through the external auditors.
Range	<ul style="list-style-type: none"> • review and analyse the financial condition on Individual banks using prudential reports, statistical returns and other appropriate information, including publicly available information • monitor trends and developments for the banking sectors as a whole 	<ul style="list-style-type: none"> • provide independent verification that adequate corporate governance (including risk management and internal control system) exists at individual banks • determining the information provided by banks is reliable • obtain additional information needed to assess the condition of bank

(Compile by author: Basel Committee on Banking Supervision, Core Principles p32-34)

¹⁵³ Core Principles, Principle 20

(c) Information Requirements of Banking Organizations

Banking supervisors must ensure that “each bank maintains adequate accounting records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair view of the financial condition of the bank and the profitability of its business.”¹⁵⁴ If a bank intentionally provides false or misleading information, supervisory and/or criminal action should be taken against both the individuals involved and the institution.

(d) Formal Powers of Supervisors

The supervisor has the authority to take an appropriate range of remedial actions against, and impose penalties upon banks.¹⁵⁵ These remedial actions are used to address such problems as failure to meet prudential requirements and violations of regulations. Depending on the severity of the situation, the range of possible actions include restricting the current activities of bank, withholding approval for new activities or acquisitions, restricting or suspending payments to shareholders or share purchases, replacing or restricting the powers of managers and directors, and, in extreme circumstances, revoking the banking license.

¹⁵⁴ Core Principles, Principle 21

¹⁵⁵ Core Principles, Principle 22

(e) Cross- border Banking

To practice global banking consolidated supervision, home country supervisors must adequately monitor and apply appropriate prudential norms to all aspects of business conducted by their home banking organizations worldwide, primarily at their foreign branches, joint ventures, and subsidiaries.¹⁵⁶ On the other hand, the host country supervisors also play a role to require the local branches and subsidiaries of foreign banks to be conducted to the same standards as required by the domestic institutions.¹⁵⁷ The information sharing arrangements between home country supervisors and host country supervisors are of extreme significance to carry out consolidated supervision.¹⁵⁸

The principles set out in this section are consistent with the so-called Basel Concordat and its successors.¹⁵⁹ The Basel Concordat sets forth four basic principles delineating the responsibilities of home and host countries' banking supervisors in monitoring the international banks. They are as follows:¹⁶⁰

- The supervision of foreign banking establishments should be the joint responsibility of home and host country authorities.
- The supervision of solvency of foreign branches should be essentially the responsibility of the home country authorities.
- The supervision of liquidity of foreign branches should be the primary

¹⁵⁶ Core Principles, Principle 23

¹⁵⁷ Core Principles, Principle 25

¹⁵⁸ Core Principles, Principle 24

¹⁵⁹ See p 44

¹⁶⁰ The Basel Committee, Basel Concordat on Principles for the Supervision of Bank's Foreign Establishments. The original Basel Concordat was not be released to public until March 1981, and reprinted by the IMF, Occasional Paper No 7, August 1981

responsibility of the host country authorities.

- Practical cooperation would be facilitated by transfers of information between home and host country authorities, and by granting the permission for inspections by the home authority on the territory of the host authority.

Subsequently, several amendments were made to supplement the Basel Concordat, and mainly concentrated in two respects. First, the approach to consolidated supervision was well developed. Consolidated supervision requires the home authorities to monitor the risk exposures (including the concentration of risk, the quality of the assets, and the capital adequacy) of the banking groups, wherever conducted. If a host authority determines that the home authority has inadequate supervision or fails to meet the prudential requirements of Basel Committee, the host authority could prohibit the entry of foreign branches from that home country or impose restrictive measures necessary to satisfy the prudential concerns.¹⁶¹ Later in 1996, the Basel Committee and Offshore Banking Groups jointly pronounced minimum criteria to assess the effectiveness of consolidated supervision (See Table 2.6).

¹⁶¹ See Basel Committee, Principle for the Supervision of Foreign Establishments, May, 1983; Minimum Standards for the Supervision of International Banking Groups and Their Cross-border Establishments (Minimum Standards); June 1992, Principle 1,4

Table 2.6 Checklist of Principles for Effective Consolidated Supervision

A. Powers to exercise global oversight (does the home authority have adequate powers to obtain the information needed to exercise consolidated supervision)
<ul style="list-style-type: none"> • Does the home authority receive regular financial information relating both to the branches and the whole bank groups? • Is the home authority able to verify the information?
B. Exercise of consolidated supervision
<ul style="list-style-type: none"> • Adequate control of authorization, both at the entry stage and on changes of ownership? • Adequate prudential standards for capital, credit concentrations, asset quality, liquidity, market risk management? • Off-site capability • The capability to inspect or examine overseas entities? • A track record of taking effective remedial action when problems arise?

Summarized by author: Basel Committee and the Offshore Groups of Banking Supervisors, *The Supervision of Cross-border Banking*, October, 1996, p 22-24

In addition, information flows between home and host authorities have also been extensively discussed. The Basel Committee encourages that both the home and host authorities should possess the right to gather information from the cross-border banking establishments of the banks/banking groups¹⁶², and, if necessary, cross-border inspections can be conducted.¹⁶³ In order to provide legitimate protection for bank customers, it is important that the information obtained by supervisory authorities, especially that related to the depositor's or investors' names and account information, is subject to strict confidentiality. In general, information can only be interrogated by officials engaging in prudential supervision, and only for supervisory purposes.¹⁶⁴

¹⁶² See supra note 134, Minimum Standards, Principle 3

¹⁶³ More detail of the procedure of cross-border inspections, see Basel Committee and Offshore Group of Banking Supervisors, *The Supervision of Cross-border Banking*, October 1996, at 12-14, 24

¹⁶⁴ See supra note 163, *The Supervision of Cross-border Banking*, at 9-10, 13

D Conclusion

Since the Basel Committee came into being in 1974, it has focused its efforts on prudential supervision of international banks to maintain the financial stability both in national and international level and to prevent the eruption of international financial crises. A series of recommendations are developed to incorporate the monitoring of capital adequacy, consolidated supervision, risk management supervision, information flows between cross-border banking supervisors.

Basel Committee possesses only informal supervisory power and does not intend to give Basel Principles legal powers. These principles are minimum references and in many cases may need to be supplemented by other measures designed to address particular conditions and risks in the financial regime in individual countries. The Basel Committee does not seek to unify all national laws and practices, but rather to link disparate regulatory regimes with a view toward ensuring that all banks are supervised according to common principles.

In order to effectively implement these principles, the Committee closely cooperates with other international groups. First, Basel Committee has widely expanded its influence from the Basel members to many non-Basel members through IMF's loan agreements and bailout packages. The efforts of European single market have successfully provided a legal framework for shaping the national implementation of the Basel Principles within Europe. The NAFTA framework also has an impact on promoting the Basel standards, because it explicitly demonstrates that Basel Principles, for prudential reasons, can be applied as general standards to evaluate the entry and the scope of permissible activities of foreign banks. Additionally, the emergence of the

GATS may also have a role to play in Basel Principles' implementation through WTO's widely spread members. However, further cooperation between WTO and Basel Committee, based on either the EU or NAFTA model, should be encouraged.

In many countries, although the supervisory authorities do not, at present, have the statutory authority to implement all of the Basel Principles, the Basel Committee encourages that supervisors should give urgent consideration to any changes necessary to ensure that the Basel Principles can be effectively applied. The need for new pronouncements will also be taken into account by the Basel Committee in monitoring the time individual country takes to progress toward implementation. This is because the pursuit of a safe and sound banking environment is no less important than the process of globalization.

III Conclusion: Incentives for China's and Taiwan's to Apply GATS and Basel Principles

GATS and Basel Principles are two different international regimes governing the cross-border banking operation. First, the chief objective of the GATS is to promote financial globalization and liberalization based on the MFN and national treatment principles while the Basel Principles mainly focus on the early warning system to maintain financial stability and avert international financial crisis. In addition, their legal effects are different as well. GATS is a multilateral agreement which is not only legally enforceable but also subject to the WTO dispute mechanism, whereas Basel Principles have no legal impact and simply constitute supervisory recommendations to international banking activities. It is difficult to evaluate two different regimes because they have different merits and demerits. The former provides more direct, effective and immediate legal protection but the latter is more flexible to accommodate to the cultural, economic, and political differences.

However, to strike a balance between merits and demerits, some adjustments are made to GATS and Basel Principles. For example, GATS exempts WTO Members from the national treatment. Although this concession was made mainly to serve developing countries' interest because financial services in developing countries are usually less competitive than developed countries and require a period of time to create their competitive advantages, it would, to some extent, accommodate GATS to different national regimes. Moreover, Basel Committee also cooperates with other international organizations, such as IMF, to guarantee that more countries will include Basel Principles into their national legislation in a more positive and clear manner.

Despite the significant roles of GATS and Basel Principles in international banking, it

is worth considering the incentives for China and Taiwan to comply with these two regimes since they are neither WTO members nor Basel members. Both China's and Taiwan's bids for WTO membership have high priorities in their governmental economic policies. For China, membership in WTO would enhance China's attractiveness to foreign investors, and amass the foreign capital needed to build its infrastructure and further industrialized. Furthermore, joining WTO will also benefit China's export-led economic policies by receiving the MFN treatment. Currently China's MFN treatment by the U.S. requires annual presidential certification that China is not violating human rights. Although WTO membership does not automatically ensure China's unconditional and irrevocable MFN status from the U.S., there is a good possibility that human rights will have less impact on Sino-American trade relations.¹⁶⁵

Similar incentives exist in Taiwan's bid for WTO membership. MFN treatment will benefit Taiwan's export to other WTO members and thereby promote its domestic economy. Furthermore, Taiwan will obtain access to GATS procedures for dispute resolution concerning unfair trade practices. It is particularly significant because Taiwan is excluded from traditional dispute resolution mechanisms such as those provided by the United Nations. Another potential incentive is to provide a non-political forum for Taiwan and China to have communications with each other.¹⁶⁶ Despite the growing economic interdependence between China and Taiwan¹⁶⁷, political tension forbids official contact and sometimes widens the supervisory gaps. Thus, WTO may, but not necessary will, overcome some of the political obstacles to economic cooperation.

The major incentive for China's and Taiwan's adoption of Basel Principles follows

¹⁶⁵ See Monica Hsiao, "China and the GATT: Two Theories of Political Economy Explaining China's Desire For Membership in the GATT," (1994) 12 UCLA Pacific Basin L. J. 431, at 442

¹⁶⁶ See Susanna Chan, "Taiwan's Application to the GATT: A New Uruguay With the Conclusion of the Uruguay Round," (1994) 2 Indiana J. Global Legal Stud 275, at 291

their bid for WTO membership. Undoubtedly, China's and Taiwan's financial markets will be further integrated into global market once their bids are accepted. The more globalized the banking institutions operated, the more risk and competition they face. However, the banking sectors in China and Taiwan have been traditionally intervened and protected by government and thereby can neither compete with foreign banks nor are they safe and sound enough to fight off the international financial crises. Although China and Taiwan have embarked on a series of financial reform in the past decades, the path of reform is not clear. As a consequence, a prudential and comprehensive financial regulatory infrastructure that is consistent with Basel Principles should be developed. Additionally, China and Taiwan may not benefit from the MFN treatment even after they become WTO members, if their banking supervisory regimes do not meet the requirements in Basel Principles. It is because that, under the current GATS, a WTO member is eligible to discriminate the WTO member who has yet to adopt the Basel Principles for prudential reasons.

These incentives for China and Taiwan to adopt GATS and Basel Principles appear to be continued in the future since the trend of financial liberalization and globalization will not be easily reversed. The next two chapters will delineate the banking supervisory regimes in China and Taiwan under the impact of both GATS and Basel Principles.

¹⁶⁷ relevant statistics see p2

Chapter Three The Banking Supervisory Regime in China

In late 1978, China announced its “open door” policy and therefore, ensured that it would be a global market power. In doing so, China borrowed economic theories from capitalist countries, but modified them to fit into its own socialist economy. Accordingly, the central government remains the chief actor in making economic decisions that drive the economy and businesses to respond to market conditions. The government believes it can incorporate capitalist functions to allow economic growth while retaining control by implementing underlying social policies.¹⁶⁸ As shown in the following statistics, the policy appears to have been successful. China’s official foreign trade, which has grown from US \$ 30 billion in 1978 to US \$ 290 billion in 1996 at the average rate of 16-17 %, has surpassed all expectations.

However, China’s bid for inclusion into WTO has created uncertainties in its financial market. The removal of the geographic and operational restrictions on foreign banks may increase the market participation of foreign investors by one-third¹⁶⁹. It is worth considering whether the domestic banks can maintain the competitive advantage in this environment, and whether China can fight off the next possible international financial crisis under its current supervisory regime.

¹⁶⁸ See Matthew D. Bersani, “Privatization and Creation of Stock Companies in China” (1993) Colum. Bus. L. Rev. 301, 302

¹⁶⁹ See Song-Chi Wang, “What Does WTO Bring for China’s Financial Market ?,” (Centre for China’s Financial Policy) at <http://www.frc.com.cn/hot/wto/finance.htm>

I. Historical Review of Pre-crisis Banking Reform in China

China embarked on its open door economic policy in 1979 when it established several special economic zones (SEZs) and reformed the agriculture sector.¹⁷⁰ However, the open door policy barely touched the financial system for the first five years. In the meantime, the banking system in China continued to be characterized as an "all-inclusive mono-bank system" and functioned as an integral part of the centrally planned economy.¹⁷¹ Under this system, the People's Bank of China (PBOC) served as the mono-bank institution, pursuing both commercial and central bank functions. Its main responsibilities include granting credit, issuing cash and monitoring the proper use of financial funds according to government planning. Although there are some specialized banks, such as the Agricultural Bank of China (ABC), Bank of China (BOC), and People's Construction Bank of China (PCBC), they were not independent per se and were under the administrative supervision of the PBOC.

On January 1, 1984, the Soviet-style monobank was split in two. The PBOC continued its role as the actual central bank to entirely control the monetary policy¹⁷², and four specialized banks were created or recreated to receive the PBOC's responsibility of conducting commercial-lending business in different sectors. (See Table 3.1) These first four commercial banks are still known as the "Big Four." They enjoyed a virtual monopoly position in their respective banking sectors until 1995.¹⁷³

¹⁷⁰ See supra note 11, Wendy Dobson & Pierre Jacquet, "Financial Services Liberalization in the WTO", at 164-165

¹⁷¹ See P. Bowles & G. White, "The Political Economy of China's Financial Reforms: Financial in Late Development" (Oxford: Westview Press, 1993) at 58

¹⁷² See G. Yi, "Money, Banking Financial Market in China" (Oxford: Westview Press, 1994) at 1

Table 3.1 The Responsibilities of “Big Four”

	Area of Commercial Lending
Industrial and Commercial Bank of China (ICBC)	general commercial lending responsibility
Agriculture Bank of China (ABC)	in agriculture sector
China Construction Bank (CCB)	in capital and construction area
Bank of China (BOC)	in international financial transaction

compiled by author

This is not to say that the Chinese government did not allow for the creation of supplementary banking institutions. In fact, several other commercial banks were also established around this period including Shenzhen Development Bank, Bank of Communications (BOCOM), CITIC Industrial Bank and China Merchants Bank (CITICIB), and etc.¹⁷⁴ In addition, some non-bank financial institutions (NBFIs)-namely trust and investment companies (TICs), also came into existence in the 1980s. The following descriptions best summarize China’s banking system in the mid-1980s.

“ The organizational principle of the current financial system in China is unified leadership and division of specialism. The overall financial system implements the unified policy, plan, and system, which are stipulated by the State. Each specialized bank has its special responsibility in its own field. Thus a socialist multi-level financial system with Chinese characteristics has been established, with the central bank as its core and specialized state banks as its main body, and with co-existing diversified forms of financial organizations.”¹⁷⁵

¹⁷³ See supra note 172 G. Yi, “Money, Banking Financial Market in China”

¹⁷⁴ More details see supra note 172 G. Yi, “Money, Banking Financial Market in China” at 27-32; Christian A Katz, “Red Chips and Globalization of China’s Enterprises,”(Asia 2000 Limited Hong Kong, 1998) at 94-96

¹⁷⁵ See Andrew Xuefeng Qian, “Transforming China’s Traditional Banking Systems Under The New

However, China's open door policy, joined with the trend of globalization in the 1990s, have exposed its banking industry to a more open but competitive environment, and fully demonstrates that the foregoing reforms are not enough. Owing to the heavy administrative interference and the lack of legal framework, the banks accumulated vast amounts of loans against loss-making state-owned enterprises (SOEs) in the mid-1990s. This became a potential for the collapse of banking system and led to instability at the macroeconomic level. Therefore, in 1994-1995, China's banking reform took three steps toward building an efficient and autonomous banking system. The most significant aspect is that each step of reform is linked to the promulgation of law rather than mere policy declarations.

First, China commenced to reform its foreign exchange control system. It eliminated the dual exchange rate system for RMB that had been in practice for many years, and permitted limited foreign exchange trading in four locations, including Shanghai, Dalian, Shenzhen and eastern Jiangsu Province.¹⁷⁶ Second, three policy banks, including the State Import and Export Bank, the State Development Bank, and State Agriculture Bank, were created to assume all the policy lending functions from the Big Four. Henceforward, all the Chinese commercial banks, including the Big Four, will operate with responsibility for their own risks and to some extent free from interference by government units. Only the policy banks will be used for sector-specific loans made in the interests of the central government. However, whether this division can settle the deteriorating problems of non-performing loans and contribute to the commercialization of the commercial banks still depend on the circumstance of SOEs, which will be examined later in this chapter. Third, owing to China's bid to rejoin the WTO, its

National Banking Laws," (1996) 25 Ga. J. Int'l & Comp. L. 479, at 482

banking industry is gradually opening up to foreign participation. China has opened over 20 cities to foreign financial institutions, and has permitted foreign banks to participate in some local or non-banking financial business.

As a result of different phases of reform, the current system is composed of, on the one hand, four huge state commercial banks, created initially as specialized banks for separate sectors of the economy, and three policy banks, which were set up in 1993-1994 (Figure 3.1). In their shadow are some smaller commercial banks, with either national or regional coverage, most of them established since the late 1980s. At the edge is a strong growing competitive fringe of non-bank financial institutions (NBFIs) that has emerged as a force in the recent years.

However, the various types of financial institutions have very uneven share of deposits and credits. (Table 3.2) The Big Four still account for around 60-70% of the current domestic loan market. The BOC controls 70% of the foreign exchange market today and holds about US\$240bn in overseas markets.¹⁷⁷ Profiting from its inheritance from the PBOC, the ICBC remains as the largest bank in the country with a balance sheet in excess of US\$428bn at the end of 1999. It now runs a network of over 35,000 branches and offices with a staff of more than 150,000 controlling most of the Chinese retail banking market.¹⁷⁸ Additionally, ten national commercial banks occupy approximately 9% of domestic banking business while over 80 regional commercial banks have approximately 4%. The UCCs represent 4 % of domestic banking business, and the RCCs and other small institutions have approximately another 9 %.

¹⁷⁶ See Tony Walker, "China to Permit Limited Foreign Trading", Financial Times, (March 4, 1996) at 4

¹⁷⁷ at <http://www.bank-of-china.com/newlevel2/nb.htm>

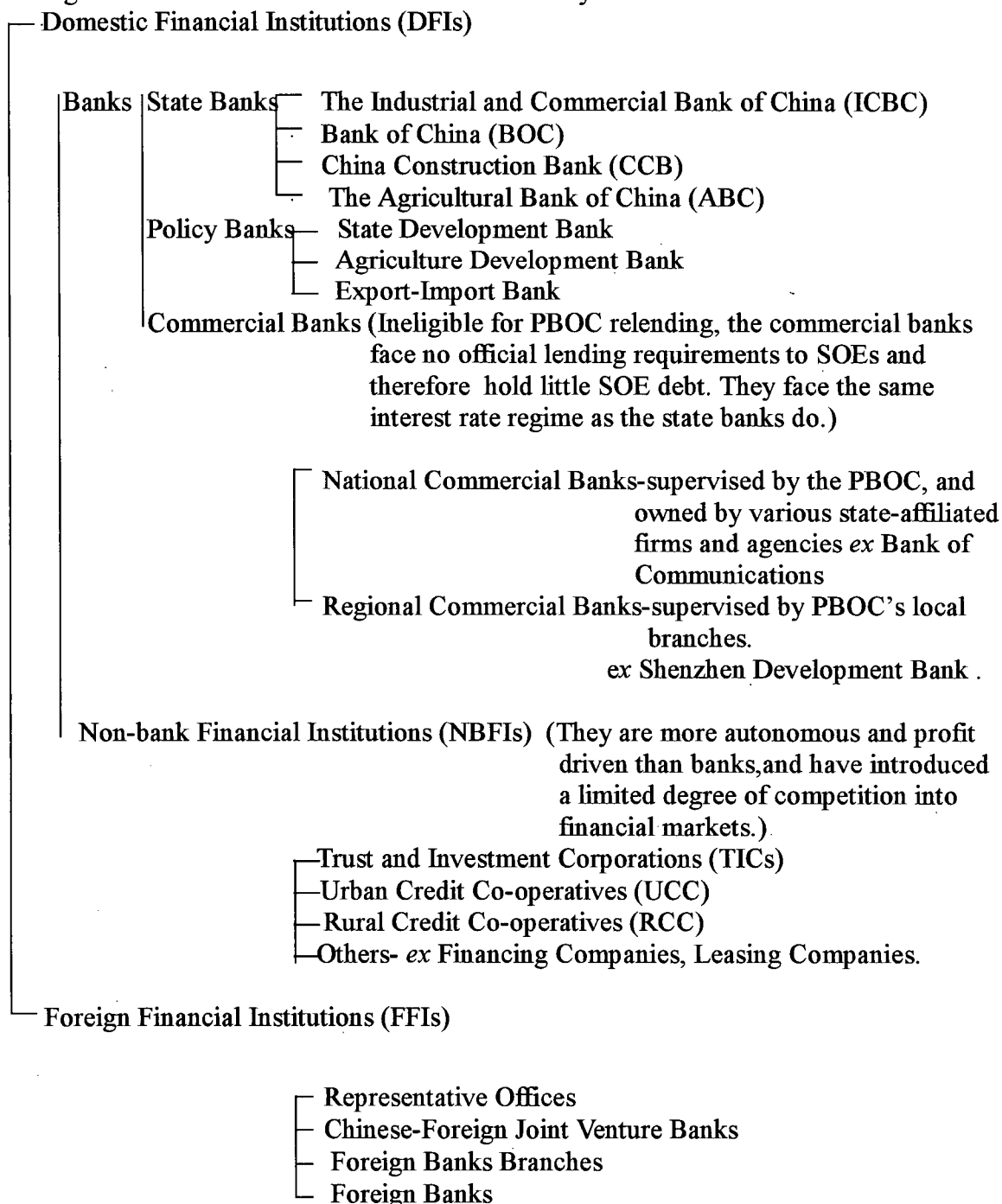
¹⁷⁸ at <http://www.icbc.com/english/w-jrghe.htm>

Table 3.2 Market Share of Domestic Financial Institutions, 1994 (US\$ billion and Percentage)

	Total	State Banks	Other Banks	Urban Credit Co-operatives	Rural Credit Co-operatives	Financial Co-Trust Institutions	Finance Companies
Loans	4081.00 (100 %)	3244.12 (79.5 %)	61.37 (1.5 %)	132.36 (3.2 %)	416.86 (10.2 %)	203.15 (4.9 %)	23.15 (0.5 %)
Deposits	4047.23 (100 %)	2933.10 (72.5 %)	82.75 (2.5 %)	235.37 (5.8 %)	568.11 (14.1 %)	209.32 (5.2 %)	18.30 (0.4 %)

Source: Eric Girardin, Banking Sector Reform and Credit Control in China, OECD Development Center, at 25-26

Figure 3.1. Structure of the Chinese Financial System



(compiled by author)

Why have smaller commercial banks and non-bank financial institutions in China not captured a higher market share of domestic financial markets? The core of the answer is central planning. Given China's planned economies, it is both understandable, and to a certain extent necessary that any economic policy is closely linked to a central policy. However, the banks in PRC have traditionally been used as the main focus of the central planning to support the growth of important SOEs. As a result, the Chinese government remains sensitive to losing control over the banking sectors, and has cautiously maintained the preferential market share of the state-owned banks (SOBs).

As to the foreign financial institutions (FFIs), they have largely increased their local presence in the 1990s. Since 1985, China has allowed foreign banks to set up branches/joint ventures in five SEZs.¹⁷⁹ However, they have been limited to dealing only with foreign-funded companies and joint ventures, and a certain number of foreign exchange transactions. In 1991, seven foreign banks obtain PBOC's approval to open branches in Shanghai, and the number increased to 30 by late 1994.¹⁸⁰ As of the end of 1996, there were 538 representative offices, 131 foreign bank branches, 6 joint venture banks, and 5 wholly foreign owned banks to conducted RMB business in Shanghai.¹⁸¹ Despite the rapid growth of FFIs, they are not likely to create significant competition for domestic financial institutions. Although 160 foreign banks maintain branches or representative offices in China, they account for only 2 % of the total banking assets in China because of the stringent operating requirements to which they are subject.

¹⁷⁹ Five SEZs includes Shenzhen, Zhuhai, Shantou, Xiamen, and Hainan Island.

¹⁸⁰ See supra note 172 G. Yi, Money, Banking Financial Market in China at 33

¹⁸¹ See supra note 11, Wendy Dobson & Pierre Jacquet, "Financial Services Liberalization in the WTO "at 173

II. China's Performance in the Asian Financial Crisis

Compared with many other countries in Asia, Chinese economy has so far been left largely unaffected by the financial crisis.¹⁸² As Asian currencies have plummet one after another since the middle of 1997, the Chinese RMB has stood its ground, despite repeated attempts by international media and fund managers to "talk it down." (See Table 1.1¹⁸³). Therefore, China has won the praise of many governments for playing a positive role during the currency crisis by maintaining the exchange rate stability of the RMB. In the words of the US Treasury Secretary Robert Rubin, China "has been an important island of stability in the turbulent region."¹⁸⁴

Though China has so far successfully fended off the Asian Financial Crisis, it has not escaped from its contagious effects. First, on account of weak domestic demand as well as a slowdown in export growth, China's economy in 1998 grew at merely 7.8 % (the growth rate in 1997 was 8.8 %), still falling short of the official target of 8 % for the whole year.¹⁸⁵ In addition, the growth of Chinese exports, at US \$183.8 billion in 1998, has slowed down significantly to 0.5 % compared to 26.2 % in 1997. This is mostly due to the decline in exports to the affected Asian countries. Chinese imports declined for the first time in the past decade by 1.5 %. Furthermore, more than 70% of the foreign direct investments in China have been hit, in varying degrees, by the financial crisis.¹⁸⁶

Specifically, what has made China different from those crisis-ridden Asian

¹⁸² See Nicholas R. Lardt, "China and the Asian Contagion," (Foreign Affairs, July/August, 1998), at 78

¹⁸³ See Chapter One .p3

¹⁸⁴ See Remarks (May 26, 1998), Opening Plenary for China-US Joint Economic Committee-Eleventh Session, (USIA, Washington, DC)

¹⁸⁵ See George C.S. Lin, "The Asian Financial Crisis and Restructuring of the Chinese Economy- A Preliminary Assessment", (University of British Columbia, Institute of Asian Research, CCR Discussion Paper99-1, 1999)

¹⁸⁶ See Shanghai Briefing, South China Morning Post (November 28, 1997) (Chin)

economies is China's external economic position. On account of its strong export growth and rising trade surplus in recent years, China has no current account deficit. It has also been conspicuously successful in attracting foreign direct investment so that its external debt (US\$ 124 billion by 1997) is relatively small in terms of China's annual exports (US\$ 180 billion for 1997) and its existing international reserves (currently, US\$ 151 billion).¹⁸⁷ Clearly, China has not over-borrowed as Thailand or South Korea has. Furthermore, as the Chinese RMB is only partially convertible on the currency account, it is not possible for international currency speculators to mount a direct attack on RMB. Of even greater importance is the political aspect of the RMB stability. The RMB exchange rate is essentially determined by administrative decisions of the Chinese government rather than by the financial markets. Thus, to avoid a "loss of political face", China's supreme leaders has declared more than once that China would not devalue the RMB.¹⁸⁸

China is a large economic entity, which has sufficient internal dynamics to maintain reasonable economic growth when the international economic environment becomes less conducive. Additionally, the restricted RMB transaction and certain political concerns have also made China less vulnerable to the Asian Financial Crisis than smaller economies in Asia. However, it does not demonstrate that China can shrug off the contagion effects of any future financial crisis. In fact, China's banking sector is very "shaky" on account of its huge amount of non-performing loans incurred by state-owned enterprises (SOEs). This poses a serious challenge for the future banking reform.

¹⁸⁷ See John Wong, "China's Economy in 1998- Maintaining Growth and Staving off the Asian Contagion," (Singapore University Press, EAI Occasional Paper No 15, 1999.) (Chin)

¹⁸⁸ See EAI Occasional Paper No.4, "China Economy and The Asian Financial Crisis," (1998) at 25

III. Regulatory Framework of China's Post-Crisis Banking System

The promulgation of the new Commercial Banking Law (hereinafter CBL) is a turning point of China's banking regime, in that it is the first time that banks are required to operate under the principles of efficiency, safety, and liquidity. More specifically, the commercial banks should rely on self-operation, self-risk management, self-responsibility for profit or loss, and self-restraint.¹⁸⁹ The operation should be independent and free from excessive interference of any work units or individual. However, to what extent the foregoing principles will be realized still hinges on Chinese government's willingness to implement these policies.

CBL will apply to all commercial banks within China, incorporating domestic and foreign commercial banks although, in most case, foreign banks are subject to other regulations. In the mid-1990s, two sets of regulations were passed. They are "Regulations on Management of Foreign Financial Institutions Resident Representative Offices in China", and "Establishment of Foreign Investment Financial Institutions in PRC (FIFI)."

Notwithstanding the inadequacy and imperfection of current regime, it is fair to say that these regulations have moved toward streamlining and improving the procedure for establishment of domestic banks, as well as the opening of foreign banks.

¹⁸⁹ CBL, Article 4

A. Macro-Control of the Commercial Banks

To better comprehend the government-led nature of China's socialist economy, the role of the State and the PBOC in banking supervision will be examined before more details of relevant banking provisions are provided.

1. The Role of the State

China's banking regime is based on a regulatory ethic that posits the State as the primary actor for economic and social development. It is to some extent consistent with the common theme in East Asian development, which suggests that the State can play a positive role in managing economic development while in contrast with critical approaches that tend to view the State as more problematic.¹⁹⁰

It is true that the law and policy are widespread tools to achieve instrumental social and political objectives internationally. However, in China, law and policy are more strongly linked, as law is designed to supplement and /or replace policy in its role of effecting social change. Prior to the rapid reintroduction of legal norms in the 1980s, policy was clearly regarded as superior to law¹⁹¹. Even though the position of law vis-à-vis policy so far appears more equivalent, the domination of politics over law can also be seen. For example, the Constitution of the Communist Party of China in its General Programme clearly stated that legislative, judicial, and administrative organ of the State

¹⁹⁰ See Pitman B. Potter, "Foreign Investment Law in the People's Republic of China: Dilemma of the State Control" (1995) *The China Quarterly*, at 156-157

¹⁹¹ See Epstein E.J., "The theoretical System of Property Rights in China's General Principles of Civil Law: Theoretical Controversy in the Drafting Process and Beyond" (1989) *Law and Contemporary Problems* 52:177, at 213

are to be "supervised" by the party.¹⁹² Logically, if the party can legitimately supervise the State's lawmaking body, it cannot be subject to the law of the State. Thus, the policy intervention in China is not only usual but also consequential.

Furthermore, the extent to which law is implemented depends heavily upon policy guidance.¹⁹³ In the absence of policy support, laws are mostly ignored and discarded. More specifically, implementation tends to be sporadic and limited to certain area where the central government has publicly formulated guidelines/directives directing that certain provisions shall be strictly enforced. Law has not yet become entrenched as a source of normative guidelines in China. This may explain why laws and regulations in China are relatively general and vague in contrast to international standards.

Political interference will not end easily even though the international community continuously compels China to liberalize its global ties, to eliminate the discriminatory treatments between domestic and foreign sectors, as well as to make the policy more transparent, coherent and predictable. This is because of the historical centralization of State authority, and the efforts made by many leaders, bureaucrats, industrial managers, and regional officials to support State's involvement in China's economic development during the transition. That is, China's economy will grow but in directions set by official definitions of China's interest, rather than simply by domestic or even global market force.¹⁹⁴

¹⁹² Constitutions of the Communist Party of China (1982), translated in Beijing Review, 1982, No38:8

¹⁹³ See Peter Howard Corne, "Foreign Investment in China: Administrative Legal System", (Hong Kong University Press, 1997), at 222-223

¹⁹⁴ See David Zweig, "Will China Liberalize?" (University of British Columbia, CCR Discussion Paper

2. The Role of the PBOC in Supervision

In addition to the political interference, the PBOC's inability to promulgate regulations and operate on an independent and efficient basis is also a significant problem for the Chinese banking regime. According to the Law of People's Bank of China on People's Bank of China (PBOC Law), the PBOC, specifically identified as the central bank of PRC, makes and implements national monetary policy, supervises and administers financial institutions, and issues and maintains the stability of the RMB.¹⁹⁵ It also supervises and controls banks and financial institutions by approving the establishment, alternation, scope of business, and termination of a bank.¹⁹⁶ In addition, the granting of deposits and loans, account settlements, and non-performing loans are under its supervision as well. The PBOC has a broad range of operational functions, such as a lender of last resort for the Chinese banking system by making commercial loans to banks¹⁹⁷; organizing and supervising the interbank market¹⁹⁸; and stipulating repayment schedules and rates of the interest granted by commercial banks¹⁹⁹.

To maintain "the legitimate, stable, and sound operation of the banking industry"²⁰⁰, the PBOC is empowered to conduct both on-site supervision and off-site supervision. In contrast to the "periodical" audits in Basel Principles, the former in China means that a "random" audit can be arranged if the PBOC considers it as necessary²⁰¹. It is not clear whether the PBOC will undertake random audits, but, in the past, this would have been unlikely to happen. As for the off-site supervision, PBOC is eligible to demand the

98-3, March 1998), at 9-10

¹⁹⁵ PBOC Law, Article 2

¹⁹⁶ PBOC Law, Article 4

¹⁹⁷ PBOC Law, Article 22 (4)

¹⁹⁸ PBOC Law, Article 26

¹⁹⁹ PBOC Law, Article 27

²⁰⁰ PBOC Law, Article 30

disclosure and submission by banking institutions of a number of financial statements. These include: (i) balance sheets, (ii) statements of profit and loss, and (iii) other financial and accounting reports and materials. However, these provisions appear somewhat general and vague, and, thus, make sound banking supervision unachievable.

Owing to its principal role, the independence of PBOC while facing political interference from the State shall be examined. First, the appointment and removal of governor and deputy governor are somewhat vague and deeply rely on the political force. PBOC requires one governor, and a number of deputy governors. The governor is to be nominated by the Premier of the State Council and shall be confirmed by the National People's Congress (NPC). In the event that the NPC is not in session, the governor's appointment may be confirmed by the Standing Committee of the NPC. Besides, the governor can be removed by the President of the PRC and all deputy governor may be appointed and removed by the Premier of the State Council.²⁰² It is interesting that the provisions are vague and do not specify how many deputy governors will be appointed, and the tenure of the governor and deputy governors. There does not appear to be adequate reason for the vagueness although one can imagine that the provisions were drafted so as to create flexibility within the system.

Second, the de facto financial independence still requires further reforms. Although, pursuant to PBOC Law Article 37, the PBOC shall exercise independent control over its financial budget, its budget remains incorporated into the central budget following examination and verification of the State Council. It will also be subject to any budget implementation and supervision by the finance department of the State Council. Furthermore, in the event that the PBOC makes profits, it must pay all profits to the State

²⁰¹ PBOC Law, Article 32

Treasury.²⁰³ The PBOC is permitted to withdraw from such profits and treat it as a general reserve, although permission to make withdrawals is at the discretion of the State Council. In the event that the PBOC suffers losses, these will be met by payments from the State thereby ensuring that the PBOC is never underfunded. Therefore, the jurisdictional lines between PBOC and State Council are unclear. The PBOC continues to act more like a government's agency, and unable to operate independently as a real central bank²⁰⁴.

Third, the PBOC administers banks through administrative guidelines, not banking regulations. It does not have independent legislative authority. For example, the PBOC is not qualified to establish loan classification and provisioning methodologies.²⁰⁵ Detailed guidelines and regulations implemented under PBOC Law and CBL are still needed. Despite 1994-1995 reforms that attempted to make the PBOC less like a socialist central bank by improving the transparency in operations, the lack of detailed guidelines and regulations has fostered a gray area that permits political interference.

3 Case Study- Non-Performing Loans of State-Owned Banks

The tremendous number of non-performing loans (NPLs) of Chinese banks represents 20-40 % of their total loans. This is deemed to be the thorniest problem caused by political interference in Chinese banking regime. According to statistical data provided by the PBOC in 1994, the non-performing loans of the four stated-owned

²⁰² PBOC Law, Article 9

²⁰³ PBOC Law, Article 38

²⁰⁴ See supra note 1, Lawrence L.C. Lee, "Adoption and Application of a "Soft Law" Banking Supervisory Framework Based on The Current Basle Accords To The Chinese Economic Area", at 707-708

²⁰⁵ See supra note 182, Nicholas R. Lardt, China and the Asian Contagion, at 60

commercial banks (hereinafter SOBs) accounted for 20.2 % of their total loans, or up to 530 billion RMB. This figure increased to over 23 % of the total loans by the end of 1995 and up to 25 % by May 1998.²⁰⁶ Chinese bank official usually put this ratio at 20 %, while foreign observers often estimated the ratio to be more in the range of 30-40 %.

The NPL problem in China is fundamentally different in nature from that in other market-oriented economies. First of all, these NPLs are almost exclusively owed by the state owned enterprises (hereinafter SOEs) to the SOBs. Second, the fact that the loans have become "non-performing" is in general predictable to either lenders or to borrowers.²⁰⁷ In other words, most of the lenders do not expect the loans to be collectible even when first granted, and most of the borrowers know full well that they will not be able to repay the loans. It is true that the basic relation between the banks and enterprises is the supplying and demanding. In a market-oriented economy, such a relationship should be independent, equal, cooperative and mutually beneficial. However, with the Chinese government's clinging to a centrally planned state sector, SOBs in China operate more like an administrative agency, and the majority of the non-performing loans are essentially government subsidies for making up the losses of SOEs. Thus, the fate of the SOBs has been contingent on how the SOEs are faring, and the burden of the loss of SOEs has passed from the State finance to the SOBs, leading to the astonishing amount of non-performing loans. In 1994/1995, the SOBs still allocated 70-80 % of their loans to SOEs, of which 40-50 % were loss-making and only 30% were making a profit.

To target the NPL problems, the central government responded with a series of banking reforms, including the creation of three policy banks to assume all policy

²⁰⁶ See Yang Qinhuo, "The Present Credit Situation of State-owned Banks and its Effect on the New Bankruptcy System in China," (1998), 9, Australian J. of Corp. L. 345 at 345

²⁰⁷ Bank For International Settlements, "Strengthening the Banking System in China: Issues and Experience", BIS Policy Paper No7, (October 1999), at 43-44

lending function from previous Big Four, and the promulgation of PBOC Law and CBL to define the competitive position of all commercial banks including the Big Four. Unfortunately, these efforts failed to remove the high proportion of NPLs from the SOBs' balance sheet. First, the policy banks are not designed to take over the NPLs accumulated by banks prior to the mid-1990s, and deemed as new institutions that should start from a clean basis. Thus, commercial banks remain stuck with their old NPLs and their long-time SOE clients. Second, government interference in bank credit decisions and in the enforcement of the prudential regulation remains widespread. Accordingly, new NPLs might be continuously generated by granting loans to loss-making SOEs under the guidance of the Credit Plan.

The eruption of Asian Financial Crisis has reminded China that the inexorable growth of the NPL problem demands immediate attention. As a consequence, various projects are under way to test possible approaches to debt relief. The abolishment of long-existing Credit Plan was the first step to release the SOBs from excessive policy interference in making new loans. The Credit Plan is the main instrument at the disposal of central authorities in their endeavour to channel bank financing to specified activities in the state sector. That is, the stated-owned financial system raises capital to allocate it on terms set by the central government and to users it designated, usually the loss-making SOEs. Effective from the January 1, 1998, the PBOC replaced the Credit Plan system with an directive, non-binding target.²⁰⁸ The government has stressed that the directive target only serves as a reference for commercial banks to schedule their business. Since the abolition, banks have been "institutionally" free to lend according to commercial considerations, provided that their total lending is in line with asset / liability

²⁰⁸ See supra note 207, BIS Policy Paper, Strengthening the Banking System in China: Issues and

ratios and monetary policy targets of the PBOC.

Additionally, the legacy of NPLs has been tackled by the creation of Asset Management Corporations (AMC).²⁰⁹ Capital for AMC has been provided by the Minister of Finance, and, thus, all AMC are wholly owned by the central government. Generally speaking, non-performing loans made prior to 1996 are being transferred to the AMC at their face value. The banks are not taking write-offs on loans transferred to the AMC. By removing the pre-1996 loans- the so-called legacy policy loans- but not removing the non-performing, non-policy loans made by the banks, the central government are holding the banks accountable for their own poor lending decisions. No AMC is so far being planned for any Chinese financial institutions other than the Big Four. For example, ICBC has recently reached an agreement with the Huarong AMC, founded in October 1999 in accordance with the plan of the State Council²¹⁰. Over the years, ICBC has implemented a massive government policy and accumulated the massive amount of NPLs, which have burdened the bank and increase the potential of financial risk. After receiving approximately one hundred billion NPLs from ICBC, Huarong AMC may start to put them into operation as soon as possible. Relying on its special legal position and preferential policy granted by the State, Huarong AMC will participate in debt-for-equity swaps. Under these debt-for-equity swaps, the AMC will acquire from the bank a face value loan made by the bank to a SOE, then forgive the debt of the SOE in exchange for equity of the enterprise, and sell the equity simultaneously. Although a number of other debt-for-equity swaps have been completed, it is unclear the extent to which the AMC have actually issued bonds to the banks in exchange for the

Experience, at 99-100

²⁰⁹ See supra note 207, BIS Policy Paper, Strengthening the Banking System in China: Issues and Experience, at 184-186

²¹⁰ See, ICBC News Office, (Mar 20, 2000) at <http://www.icbc.com.cn/english/w-xxfbc.htm>

loans.

However, the crucial aspect is how effectively these new measures could facilitate the operations of the SOBs on a commercial basis. Generally speaking, notwithstanding the separation of policy loans and commercial loans, and the abolishment of national Credit Plan, the credit provisioning is still highly channelled by government's policies and objectives. It is not only because the Chinese government would like to maintain its control over financial market and the speed of privatization in China, but also because the terms in laws and regulations are too general and ambiguous. Besides, over the years there has been a hypothesis that the government would cover all the losses incurred via policy-led loans. As a consequence, managers in domestic commercial banks were not inclined to turn down loan requests from SOEs, and currently may be confronted with the moral hazard. A comprehensive solution to the NPL problems will not be available unless the solution can efficiently arrange the issues of the excessive policy interference, the lack of credit culture, and the vagueness and ambiguity in laws.

B. Micro-control of the Commercial Banks

1 Domestic Commercial Banks

(a) Licensing Requirements

Pursuant to the CBL, the establishment of any commercial banks in PRC is subject to approval, supervision and administration by the PBOC.²¹¹ In other words, PBOC is the licensing authority, as well as the supervisory authority, of all commercial banks within China, encompassing the domestic and foreign commercial banks. No unit or individual is permitted to engage in commercial banking business, or to use the word “bank” in its name unless PBOC’s prior approval is obtained.²¹² The PBOC is obligated to apply the following requirements when determining whether it is appropriate to grant the license.²¹³

- (i) A bank should have articles of association which is consistent with the PRC, Company Law;
- (ii) A bank should have a minimum amount of registered capital;
- (iii) A bank must have qualified managers with relevant working experience, and with no record of criminal activities or adverse regulatory judgements listed in CBL Article 27;

²¹¹ CBL, Article 11 (1) and Article 12

²¹² CBL, Article 11 (2)

²¹³ The following (a)-(e) reference to CBL, Article 12 (1), and (f) reference to Article 12 (2)

- (iv) A bank must have a sound organisational and management structure;
- (v) A bank must have operational premises and security facilities to operate in line with the requirements pursuant to law.
- (vi) The need for economic development and details of competition in banking industry should be reviewed as well.

The minimum amount of registered capital is stipulated in CBL Article 13 : (i) in the case of commercial bank, it must have a registered minimum capital of RMB 1 billion (ii) in the case of urban co-operative commercial bank, it must have a registered minimum capital of RMB 100 million and (iii) in the case of rural co-operative commercial bank must have a registered minimum capital of RMB 50 million. The paid-up capital of these commercial banks is equivalent to the registered capital. (Table 3.5)

In proceeding with the application, some essential documents should be submitted to the PBOC.²¹⁴ It includes not only the verification of foregoing requirements, but also information on ownership structure, such as a list of the names of shareholders, amount of capital contributions and number of shares of such shareholders, and the creditworthiness of shareholders holding 10 % or more of the registered capital. Besides, the qualification of senior management personnel should be properly reviewed. Generally speaking, no persons who have been convicted of fraud or who have been involved with a liquidated corporate enterprise are eligible.²¹⁵

Commercial banks are entitled to establish branches both in and outside the China if PBOC's prior consent is acquired.²¹⁶ To be eligible to establish a branch within China, a

²¹⁴ CBL, Article 14 and 15

²¹⁵ CBL, Article 27

²¹⁶ CBL, Article 19, para 1

commercial bank shall allocate an amount for working capital which is “ to the appropriate scale of the operation of the branch”, and this amount must not exceed 60 % of the total amount of capital of the commercial bank’s head office.²¹⁷

If a commercial bank changes any of the registered details, it shall notify the PBOC and receive prior approval before it may proceed with the changes.²¹⁸ There are seven matters requiring the prior approval, such as changes of registered capital, adjustment of business scopes, and changes of shareholders holding 10 % or more of the total capital.

Additionally, the “Provisional Regulations Concerning Investment in Financial Institutions Through Purchase of Shares”²¹⁹ is promulgated to guarantee that the capital of domestic commercial banks is sourced via lawful channel within a rational framework. Three groups of possible source are generalized by identifying whether it is eligible to invest in financial institutions. (Table 3.3)

²¹⁷ CBL, Article 19, para 2

²¹⁸ CBL, Article 24, para 1

²¹⁹ It is promulgated on 28th July 1994 by the PMOC.

Table 3.3 The Qualifications of Investment in Financial Institutions via Purchase of Shares

Status of investment via purchase of shares	Types of investors listed in legislation
Permitted, But subject to certain restrictions	(1) financial institutions other than banks, such as leasing company, etc. (Article 5, 6, 7, 8)
	(2) industrial and commercial enterprises (Article 11)
Not permitted, Unless PBOC's prior approval is obtained	(1) party or government organ, state-funded institutions, etc. (Article 1)
	(2) local financial departments (Article 2)
	(3) Big Four (Article 4)
Not permitted, Under any circumstances	(1) Policy banks (Article 3)
	(2) Branch of a financial institution (Article 9)
	(3) foreign-funded and Sino-foreign joint equity financial institutions and enterprises invest in Chinese-funded financial institutions (Article 12)
	(4) cross-investment between industrial and commercial enterprises/financial institutions, and between financial institutions through means of an exchange of shares (Article 13)

Source: Compiled by author

Notes:

1 All the articles above are by reference to "Provisional Regulations Concerning Investment in Financial Institutions Through Purchase of Shares"

2 Any investments in excess of 10 % of the capital funds of a financial institutions is subject to PBOC's prior approval. (Article 15; CBL Article 28)

The licensing requirements apply not only to the establishment but also to the closure of commercial banks. The PBOC sets out the following preconditions for closing financial institutions in its "Provisional Regulation on Financial Institutions." The PBOC will close an institution if:

It violates relevant laws, rules or policies stipulated by the authorities

It does not start to operate 90 days after the License For Legal Person and License For Operation of Financial Business have been granted

Its capital does not meet the minimum standards required by the central bank, or its management does not meet the “fit and proper” requirements of the central bank;

It has ceased operation for more than six consecutive months or cumulatively for more than one year

It merges with, or is acquired by, another financial institution

Its losses in each of the last three years have been more than 10 % of its capital, or accumulated losses have been more than 15 % of its capital

It does not make sufficient progress after failing to qualify in an annual review based on major financial statements, or fails to qualify for two successive years in annual examinations

It provides false information or behaves inappropriately during application for establishment

Other situations arise under which the central bank thinks the institution should be closed. For example, in practice, the PBOC will close a financial institution when any of the following three situations emerge:²²⁰ it has been continuously loss-making for several years; it is seriously insolvent, cannot meet maturing debts, and is bankrupt; it violates relevant rules or laws.

²²⁰ See BIS Policy Paper No6, “Bank Restructuring in Practice: an Overview” (August 1999)

(b) Business Scopes and Operational Restrictions

As soon as a domestic commercial bank is established under the PBOC's approval, it may undertake part or all of the traditional banking businesses recited in CBL Article 3, comprising deposits, loans, business relevant to bonds/government bonds, negotiable instruments business, foreign exchange business, and so on. Nevertheless, there are a number of prohibitions on commercial banking activities, which are supported by the government's policy to enforce the separation between the banking business and non-banking business to restrict and control the inadequate risk with which the banks may be confronted. First, commercial banks are not permitted to engage in trust investment or stock operation²²¹. Second, they are not allowed to invest in immovable property not for their own use.²²² Third, they are prohibited from investing in non-banking institutions or enterprises within PRC. If the investment is made prior to the implementation of CBL, the State Council shall formulate separate implementing procedures.²²³ For instance, it has been announced that the ICBC and CCB would convert their trusts and investment companies into bank branches.²²⁴

In addition, commercial banks must comply with a number of conditions in regards to the administration of their asset liability ratio:

- (i) The capital adequacy ratio must not be lower than 8 %;
- (ii) The ratio of the loan balance to the deposit balance must not exceed 75 %;
- (iii) The ratio of current asset to current liabilities must not be lower than 25 %;

²²¹ CBL, Article 43, para 1

²²² CBL, Article 43, para 1

²²³ CBL, Article 43, para 2

²²⁴ See Shanghai Securities News (October 19, 1995) (Chin)

- (iv) The ratio of loan exposure to single borrower to the balance of the total capital must not exceed 10 %;
- (v) Any other regulations relates to the administration of asset liability ratios. For example, "Administration of Asset Liability Ratio Conducted by the Commercial Banks"²²⁵ requires the commercial banks to submit to the following criteria: the ratio of medium/long-term loans (more than one year) to more than one year deposits must not exceed 120 %; the ratio of overdue loans to total loans must not exceed 8 %; the ratio of non-performing loans to total loans should not exceed 2 %; and so on.

(c) Provisions Relating to Making of Loans

CBL imposes a number of conditions on commercial banks when making loans. Article 36 of CBL provides that in every occasion that a bank grants a loan, a borrower must provide a guarantee or collateral. Apart from considering the creditworthiness of the borrower, the commercial bank must also examine the guarantor's ability to repay the loan, the ownership and value of any collateral and feasibility of realising mortgage or pledge rights. Where the commercial bank determines that the borrower is creditworthy and is able to repay the loans, the borrower is not required to provide a guarantee or collateral. In addition, to underscore the importance of consumer protection, a written contract is required and formalised. It should at least incorporate: (i) the types of loans; (ii) the purpose of loans; (iii) the amount of loans; (iv) the interest rate at which the loan is made; (v) the term of the loan; (vi) the methods of repayment; (vii) the liability for

²²⁵ PBOC, Administration of Asset-Liability Ratio Conducted by the Commercial Bank (February 15, 1994).

breach of contract as well as any other items the parties deem necessary.²²⁶

For the sake of credit risk management, commercial banks are prohibited from granting loans to connected persons. The term "connected persons" is broadly defined to include directors, supervisors, and their relatives, as well as companies and economic organisations in which the foregoing persons have either invested or held senior management positions.²²⁷

The promulgation of Lending General Provision (LG P)²²⁸ in July 1995 also contributes to regulating the lending activities. However, the provisions apply only to domestic commercial banks rather than foreign-funded commercial banks. To elgibly apply for a loan, a borrower must meet the following basic requirements²²⁹:

- (i) He is able to repay the principal plus interest according to the schedule;
- (ii) He has already repaid the interest on previous loans / due loans according to schedule;
- (iii) He must have passed the annual enterprise inspection by industrial and commercial department, unless he is a natural person;
- (iv) He has already opened a basic or an ordinary saving account;
- (v) In the case of an enterprise legal person, the total amount of his equity in third parties should not be exceed 50 % of net asset value;
- (vi) For medium- and long-term loans, the ownership interest of an enterprise legal person in a new project should not be less than 25 % of the total investment in such project;

²²⁶ CBL, Article 37

²²⁷ CBL, Article 40

²²⁸ Promulgated by the PBOC on, and effective as of July 27, 1995; both the text and the English translation are available in China. L & Practice, Nov.1, 1995, at 35-53

- (vii) For short-term loans, the amount of the increase in the current capital of an enterprise legal person should not be less than the amount of the increase in its current liabilities.

Article 21 of LG P imposes a number of restrictions on borrowers²³⁰, stating that borrowers may not obtain loans for the purposes of equity investment, speculation in negotiable securities, futures, real property, and seeking illegal profit or converting foreign exchange loans into RMB for use. Additionally, the loans of the same borrower should not be obtained from two or more branches of the same lender in the same area and at the same level. Any provision of false information, or withholding of major information about the financial status shall not be permitted.

The independence of commercial banks is further enhanced by the fact that no State units or individuals connected with such units are allowed to compel banks to grant loans or provide guarantees.²³¹ However, it does not indicate that the banking activities of commercial banks are entirely discharged from policy interference. As stipulated in CBL, Article 34, the lending activities shall be consistent with the development of the national economy and society, as well as under the guidance of State policies on industry.²³² Rather, in the case of state-owned commercial bank, they may be required to provide specific loans or guarantees under the advice of State Council.²³³ If any loss is generated from such loans, the State Council shall take appropriate remedial measures.

Nevertheless, the Asian Financial Crisis wholly demonstrated that the former reforms conducted in most Asian countries were inadequate, and a new and risk-based

²²⁹ LG P, Article 18

²³⁰ LGP, Article 21

²³¹ CBL, Article 41, para 1

²³² CBL, Article 34

supervisory system should be introduced. In 1998, China has taken an important step toward the recognition of a risk-based loan classification system, which follows Basel pronouncements of dividing NPLs into four categories: special mention, substandard, doubt, and loss²³⁴. The old system in China loosely classified loans as overdue (loans overdue up to 3 months), doubtful (loans overdue for more than 3 months but less than 24 months), and bad (loans overdue than 24 months). Under the system, undue loans could still be classified as “performing” even when the enterprises ceased operation due to the financial dilemma. No provisions were required to be made against the undue loans. With the implementation of the new classifications, banks were initially permitted to carry out more progressive provisioning against NPLs, and were required to make provision against a loan according to the category it is in. However, China has so far made no announcements of any detailed provisioning requirements that follow the new classification system while most of the Asian countries have already summarized some provisioning requirements in line with the Basel Principles. (Table 3.4)

Table 3.4 Summary of Provisioning Requirements in Asia

Loan Category	Singapore	Thailand	Korea	Indonesia	Philippines
General provision	Up to 3 % of total gross loans and investment portfolio				
Special mention	-----	-----	1 %	-----	-----
Substandard loans	10 %	15 %	20 %	10 %	25 %
Doubtful loans	50 %	100 %	75 %	50 %	50 %
Loss loans	100 %	100 %	100 %	100 %	100 %

•By reference to: BIS Policy Paper NO7, Strengthening the Banking System in China: Issues and Experience, at 97

²³³ CBL, Article 41, para 2

²³⁴ See supra note 207, BIS Policy Paper No 7, “Strengthening the Banking System in China: Issues and Experience,” at 96

(d) Evaluation

China did not introduce the Basel Principles to improve its banking supervisory regime until the promulgation of CBL in 1995. Its earlier compliance with the Basel Principles was focused on capital adequacy, and credit exposures to single borrower and related party. However, many domestic banking regulations are evaluated as unsafe and unsound because they are largely untouched by Basel Principles.

The failure to review the internal control system of the commercial bank prior to its establishment is regarded as a major deficiency in China's licensing process for the continuing commercialisation of Chinese banking industry. According to CBL Article 4, the commercial banks shall independently exercise autonomous management, bear risks, and assume responsibility for profits and losses. Therefore, adequate internal policies and decision-making procedures are crucial, and shall be applied as an entry threshold in a more risk-taking environment of banking activities.

Except the examination of internal control system, the licensing requirements, as well as closure requirements, are approximately consistent with the Basel Core Principles but to some extent less definite and objective. This is mainly because these requirements were first stipulated in 1994, and the PBOC lacks experience with licensing and closure under the jurisdiction of the old regime, which cannot fit into the rapid development of China's financial markets. The terms "relevant information" or "other documents and information as specified by the PBOC" reinforce the possibility of policy intervention and make the assessment of China's licensing requirements more puzzling.

Another major inadequacy in China's compliance with the Basel Principles is its failure to incorporate the concept of market risk. For example, although the current CBL

requires 8 % of the minimum capital adequacy ratio for conducting loan business, which is in consistent with the Basel Principles, the failure to incorporate a risk-based classification of capital still leads to capital inadequacy when operational loss occurs. Thus, it is necessary to strengthen the composition of both the core and supplementary capital, as well as to introduce the consideration of risk weight. Moreover, China applies numerous fixed asset ratios as prudential regulations to supervise the banking operation. These fixed asset ratios not only hinder the liquidity of banks by imposing an asset-led regime but also ignore the influence of market risk on different banks. Specifically, different banks with different financial structures may undertake different risks even if they grant loans to the same borrower under the same condition. The same banks may also face different risks if they grant loans to different borrowers, such as small enterprises or state-owned enterprises. Accordingly, to impose fixed asset ratios cannot reflect the real risk that banks are confronted with in China. Risk-based prudential regulations consistent with the Basel Principles should be introduced.

Finally, one crucial underlying weakness in China's banking regime has been political interference in bank credit decisions, and/or in the enforcement of prudential regulations. There are many ways in which government or political interference brought the banking system to their knees. Most commonly, governments leaned on banks, state-owned banks in particular, to grant loans to priority sectors or borrowers, not only directly undermining the banks' financial viability, but also eroding the banks' incentive and ability to carry out loan appraisal on a commercial basis. This is also the experience of China's banking system in the transition from centrally planned economy to market economy. Thus, easy loan classifications and provisioning standards, as well as the relatively weak supervision of borrower's creditworthiness, are designed to facilitate the

political interference.

2. Foreign Commercial Banks

(a) Licensing Requirements

Although the CBL fundamentally applies to all commercial banks within China, "Establishment of Foreign Investment Financial Institutions in PRC"(FIFI) requires additional criteria for the licensing and supervision of foreign commercial banks. According to FIFI, Article 6, certain capital requirements must be met. (Table 3.5)

Table 3.5 Capital Requirements for The Establishment of Commercial Banks

Domestic Commercial Bank	Minimum registered capital	Paid-up capital
Commercial Bank	RMB 1 billion	= registered capital
Urban Co-operative Commercial Bank	RMB 100 million	= registered capital
Rural Co-operative Commercial Bank	RMB 50 million	= registered capital
Foreign Commercial Bank	Minimum registered capital	Paid-up capital
Foreign Investment Bank/ Joint Venture Bank	RMB 300 million	Not less than 50% of the registered capital
Branch of Foreign Banks	RMB 100 million.(shall be allocated without consideration by its head office)	Not less than 50% of the registered capital

Source: Compiled by author

Besides the capital requirements, an applicant must²³⁵: (i) be a financial institutions; (ii) have had a representative office in PRC for not less than two years; (iii) have assets not less than US\$ 10 billion at the end of year prior to the application; (iv) the country or region where the applicant is located must have sound business administration. As to the establishment of foreign bank branch, the requirements are even more stringent in that the applicant must possess assets not less than US\$ 20 billion.²³⁶

Since possessing a representative office is the prerequisite of establishing a foreign commercial bank, one must first understand the licensing requirement of representative office.²³⁷ The first consideration relates to the standard of foreign commercial bank's home supervision. The regulation requires that the jurisdiction of the foreign financial institution must have a similar system of financial supervision and management. This would presumably allow the commercial banks from Basel members immediately to meet this requirement. The foreign commercial bank must be established with the approval of their home supervisory authority, or be a member of a trade association in the financial sectors within their home jurisdiction. In addition, the foreign commercial bank must have earned a profit from its last three years of business and have maintained a good reputation. However, one thing made clear under the regulation is that the representative office is not permitted to make any profit, or generating any income.²³⁸

²³⁵ FIFI, Article 6

²³⁶ FIFI, Article 7

²³⁷ Regulations on Management of Foreign Financial Institutions Resident Representative Offices in China (hereinafter FIRO) , Article5

(b) Business Scopes and Operational Restrictions

Compared with the domestic commercial banks, the business scope of foreign commercial banks are subject to more rigid restrictions in that they can only conduct foreign exchange business. (See Table 3.6) In addition, their clients are exclusively targeted at foreign investment enterprises, foreign nationals, and overseas Chinese and compatriots from Hong Kong, Macao, and Taiwan.²³⁹ RMB business in China is still out of the reach of foreign banks.

Moreover, applying certain provisions under the control of the PBOC further confines foreign participation of domestic banking markets:

- (i) It requires the establishment of deposit reserve fund at a PBOC branch. The level of the fund is to be determined at the discretion of the PBOC from time to time and no interest will be carried on that.²⁴⁰
- (ii) 30% of the working capital of a foreign bank branch must be in the form of interest-generating assets designated by PBOC, including deposits at a bank.²⁴¹
- (iii) The total assets shall not exceed 20 times the sum of the paid-up capital and reserves.²⁴²
- (iv) Loans to an enterprise and its affiliates shall not exceed 30 % of the sum of the paid-up capital and reserves, unless PBOC's approval is obtained.²⁴³
- (v) The total investment shall not exceed 30 % of the sum of the paid-up capital

²³⁸ FIRO, Article 12

²³⁹ FIFI, Article 19-21

²⁴⁰ FIFI, Article 23

²⁴¹ FIFI, Article 24

²⁴² FIFI, Article 25

and reserves, unless PBOC's approval is obtained.²⁴⁴

(vi) The fixed assets shall not exceed 40 % of the sum of the paid-up capital and reserves.²⁴⁵

(vii) The total deposits taken up in PBOC by a foreign financial institution should not exceed 40 % of its total assets.²⁴⁶

(viii) At least one senior Chinese citizen shall be employed at senior management level.²⁴⁷

Table 3.6 The Business Scope of Domestic/Foreign Commercial Banks

Domestic Commercial Banks (CBL, Article 3)	Foreign Commercial Bank (FIFI, Article 17)
(1) Taking deposits from the public	(1) foreign exchange deposits
(2) Granting short-term / medium-term / long-term loans	(2) foreign exchange loans
(3) Conducting domestic/ overseas settlements	(3) foreign exchange bill discount
(4) handling discounting of negotiable instruments	(4) approved foreign exchange investment
(5) issuing financial bonds	(5) foreign exchange remittance
(6) acting as agent to issue/honor/underwrite the government bonds	(6) foreign exchange guarantee
(7) buying/ selling government bonds	(7) import and export clearing
(8) engaging in interbank lending	(8) foreign exchange transactions
(9) buying/selling foreign exchange on its own behalf or as an agent	(9) acting as an agent for the exchange of foreign currencies/foreign exchange notes
(10) providing letter of credit services / guarantees	(10) acting as an agent for foreign credit card payments
(11) acting as an agent for the receipt/payment of money and as an insurance agent	(11) custody and safe deposit box services
(12) providing safe deposit box services	(12) credit investigation and advice
(13) other business approved by PBOC	(13) approved domestic currency business and other, foreign currency business

Source: Compiled by author.

²⁴³ FIFI, Article 26

²⁴⁴ FIFI, Article 27

²⁴⁵ FIFI, Article 24

²⁴⁶ FIFI, Article 30

²⁴⁷ FIFI, Article 33

(c) Evaluation

To pave its accession to the WTO, China has conducted several reforms to gradually remove both the licensing and operational restrictions on foreign banks. However, the achievements seem to be unsatisfactory in that, besides the restrictions on domestic banks, foreign banks remain subject to some discriminatory treatments.

As to the licensing requirements of foreign banks, it appears that they are subject to less stringent capital requirements for their establishment than domestic banks. However, foreign banks are also subject to PBOC's evaluation of their "contributions to China," but the criteria for these assessment lack transparency and often are politically motivated. Owing to the crucial role of these "unofficial" considerations, gaining the approval in China is still ambiguous and less straightforward. The unofficial considerations are the following²⁴⁸:

- (i) they are well-known and enjoy outstanding international reputation;
- (ii) they have demonstrated a commitment to China and are seeking to establish a long-term business relationship rather than securing short-term profits;
- (iii) they have established positive relationships with Chinese financial institutions through their commercial dealing, and from countries where Chinese financial institutions would like to develop a commercial presence;
- (iv) they have contributed to China's financial sector by supporting/offering training programs for Chinese regulatory officials and financial executives;

²⁴⁸ See supra note 63, Chia-Chi Jackie Lin, "Foreign Access to Banking Markets in China and Taiwan," at 1

- (v) they continued to deal with China following the Tiananmen Square incident.

Furthermore, the foreign banks are in a dilemma because of stringent operating requirements. (Table 3.7) For example, in order to engage in deposit business, foreign banks must keep two separate reserves (both in local and foreign currency) equal to 18 % of RMB deposits while domestic banks simply reserve 3-5 % of the deposits. Besides, FIFI also imposes additional restrictions on foreign banks by regulating the maximum of assets/deposits/investments/loans to the paid-up capital while CBL merely demands the domestic banks to comply with the asset-liability ratios, typically deemed as prudential measures to maintain financial stability. Under the GATS, Annex on Financial Services, governments are allowed to take prudential measures to supervise the foreign financial institutions for the considerations of depositors' protection and financial stability. However, the measures adopted by the Chinese government appear not to be for prudential reasons per se, but rather impede the broader and comprehensive foreign participation in local market.

Another issue of China's compliance with GATS principles is its violation of national treatment by binding the RMB transactions of foreign banks. Prior to 1999, although few foreign banks were entitled to conduct RMB business, they were subject to harsh geographic and operational requirements. In the mid-1999, PBOC announced the new relaxed restrictions²⁴⁹. These RMB operations will not only be expanded from Shanghai and Shenzhen to Jiangsu, Zhejiang, Guangdong, Guangxi and Hunan provinces, but will also relax the ratio of their RMB debts to foreign currency debts from 33% to 50%. Foreign banks will also be allowed to increase their RMB inter-bank loans, and borrow

²⁴⁹ Shanghai Securities News (Aug 5, 1999) (Chin)

RMB from Chinese financial institutions. The loans are limited to a term of one year. Notwithstanding the deregulation of the RMB transactions in 1999, foreign banks in China are so far subject to discriminatory treatment.

Table 3.7 Operational Restrictions on Domestic/ Foreign Commercial Banks

	Domestic Commercial Banks	Foreign Commercial Banks
Capital	<p>(1) Capital requirements for the establishment (Table 3.4)</p> <p>(2) Paid-up capital =registered capital</p> <p>(3) Capital adequacy must not lower than 8 % (CBL, art 39 (1))</p>	<p>(1) Capital requirements for the establishment (Table 3.4)</p> <p>(2) Paid-up capital shall be not less than 50 % of registered capital</p> <p>(3) If the total amount of paid-up capital and reserves is less than registered capital, 25 % of the after-tax profits should be withdrew every year until the difference is covered. (FIFI, art 32)</p>
Deposit Reserve	Place the deposit reserve (of between 3-5 %) with PBOC (CBL, art 32)	Place the deposit reserve with PBOC branch (including local and foreign currency reserves and is equal to 18 % of RMB deposits) (FIFI art 23)
Interest Rates	Commercial banks should determine within the upper and lower limits set up by PBOC (CBL, art 31)	Set by the PBOC (FIFI art 22)
Assets	<p>Has no limitations on total amount</p> <ul style="list-style-type: none"> the ratio of current asset to current liability must not lower than 25 % 	<p>(1) Total asset shall not exceed 20 times sum of paid-up capital and reserves (FIFI, art 25)</p> <p>(2) Fixed asset shall not exceed 40 % of paid-up capital and reserves (FIFI, art 28)</p> <p>(3) Ensure the liquidity of asset. (FIFI art 29)</p>
Deposits	No limitations	The total deposits taken up in PBOC by a foreign financial institution should not exceed 40 % of its total assets (FIFI, art 30)
Investments	No limitations	Total investment shall not exceed 30% of the paid-up capital and reserves (FIFI, art 27)
Loans	<p>(1) The ratios of loan to deposit shall not exceed 75 % (CBL, art 39 (2))</p> <p>(2) The ratio of loan exposure to single borrower to the balance of the total capital must not exceed 10 % (CBL, art 39 (4))</p>	Loans to an enterprise and its affiliates shall not exceed 30 % of the paid-up capital and reserves, except PBOC's approval is obtained (FIFI, art 26)

Source: Compiled by author

IV Moving Forwards: Challenges for China

China's bid for WTO has been the focus of world attention for a long time. In fact, China never wanted a completely open trade regime. Bureaucrats, whose interests depend upon their ability to regulate domestic and international transactions, benefit most from China's "mixed economy" and remain a powerful brake on the shift to a fully market-oriented system. However, powerful economic forces, typically the United States, push China towards decentralisation and liberalisation. Entry to the WTO has also forced the Chinese central government to push down the barriers of China's foreign trade regime, remove the excessive state control over markets, and pursue the "competitive advantages" to enable domestic economic activities to adjust to keen international competition.

China has successfully gone a step further to WTO membership since the U.S.-China Bilateral WTO Agreement was signed in Nov.11, 1999. Among 37 WTO Members expressing an interest in negotiating market-access in goods and services, China has concluded market-access accords with some 27 Members. Only 10 remain, specifically, the European Union, Costa Rica, Ecuador, Guatemala, the Kyrgyz Republic, Latvia, Malaysia, Mexico, Poland and Switzerland. Of these, several are close to technical completion. This marks a very major progress and demonstrates that China is currently entering the final phase of accession to WTO membership.

It is important to realize China's comprehensive obligation in the moment of accession, as well as after accession. The obligation under the GATS is constructed on MFN and national treatment but specifically subject to MFN exception list and sector-specific national schedules. Thus, the true obligation of China still depend upon its commitments in negotiations, and its ability and willingness to enforce the commitments.

Up to the present, China's commitments on banking sectors simply formalize the status quo. There is almost no further commitment except on the minimum capital requirements for establishing commercial presence. (See Table 3.8) Besides, some commitments are even less than the status quo (See Table 3.8.1), and many circumstances are left to be "unbound" to the GATS obligation.

Table 3.8 Summary of the Status Quo and the Current Commitments Made by China

Sector/Sub-sector	Modes of Supply	Limitations on Market Access	Limitations on National Treatment	Additional Commitment
Deposits; Lendings; and others	Cross Border	<i>Unbound</i>	<i>Unbound</i>	
	Consumption Aboard	<i>Unbound</i>	<i>Unbound</i>	
	Commercial Presence	<i>Limitations (Table 3.8.1)</i>	<i>Limitations (Table 3.8.1)</i>	
	Movement of Natural Person	<i>Unbound except Additionally indicated</i>	<i>Unbound except additionally indicated</i>	

Compile by Author: by reference to the "Evaluating Offers and Concessions in the Services Context", Taiwan's Council for Economic Planning and Development, 1998

Table 3.8.1 Summary of Limitations on Commercial Presence in China's National Schedule

Limitations on Market Access	Limitations on National Treatment
<p><i>Representative Office</i></p> <p>The establishment shall be approved by PBOC, and the business scope shall include consultancy, liaison, market surveys, and other non profit-making activities;</p> <p><i>Qualifications for Establishing a foreign banks</i></p> <p>(1)The investor shall be a financial institution</p> <p>(2)It shall have a representative office of <u>more than 3 years</u> in China (Status quo: <u>more than 2 years</u>)</p> <p>(3)It shall have total assets more than <u>20 billion USD</u> at the end of the year prior to application (Status quo: <u>10 billion USD</u>)</p>	<p><i>Requirements for Register Capital</i></p> <p>(1)Minimum Capital Requirement</p> <p>Foreign-funded Banks- <u>30 million USD</u> (approx. 248 million RMB)</p> <p>Foreign Bank Branches- <u>10 million USD</u> (approx. 82.7 million RMB)</p> <p>(Status quo Foreign Banks- <u>300 million RMB</u> Foreign Branches- <u>100 million RMB</u>)</p> <p>(2)Foreign Financial Institutions shall withdraw 25 % of the after-tax profits until the total amount of its paid-up capital and reserves is <u>twice its registered capital</u>. (Status quo: <u>equal to the registered capital</u>)</p> <p>(3)A foreign branch must keep <u>25 %</u> of its after-tax net profit in China (Status quo: <u>no limitations</u>)</p> <p><i>Other Regulations on Banking Activities</i></p> <p>(1)Loans to an enterprise and its affiliates shall not exceed 30 % of the paid-up capital and reserves, unless PBOC's approval is obtained. (Status quo- the same)</p> <p>(2)Total investment shall not exceed 30% of the paid-up capital and reserves. (Status quo: the same)</p> <p>(3)Total asset shall not exceed 20 times sum of paid-up capital and reserves (Status quo: the same)</p>

Compiled by Author: by reference to the "Evaluating Offers and Concessions in the Services Context", Taiwan's Council for Economic Planning and Development, 1998

Despite the unsatisfactory outcome of the initial commitments, China will continue to open up its banking market after accession to WTO. Taking the recent U.S-China Bilateral WTO Agreement as an example, several commitments are made to further liberalize the foreign access to Chinese banking market²⁵⁰:

China will grant full market access in five years for U.S.banks;

Foreign banks will be able to conduct local currency business with Chinese enterprises from 2 years after accession;

Foreign banks will be able to conduct local currency business with Chinese individuals from 5 years after accession;

Foreign banks will be subject to the same treatment as Chinese banks within designated geographic areas;

Both geographic and customer restrictions will be eliminated in 5 years;

Undoubtedly, China's direction toward opening will be irreversible once China has been brought into WTO. Although the financial crisis is not an inevitable consequence of liberalisation, it is true that keen competition following the liberalisation will ferment potential risk and indirectly lead to turmoil in the entire system. Thus, China shall conduct more financial reforms to make the domestic banks compete with foreign banks, as well as to create a safe and sound banking environment prior to further liberalisation.

It is true that China has made several crucial reforms in the past decade, especially the promulgation of PBOC Law and CBL, and measures taken to cope with the non-performing loans. It also closely cooperates with the Basel Committee and endeavours to

²⁵⁰Summary of U.S-China Bilateral WTO Agreement, Feb,2,2000, at

fit the Basel Principles into China's supervisory regime. However, it does not appear to achieve remarkable success partly due to China's inadequacy regards the "precondition for effective banking supervision" set in Basel Core Principles. The following will simply draw attention to some crucial unsoundness at macro-supervisory level in Chinese banking system.

First, transparency in China should be improved to permit market mechanisms to function fairly and efficiently, and to make sound banking supervision achievable. One supervisory lesson drawn from Japan and Korea during the Asian Financial Crisis is the inadequate transparency, which made the supervisory authorities unaware of the deteriorating banking operations until those banks went bankrupt. In China, the lack of transparency seems to be more aggravated than any other countries in Asia owing to its chronic centrally-planned economy. Thus, as is emphasized in both GATS and Basel principles, improving the transparency is the most urgent task. Three basic elements of transparency are internationally accepted accounting standards, sound disclosure requirements, and an independent audit system. In recent years, false statistics and financial reports are commonplace in China.²⁵¹ This makes it difficult not only for the supervisory authority to measure the real risk that a bank encounters, but also for the banks to assess the creditworthiness of their borrowers. China's requirement of well-defined and reliable accounting standards as the current accounting standards are not enough to ensure the stability of Chinese bank system and to make its regulatory regime internationally acceptable. In addition, although certain disclosure requirements for financial institutions have been formulated recently, only a few institutions publish their

<http://www.frc.com.cn/hot/wto/summary.htm>

²⁵¹ See supra note 182, Nicholas R. Lardt, China and the Asian Contagion, 32

fundamental indicators regularly, and the reliability and accuracy of the information disclosed by other institutions remain doubtful²⁵². Hence, adequate disclosure requirements should be established and enforced, and independent external auditing agencies can contribute to the improvement.

Another structural impediment to financial reform in China is the deficiency of a market-oriented credit culture with enhanced credit skills.²⁵³ In the past, managers at Chinese banks were not in a position to turn down loan request from SOEs, neither were they inclined to. They followed the central government's growth objective and Credit Plan instead of self-devised profitability targets. Even though the concept of commercialization was brought in 1994-1995, the lack of credit culture and qualified staff, combined with strong political interference, still made the implementation of new regime unpredictable. Over the years, either the supervisory body is unable to recruit the kind and number of staff it needs or it suffers a steady "brain drain". As a consequence, if it is impossible to remove excessive political interference in a short term, adequate resources should at least be arranged to train, pay, and provide sufficient technology for agency staff. No supervisory authority can be expected to perform to qualified international standards if it does not have adequate, properly trained human resources. To solve this problem, China will take, at a minimum, 5 years²⁵⁴.

Additionally, dealing with troubled SOBs in China was extremely complex because the root of the problems was the loss-making SOEs which have to be restructured. It will be impossible to improve the banks' asset quality and non-performing loan issues without reforming on the SOEs. In this regard, the failure of the past reforms is obvious

²⁵² See supra note 207, Strengthening the Banking System in China: Issues and Experience, at 191

²⁵³ See supra note 207, Strengthening the Banking System in China: Issues and Experience, at 323

owing that the reconstruction of SOEs is not highlighted. However, the treatment of SOEs in China will raise difficult political problems because some of the firms are big enough to affect entire segments of society. As a consequence, this will be a long-term process.

In spite of the many difficulties and inadequacies described above, prospects for China's banking market are still promising.²⁵⁵ China is such a giant economic entity that its astonishing amount of consumption and prosperous investment opportunity will steadily lure foreign capital to flow into China's domestic market. Additionally, China has three important advantages compared with other countries with severe problems, such as Russia, Japan and Indonesia.²⁵⁶ First, there is a clear and strong political will to solve the problems, and China's social and political system can guarantee that this political will is realized. However, it could be another case in Japan, where the strong public and media reaction against the use of the public funds led to the delays for controlling the turmoil. Second, the general public confidence in the China's financial market remains, while the people in Russia do not believe that their government will honour their deposits. This implicit government guarantee provides a crucial source of financial stability particularly in transition. Third, high saving and low national debt ratios make it easier for China than any other countries to absorb the cost of financial restructuring. In Indonesia, the cost of recapitalization of the banking system is estimated at about 30 % of GDP. It would be relatively difficult for Indonesia to raise such huge amount of funds, where capital flight is worse and interest rates are much higher than in

²⁵⁴ See, *supra* note 169, Song-Chi Wang, What Does WTO Bring for China's Financial Market?

²⁵⁵ See "How To Increase Foreign Bank Involvement In China's Domestic Currency Business?," (July, 9, 1999) at http://www.chinaonline.com/industry/financial/NewsArchive/Secure/1999/july/fn_b2_99052830s.asp

²⁵⁶ See *supra* note 207, Strengthening the Banking System in China: Issues and Experience, at 321-328

China.

To sum up, China should utilize its comparatively favourable environment to implement its reform programme in a decisive manner, and to succeed in solving its problems. With China's entry into WTO, the international community will persistently compel China to remove its discriminatory treatment on foreign banks and to provide comprehensive market access in China. In the meanwhile, China should give priority to upgrading its supervisory regime by reference to the Basel Principles, and to increase the independence, transparency, efficiency and quality of banking regulations.

Chapter Four The Banking Supervisory Regime in Taiwan

Taiwan has a complicated banking system resulting from its unusual history and political concerns. Since the mid-1980s, Taiwan has embarked on an ambitious program to liberalize and internationalize its financial markets. This financial reform, known as Taiwan's "Big Bang", represented a gradual departure from earlier practices that were characterized by direct control of domestic financial markets through state-owned financial institutions and by restricting foreign access to domestic markets. Presently, the banking operation in Taiwan is basically market-oriented but strongly subject to government's conservative policies. The following statistics demonstrate fruitful achievements of past reforms. By the end of 1999, 5,828 banking offices had been established throughout Taiwan. The total assets of local banks amounted to US \$ 608 billion. Total deposits accepted by local banks reached US \$ 429 billion and total loans extended by local banks was US \$400 billion. In addition, Taiwan also ranks 6th in the world for number of banks included in the top 500 banks in terms of total assets.

However, it is still uncertain to what extent the domestic banks in Taiwan can compete with those from other jurisdictions once more foreign participation is permitted in response to Taiwan's application to the WTO. It is also important to examine whether the current supervisory system is safe and sound enough to accommodate to highly volatile international circumstances and to fend off the international crisis.

I. Historical Review of Pre-crisis Banking Reform in Taiwan

A Emergence of Taiwan's Banking System: Banking Policies Applied Before 1989

Taiwan's conservative banking policies stemmed from the establishment of a predominately stated-owned banking system following the Japanese surrender in 1945.²⁵⁷ This, along with the financial crises in Mainland China after World War II (1941-1945) and the Chinese Civil War (1945-1949), compelled Taiwan to adopt conservative policies to ensure the safety and soundness of the financial system.

Japanese colonists introduced western-style banking infrastructure into Taiwan and made Taiwan the first modern banking system in CEA.²⁵⁸ In 1887, The Bank of Taiwan was established under Taiwanese Banking Law by the Japanese Parliament, and acted as a central bank in Taiwan. In addition to issuing currency and handling funds for the Japanese government, the Bank of Taiwan also commenced to provide commercial banking services in September 1899.²⁵⁹ By the eve of Japanese surrender in 1945, there were seven major banks operating in Taiwan. Five of them are Taiwan-based and remain a crucial force in the banking market. However, Japanese government also left Taiwan with a complicated, localized, and state-led banking system. The Japanese colonial authorities used the banking system as political instruments to promote Taiwan's land reform and to encourage agricultural development. The opportunities for Taiwanese people to run private banks were limited to a few who were close to the Japanese colonial government. Moreover, huge amounts of credit cooperative were established

²⁵⁷ See Robert F. Emery, "Post-war Financial Policies in Taiwan, China" (1984)

²⁵⁸ For more discussion of the Japanese occupation of Taiwan, see Kublin, "Taiwan's Japanese Interlude 1895-1945," (1973) *Taiwan in Modern Times* at 317-357

²⁵⁹ See Lai In-Jaw, "History of Taiwan Banking System", *Commonwealth*, 96, 99 (Aug. 1992) (Chin)

during the period of Japanese control. By 1934, there were 22 urban and 252 rural credit cooperative societies, consisting of approximately 295,600 members, with a total capital of approximately 19.597 million Japanese Yen, and loans of about 66.83 million Japanese Yen.²⁶⁰ Additionally, credit departments attached to agriculture or fishing associations and mutual loans and savings associations emerged and were authorized to take deposits and grant loans. Today, these entities remain active players in the fringe banking industry in Taiwan, and pose a potential risk to the entire financial system mostly due to the credit risk mismanagement, typically the large exposure to single borrower and connected lending.

Following the Japanese unconditional surrender in 1945, the Chinese Minister of Finance (MOF) promulgated the "Regulation Governing the Deposition of the Bank Notes and the Financial Institutions in the Taiwan Province" ("Deposition Regulation") on October 31, 1945 to reorganize the Taiwan's banks which had come into existence prior to 1945.²⁶¹ Under this provision, the financial institutions established by the Japanese government were to be taken over by the Chinese government.²⁶² The private financial institutions were liquidated, except those specially approved by the Chinese government. Although the Chinese government took control over the Japanese banking institutions, the Japanese influence in Taiwan's banking sector continued to prevail.

After the Chinese Civil War in 1949, the government of Kuomintang (KMT or Nationalist Party) retreated to Taiwan and continued to be known as the Republic of China (ROC).²⁶³ It was inevitable for Taiwan's government to permit the government-owned

²⁶⁰ See Kiwatna Ide, *Jih Chu Hsia Chih Tai Cheng* 143 (published by the Taiwanese Provincial Documentation Committee 1956) at 145

²⁶¹ See Central Bank of China, *Chin Jung Fa Kuei Ta Chuen*, 231 (1947) (Chin)

²⁶² Deposition Regulation, Art. 4

²⁶³ For more information of Taiwan's political history and the relation between PRC and ROC, see James C Hsiung, "The Paradox of Taiwan-Mainland China Relations", "The International Status of Taiwan in the

banks that formerly operated in Mainland China to be re-established in Taiwan to further stimulate the local economy. As a consequence, banks owned by the Japanese government and taken over by the Chinese government and the government-owned banks formerly established in Mainland China and reactivated later in Taiwan together constituted a strong government-owned banking system in Taiwan.²⁶⁴ In the mid-1960s, the number of head offices and branches of private banks represented only 2.7 % of the entirely banking industry in Taiwan.²⁶⁵ In addition, Taiwan's banking market at this stage was definitely state-led rather than market-oriented to facilitate the industrial development in Taiwan.

B The Big Bang: Taiwan's Banking Internationalization and Liberalization after 1989

In response to both internal and external pressures in pursuing financial liberalization and globalization, Taiwan's banking system has conducted significant reforms since 1989. The concrete measures adopted by the government included: (1) deregulation of interest rate and foreign exchange rate; (2) liberalization in the establishment of domestic/ foreign financial institutions; (3) enlargement of business scope and encouragement of financial innovation; and (4) internationalization of financial market.

(1) Deregulation of Interest Rate and Foreign Exchange Rate

During the period between 1940s and 1950s, interest rates were stringently controlled by the government, and used as a direct instrument to implement the national monetary

New World Order, Legal and Political Consideration" (Jean-Marie Henckaerts ed, 1996)

²⁶⁴ See Takeshi Ohta & Kuo-Shu Liang, "Banking Models and Operational Realities in Japan and Taiwan, International Banking Regulation and Supervision: Changes and Transformation in the 1990s" (Wu Nan Publisher 1994) (Chin)

policy.²⁶⁶ In 1975, the amendment of banking law promulgated that the interest rate ceiling of bank deposits should be prescribed by Central Bank of China (CBC) in Taiwan, and the range of top and bottom interest rates should be recommended by the Bankers Association to obtain the CBC's approval. The fluctuation of interest rates could be a bit more flexible than what is had been. Afterwards, a series of reforms targeted at the interest rate deregulation were conducted orderly and progressively according to market discipline. Ultimately, the restrictions on interest rates of bank loans and deposits were totally abolished pursuant to Article 41 of the Banking Law amendment promulgated in July 1989. Thus, interest rates are decided by the demand and supply of the market itself.

In addition, the regulation of the foreign exchange rate has also changed significantly. During the process of Taiwan's foreign exchange rate deregulation, the following three steps were utilized.²⁶⁷ First, a fixed rate system was applied during the 1960s and 1970s. Second, a floating rate system was put into practice in 1982 to make the representatives of CBC and five authorized foreign exchange banks negotiate the rate. Third, in 1982, the so-called central foreign exchange rate was replaced to allow banks to negotiate the rates with their customers according to the reference rate and be subject to certain limitation. In 1989, the daily fluctuation limit was abolished, and trading over US\$ 30,000 could be fully negotiated by banks and customers according to the market rate. In February 1992, however, was the reference exchange rate eliminated. As a consequence, banks had full discretion to negotiate the rate with their customers

²⁶⁵ See CBC, Yearbook of Business Summary for the Financial Institutions, 1966 (Chin)

²⁶⁶ For more deregulation of interest rates, see MOF, "Taiwan's Plans for Financial Modernization", (Address to the 10th International Conference of Banking Supervisors, 21-23 October, 1998)

²⁶⁷ See Lawrence S. Liu, "Creating an International Financial Centre: The Case of Taiwan, ROC", in Chia Jui Cheng, eds., International Banking Operations and Practices: Current Development (Graduate School of Soochow University, 1994) at 81-83,

based on the cost of capital and the demand and supply of foreign exchange.

(2) Liberalization in the Establishment of Financial Institutions

Foreign banks acted as the forerunners to speed up Taiwan's moving toward financial liberalization and internationalization. The establishment of the first foreign bank branch was in 1959 while no private domestic commercial banks have been permitted in the 40 years since 1949.²⁶⁸ The early permission to bring in the foreign bank branches served two purposes. Taiwan responded to the increasing pressure from the United States to open its doors to U.S.-based bank branches. In addition, the Taiwan government wanted to bypass the political pressure from the PRC after Taiwan withdrew from the United Nation in 1971, and endeavoured to have a foothold in international community via its impressive economic performance.

The foreign banking community in Taiwan continued to lobby the MOF, Taiwan's major banking supervisory agency, for a liberalized business environment. Thus, in response to fierce competition, as well as Taiwan's aspiration to become the Asian Pacific Regional Financial Center, the government undertook concrete measures to lift the long standing ban on the new establishment of financial institutions. In the 1991-1992 period, sixteen new private banks entered the banking market, and two trust companies were permitted to convert into commercial banks.²⁶⁹ This was deemed a milestone for privatizing the government-dominated banking industry. Moreover, to improve the capacity of these new commercial banks to compete with the government owned banks existing prior to 1992, MOF liberalized the restriction on setting up

²⁶⁸ See *supra* note 266, MOF, Taiwan's Plans for Financial Modernization, at 4

²⁶⁹ See Michael S. Bennett, "Unleashing a Tiger: Financial Deregulation in Taiwan" (1992) 11, UCLA

additional branch offices through the revision of the Regulation Governing the Establishment of Branch Offices by the Financial Institutions. MOF allowed the number of additional branches that may be established by each bank per year to increase from 2 to 3 in 1984, and, later in 1992, this restriction was further relaxed to increase from 3 to 5.

(3) Enlargement of Business Scope and Encouragement of Financial Innovation

The enlargement of the business scope has been the trend in the global financial markets to foster one-stop financial service suppliers for accommodating diversified financial service needs of modern customers. In response, the Banking Law was revised in 1989 to give the banking competent authority more discretion to approve the business scope of various banks. Simultaneously, the amended Banking Law also allows foreign commercial banks to engage in business activities previously performed simply by saving banks and trust and investment companies.²⁷⁰

(4) Internationalization of Financial Market

During the past decade, Taiwan has undertaken concrete measures to promote financial globalization. First, it implemented the policy to deregulate the entry restriction of foreign bank on a gradual basis, particularly after the GATS coming into existence in 1994. In accordance with the GATS, Taiwan significantly revised the "Guidelines for the Reviewing of Foreign Banks Applications for the Establishment of Branches and

Pac. Basin L. J. 1, at 19

Representative Offices” to comply with national treatment and allow the foreign banks to compete on an equal footing with domestic banks. Forty-three foreign banks were allowed to establish 72 branches, and 25 foreign banks were approved to establish representative offices at the end of June 1998.²⁷¹

Unlike the early admission of the foreign banks, the overseas establishment of Taiwanese banks is a relatively new phenomenon. In 1984, only three local banks set up 18 overseas establishments. In the same year, 30 foreign banks had branches in Taiwan.²⁷² There is an assumption that through the establishment of overseas offshoots, domestic banks may learn international financial experience, and cultivate and train international financial experts. Thus, the Taiwan government has actively inspired the domestic banks to establish 106 overseas branches, 44 representative offices and 10 subsidiaries.²⁷³

Additionally, to strike the balance between Taiwan’s target to promote Taipei as a regional financial center and the policy to maintain financial stability, Taiwan’s strategy is to keep the offshore and on-shore banking markets separate. Offshore market will enjoy full liberalization while on-shore or domestic markets will gradually liberalize.²⁷⁴ The separation of offshore and on-shore banking system reflects Taiwan’s conservative policies which are designed to protect the domestic banking system from the negative effect of off-shore volatility.

The Taiwan government promulgated the Offshore Banking Act (OBA) in 1983 to allow both local and foreign banks to establish an offshore banking unit (OBU) within its

²⁷⁰ Banking Law of the Republic of China, Art. 123 (1997)

²⁷¹ See Bureau of Monetary Affairs, ROC, “Financial Statistics Abstract”, (Aug 1999), at 9.

²⁷² See Bureau of Monetary Affairs, ROC, “The Modernization of the ROC Financial System,” by Tao-Shing Wang (1998), at www.boma.gov.ta/english/work/echo6.htm

²⁷³ See Bureau of Monetary Affairs, ROC, “Financial Statistics Abstract”, (Aug 1999), at 8

²⁷⁴ See Lawrence L.C. Lee, “Integration of International Banking Supervisory Standards: A Blueprint for

jurisdiction to operate the offshore banking business. In general, the operation of OBUs is exempted from the Banking Law of the ROC (NBL²⁷⁵), Act of Governing Foreign Exchange, and the Law of the Central Bank of China. Furthermore, on October 8, 1997, the amendment to the OBA permitted OBUs to accept not only foreign exchange deposits from the local residents but also to engage in full investment business.

C The Financial Institutions in Taiwan

The current financial institutions of Taiwan comprise (1) central bank, (2) deposit money banks which consist of the domestic banks, local branches of foreign banks, and community financial institutions, and (3) other financial institutions, such as investment and trust companies, securities companies, insurance companies and the postal saving system. (Table 4.1) In addition, Taiwan has four categories of domestic general commercial banks, including (1) banks established during the Japanese occupation of Taiwan from 1895 to 1945, (2) banks founded in Mainland China and re-established in Taiwan after 1949, (3) banks founded and established in Taiwan after 1949, and (4) new private commercial banks established after 1992.

the Taiwanese Banking System ,” (2000), 19 , Annual Review of Banking Law, 455, at 483

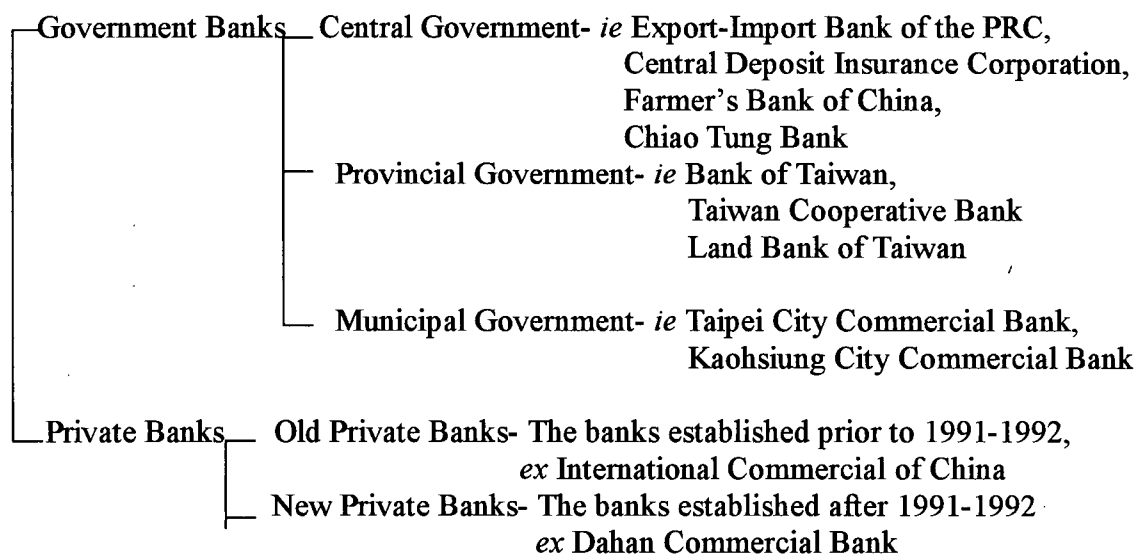
²⁷⁵ Hereinafter the NBL refers to the Banking Law of the ROC after 1989 amendment.

Table 4.1 Taiwan's Financial Institutions



Source: Financial Statistics Monthly, Taiwan District, ROC, Economic Research Department of the Central Bank of China in Taiwan, Aug 1998 at 3

Table 4.1.1 Classification of Domestic General Banks



Source: compiled by author

Note: Three government banks including First Commercial Bank, United World Chinese Commercial Bank and Chang-Huw Commercial Bank are excluded from the foregoing list of government banks because they were privatized in 1998.

Table 4.2 highlights the market share of different types of deposit money banks before the Asian Financial Crisis. Domestic banks had 47 head offices and 2,106 branches, which was equal around 58 % of the total number of deposit money banks and undertook more than 80% of total deposits/loans. Among these 80 % of deposits / loans business, 75 % were exclusively occupied by the state owned banks. However, it deserves to be mentioned that several significant state owned banks, including the First Commercial Bank, United World Chinese Commercial Bank and Chang-Huw Commercial Bank²⁷⁶, have been privatized in 1998 by releasing part of government-owned shares. Compared with the domestic banks, the foreign banks had almost the same number of head offices but were abated by the limited branches. The foreign banks in Taiwan carried only 2.5 % of deposits and 3.5 % of loans. Furthermore, the number of the community financial institutions appeared to be inconsistent with the amount of the deposits / loans they undertook. The community financial institutions possess 378 head offices and 1,496 branches that represented 39 % of the total number of the deposit money banks, but only took 17 % of total deposit and just 12.5 % of total loans.

²⁷⁶ These three banks are in turn the second, third, and fourth biggest commercial banks within Taiwan.

Table 4.2 Market Share of Deposit Money Banks (July, 1997)

	The Number of head offices/branches			Deposits (million NT\$)		Loans (million NT\$)	
	Head Offices	Branches					
Domestic Banks	47	2,106	58 %	11,249,765	81 %	10,554,386	84 %
Domestic General Banks	39	1,685	45 %	10,204,212	73 %	9,289,604	74 %
Medium Business Banks	8	491	13 %	1,009,553	8 %	1,265,182	10 %
Foreign Bank Branches	46	69	2 %	359,433	2 %	440,639	3.5%
Community Financial Institutions	378	1,496	39 %	2,438,581	17 %	1,579,710	12.5%
Credit cooperatives	64	505	13 %	1,090,015	8 %	739,606	5.8%
Credit Dept of Farmers & Fishermen Associations	314	991	26 %	1,348,566	9 %	840,104	6.7%
Total	416	3,741	100 %	14,047,779	100 %	12,538,735	100 %

Source: compiled by Author by reference to Financial Statistics Monthly, Taiwan District, ROC, Economic Research Department of the Central Bank of China in Taiwan, Aug 1998, at 24, 40, 62

II. Taiwan's Performance in the Asian Financial Crisis

Although Taiwan has experienced currency depreciation, rising interest rates, and falling stock prices like many other Asian countries, these problems have not crippled Taiwan's economy to the same extent. (See Table 4.3) Taiwan's real GDP growth rate for 1997 was 6.8 %, which was the second highest level for the 1990s, behind that for 1991 (7.6 %). However, due to the overwhelmingly weaker demand in Asian countries, which traditionally accounted for 50 % of Taiwan's export volume, exports for 1998 fell by 9.4 % as against the previous year. As a result, Taiwan's growth rate fell to only 4.83 %, a historical low since the end of the second oil shock in the early 1980s.

On the financial side, the exchange rate of the New Taiwan (NT) dollar remained stable against the US dollar until mid-October 1997. However, after the Central Bank of China (CBC) allowed the NT exchange rate to be mainly dominated by market forces on October 17, 1997, the NT dollar depreciated significantly. At the end of 1998, the NT\$/US\$ exchange rate stood at 32.216, reflecting a decline of 13.67 % since the start of the crisis in July 1997. The stock prices also witnessed some loss. From January to August 1997, local stock prices exhibited an upward trend. However, since the Asian Financial Crisis deepened at the end of August, the Taiwan Stock Exchange (TSE) markedly decreased to a low of 7,090 points at the end of October from a peak of 10,117 points in August. It had declined by as much as 30 % in just two months. The stock market resumed its bearish trend again from August 1998 until February 1999, when the index hit a low of 5,474 points, having fallen to about 60 % of its level in one year.

Table 4.3 Taiwan's overall Economic Performance: 1990-1998

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Nominal GDP(billion \$US)	160.17	179.37	212.15	222.60	240.99	260.18	272.31	283.32	261.59
Per capita GNP (\$US)	8,111	8,982	10,470	10,852	11,597	12,396	12,838	13,198	12,040
Real GDP(growth rate %)	5.39	7.55	6.76	6.32	6.54	6.03	5.67	6.77	4.83
CPI (growth rate %)	4.12	3.62	4.47	2.94	4.10	3.67	3.07	0.90	1.68
Unemployment rate (%)	1.67	1.51	1.51	1.45	1.56	1.79	2.60	2.72	2.69
Exchange rate (NT\$/US\$)	26.89	26.82	25.16	26.39	26.46	26.48	27.46	28.70	33.46
Stock Price Index	6775.3 2	4928.8 3	4271.6 3	4214.7 8	6252.9 9	5543.7 5	6003.7 2	8410.5 6	7713.9 7
Foreign Exchange Reserves (billions of \$US)	72.44	82.41	82.31	83.57	92.45	90.31	88.04	83.50	90.34

Source:(1) Financial Statistics Monthly, Taiwan District, ROC, Economic Research Department,

the Central Bank of China, various issues (1990-1998)

(2) Taiwan Statistical Data Book, Council for Economic Planning and Development, various issues

The slowdown in the overall economy in 1998, together with a depressed stock market and a bloated real estate market, eventually weakened the banking system in Taiwan. First, it provided a brake on the quick growth of deposit money bank since 1989. (See Table 4.4) The growth of domestic / foreign bank head offices and branches was retarded while some community financial institutions were liquidated or taken over by other financial institutions during the crisis. However, the number of domestic banks' overseas branches is still expanding. In addition, the average past-due loan ratio of

domestic banks rose gradually from 3.69 % in June 1997 to 4.36 % in December 1998, and further went up to 4.99 % in March 1999. The same ratio in relation to Taiwan's community financial institutions is currently greater than 10 %.

Table 4.4 Numbers of Financial Institutions Before / After the Asian Financial Crisis

	<u>Domestic Banks</u>		<u>Foreign Bank Branches</u>		<u>Community Financial Institutions</u>	
	Head offices	Branches	Head offices	Branches	Head offices	Branches
1989	24	953	33	38	381	1,043
1990	24	996	35	43	383	1,143
1991	25	1,046	36	47	385	1,210
1992	40	1,212	36	50	386	1,242
1993	41	1,382	37	53	386	1,304
1994	42	1,577	37	57	386	1,305
1995	42	1,807	38	58	385	1,486
1996	42	1,936	41	65	385	1,567
1997	47	2,176	46	69	378	1,496
1998	48	2,404	46	72	368	1,453
1999	51	2,558	43	72	365	1,434

Source: Financial Statistics Monthly, Taiwan District, ROC, Economic Research Department of the Central Bank of China in Taiwan, Aug 1998, at 24-25

Table 4.5 Overseas Offices and Branches of Domestic Banks Before / After the Asian Crisis

	Grand Total	North America	Central America	Europe	Asia
1992	57	18	2	18	17
1993	70	24	3	19	22
1994	74	24	3	20	25
1995	82	25	3	20	32
1996	97	26	4	20	45
1997	130	39	4	20	64
1998	148	43	4	20	77
1999	150	44	4	19	78

Source: Financial Statistics Monthly, Taiwan District, ROC, Economic Research Department of the Central Bank of China in Taiwan, Aug 1998, at 26-28

Taiwan has been relatively immune to the contagion from the crisis partly due to its robust economic fundamentals. As the manufacturing sector in Taiwan is mainly made up of small and medium-sized firms, its resilience and ability to adapt to the changing

environment have made it capable to respond to external shocks quickly. Efforts by both the government and the private sector in research and development since the early 1990s have also contributed to setting up Taiwan as the Technology Island. During the past decades, the ratio of high-tech exports to total exports increased from 30.0 % in 1987 to 48.6 % in 1997. The competitive edge, along with low inflation, has helped sustain high economic growth and trade surpluses. The huge foreign exchange reserves built up over the years enabled Taiwan to weather the Asian Financial Crisis. (Table 4.3)

In addition, limited foreign debt is also an important indicator of Taiwan's strength during the crisis. Unlike other Asian countries such as Thailand and Indonesia, the Taiwan government's foreign debt is less than US \$ 0.1 billion, and Taiwan's enterprises do not rely on foreign-debt financing either. At the end of June 1997, foreign assets held by non-bank private sector exceed its foreign liabilities by around US \$ 60 billion, and the bank's foreign assets and foreign liabilities were almost equivalent.²⁷⁷

Although Taiwan remains relatively unscathed in the Asian Financial Crisis, some structural weaknesses inherent in the domestic economic and financial sectors have been exposed during the crisis. These include the inadequacy of financial transparency, especially in corporate disclosure, loopholes in the supervisory structure due to the multi-supervisors and the disregard of risk management, and shrinking profit margins of banks owing to overbanking. To deal with these long-term issues, a thorough structural reform should be designed urgently.

²⁷⁷ See Jia-Dong Shea & Tsuen-Hua Shih, "Taiwan's Financial Policies in Response to the Asian Financial Crisis," (June 1999) Annual Report of Central Bank of China (Chin) at 18-20

III Regulatory Framework of Taiwan's Post-Crisis Banking System

A. Macro-control of the Commercial Banks

1. The Role of the State

The Taiwan government has taken strong command and control of the banking sector since 1949. This conservative attitude derives mainly from the painful memory of the hyperinflation caused by the Chinese Civil War in the late 1940s, combined with the shortage of foreign exchange during the early period of Taiwan's economic development. In addition, owing to Taiwan's ambiguous international status and China's military threat, it seems that the only way for Taiwan to survive in the international community is to pursue prosperous and stable economic growth. Thus, the government is reluctant to sacrifice its control of the banking sector, which has traditionally been used to support the economic policy of promoting the export-led manufacturing sector.

The role of government intervention shall be considered in two ways. First, the MOF has great authority to promulgate regulations governing the banking activities. Compared with other fields of law in Taiwan, banking law is relatively general and vague. In most cases, it needs to be supplemented by delegated legislation. It is controversial that some important restrictions, such as minimum capital requirement, are promulgated by MOF, which is a subordinate of the Executive Yuan, rather than the Legislative Yuan. Moreover, where a banking law or regulation is not clear, the implication is that the relevant institution would not have the legal authority to engage in a particular conduct.²⁷⁸ Thus, any new product or service shall be pre-approved by the government in

²⁷⁸ See Lawrence. S. Liu, "Law and Political Economy of Capital Market Regulation in the Republic of China on Taiwan" (1997) 28, *Law and Policy in International Business*, 813, at 847

a time-consuming administrative evaluation process.

Second, government intervention sometimes operates outside the legal regime governing the banking activities. For instance, a number of enterprises encountered financial difficulties due to their misconduct in fund management in August 1998. To prevent financial markets from being unduly upset by these events, the MOF required banks to allow for a six-month extension on loans due from companies that were operating normally. Moreover, the CBC also teamed up with the MOF to use "moral suasion" to encourage local banks to continue to lend to normally-operating enterprises which were facing temporary cash-flow difficulties.²⁷⁹ Although such "moral suasion" is not a law or even a government guideline, it is commonplace in Taiwan and always has de facto binding effect on its targets.

It seems that government intervention in Taiwan's banking regime will continue for some time owing to the supports of bureaucrats and vested interests. Furthermore, the tension between China and Taiwan highlights the crucial role that the government can play to maintain the public confidence. However, unlike China, Taiwan government possesses few resources to resist external pressure from international community, particularly the United States.. Thus, Taiwan's economy will drive in directions set by its government but will be subject to significant external pressure.

²⁷⁹ See supra note 277, Jia-Dong Shea & Tsuen-Hua Shih, "Taiwan's Financial Policies in Response to the

2 Multi – Agency Supervisory System

Under the current regime, the agencies entitled by law to carry out financial examination in Taiwan include the Minister of Finance (MOF), Central Bank of China (CBC), and Central Deposit Insurance Corporation (CDIC). Although the MOF is the central competent authority under the NBL²⁸⁰, it did not have its own banking examiners until 1992. The CBC had been delegated to examine all financial institutions prior to that date. The allocation of supervisory authorities has been under fierce debate between the MOF and CBC from 1991 to 1992. Eventually, the Executive Yuan made a compromise by passing a regulation entitled the “Plan for Allocation of Powers for Financial Business Examination” (“the Allocation Plan”) on October 9, 1992.

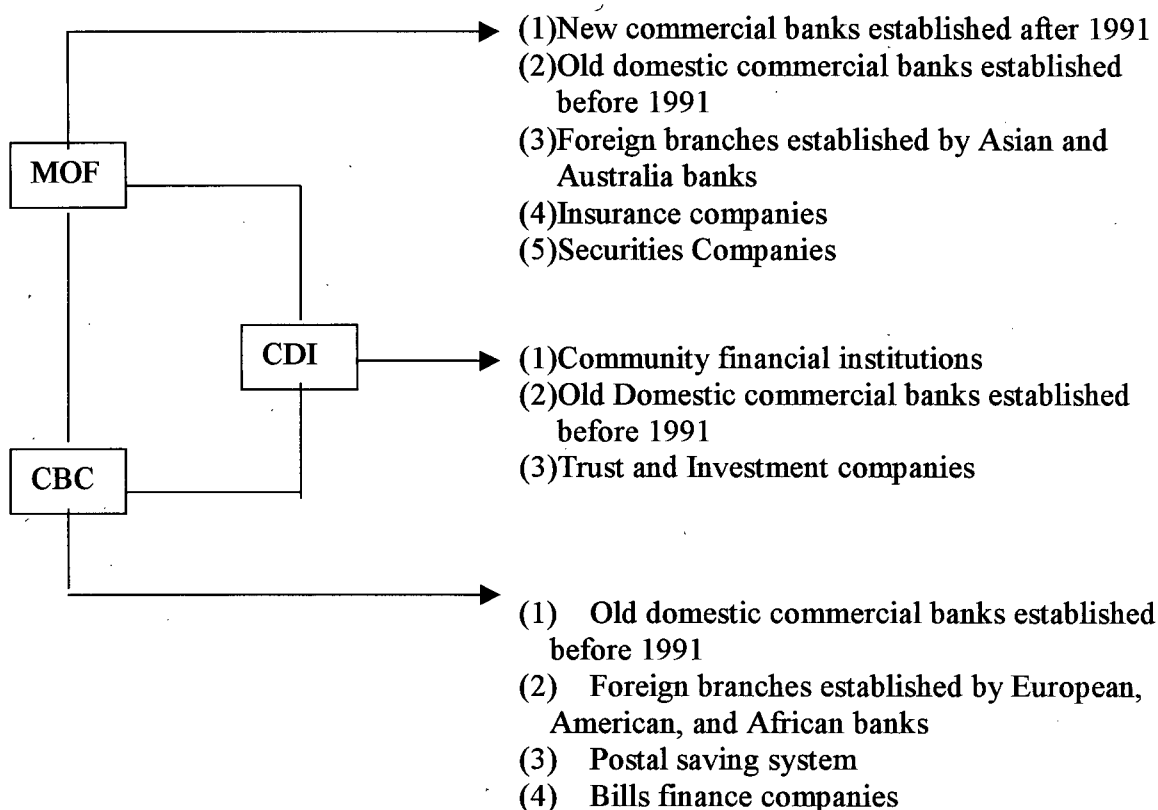
According to the Allocation Plan, the foregoing three agencies divide the duties of financial examination roughly by the type of financial institutions. (Table 4.6) The CBC examines all but three domestic banks established before 1991, the foreign branches from Europe, America, and Africa, as well as all bill finance companies. The MOF examines all new commercial banks established after 1991, three old domestic banks²⁸¹ not examined by the CBC, foreign branches established by Asian and Australian banks, trust and investment corporations, as well as insurance and securities companies. The CDIC examines the insured financial institutions (including credit co-operative associations, and the credit department of the farmers’ and fishermen’s associations) and the remaining financial institutions under the supervision of the MOF.

Asian Financial Crisis”, at 15-16

²⁸⁰ NBL, Article 19

²⁸¹ Three domestic banks examined by the MOF are the Farmer’s Bank of China, the Chang Hwa Commercial Bank and the Taiwan Enterprise Bank. They are owned by the state and the former two banks rank within top 10 banks in Taiwan.

Table 4.6 Taiwan's Banking Supervisory Authorities



Source: Hu Dong-Qing, "Financial Supervision and Examination", 3d ed, (Taiwan Academy of Banking and Finance 1997) at 26-27

Notes: Under the Allocation Plan, the MOF and the CBC undertake the responsibilities of financial examination independently while the CDIC is required to perform the financial examination under the supervision of the MOF.

Taiwan's multi-agency supervisory framework makes it difficult to maintain the consistency of policies, as well as lead to unequal treatment to financial institutions because various supervisory agencies may apply divergent standards of financial examination. In addition, it does not abide by the consolidated supervision in Basel Principles. Consolidated supervision requires all criteria and information relevant to banking supervision to be managed on a consolidated basis. However, the licensing and supervisory authorities are different in Taiwan and, thus, criteria for issuing licenses are

sometimes inconsistent with those applied in ongoing supervision. It not only creates an administrative grey area that obstructs banking supervision but also inhibits the ability of the Taiwanese government to timely and efficiently cope with financial scandals.

As a consequence, the urgent challenge for Taiwan's banking regulators is to improve financial supervision by unifying the three financial supervisory agencies into a solitary regulatory authority.²⁸² The proposal presented in 1997 by the Executive Yuan is to organize a supreme financial supervisory agency, the Department of Financial Supervision, to supervise all of the banking, securities, and insurance operations on a consolidated basis under the MOF. This restructuring will be complex but crucial to Taiwan because unified supervision is essential to enforce the remaining prudential regulations cited in Basel Principles, as well as to fulfil Taiwan's target to become a regional financial center.

²⁸² See Patrick C.J. Liang, "The Role of Financial Sector in Industrial Upgrading in Taiwan", (1997) 19 Central Banking of China's Quarterly 19 (Chin)

B Micro-control of the Commercial Banks

It happened that several significant regulations governing the operation of commercial banks have been amended or promulgated before/after the Asian Financial Crisis. First, "Guidelines for the Reviewing of Foreign Bank's Applications for the Establishment of Branches and Representatives Offices" has been amended to respond to Taiwan's application for WTO membership in March 1997, just few months before the eruption of Asian Financial Crisis. Second, the legal regime of offshore banking operation has also emerged with the promulgation of three important regulations. They are "Statute for Offshore Banking Operations" (amended in October 1997), "Administrative Rules for Offshore Banking Branches" (promulgated in March 1999), and "Enforcement Rules of the Statute for Offshore Banking Operations" (amended in March 1999). Third, the amendment of the NBL in October 2000 is probably the most notable and substantive amendment regards to the domestic commercial banks. Of all the 140 Articles in the NBL, 13 articles were deleted, 33 articles were amended and 29 articles were added. A summary and underlying purposes of the latest amendment in 2000 are compiled in Table 4.7.

Table 4.7 A Summary of the Amendment of NBL in October 2000

Purposes	Specific Example
1 strengthen the banking system and improve the efficiency of banking operation	(1) delete the chapter of saving activities (Art 77 - 86) relax the limitations on the ownership controlled by the single person or the same concerned party (Art 25)
2 broaden the business scopes and promote → financial liberalization <i>consistent with the GATS : Progressive Liberalization</i> (Although this amendment will not have direct impact on foreign banks, they will indirectly benefit because sometimes the operation of foreign banks will also subject to the limitation on domestic market.)	(1) permit the commercial banks to issue financial bonds (Art 72-1) (2) relax the limitations on bank's investment in real estate /trust and securities activities (Article 72-2, 74, 75, 76)
3 improve the supervisory authority to deal with the problematic financial institutions → <i>consistent with Basel Core Principles: Principles 22</i>	(1) illustrate the possible supervisory measures that the central competent authority can take to bring about timely corrective action (Article 61-1, 62-1 to 62-9)
4 improve the regulations of extending loans to single person and interested party → <i>consistent with Basel Core Principles: Principles 9, 10</i>	(1) Incorporate the same affiliated companies into NBL (Art 33-3, 33-5) (2) increase the relevant penalty (Art 125 to 136)

Compiled by author

1 Domestic Commercial Banks

(a) Licensing Requirements

Under Article 52 (2) of NBL, the MOF is entitled to determine the criteria for entry into the banking industry, and, therefore, the "Criteria Governing the Establishment of Commercial Banks" (hereinafter New Banking Criteria) was promulgated in April 1990.

There are several paramount features in New Banking Criteria. First, the minimum paid-up capital of a new commercial bank shall be 10 billion New Taiwan Dollar (NT dollar), which must be fully subscribed at the moment of the new bank's incorporation. Of this amount, the promoters must provide 80 percent in cash within 2 months after the MOF's approval of the bank.²⁸³ The other 20 percent shall be funded through the general public at the same price and under the same terms and conditions²⁸⁴, and no individual shareholder may own more than 10,000 shares.²⁸⁵ In order to screen against frivolous applications, the MOF requires the promoters to provide a minimum amount of 2 billion NTD upon filing an application.²⁸⁶ This amount of money is reckoned as a deposit that cannot be utilized before the bank begins to operate, unless it is used as liquidity reserve set up by the CBC, or to purchase fixed assets necessary for the business operations of the banks.²⁸⁷ In addition, the qualifications for the promoters and senior managers must be identified as well. To be qualified as a promoter or a senior manager, one must have no record of criminal activities or adverse regulatory judgements listed in New Banking Criteria Article 4. The level of education and the relevant working experience are also highlighted to meet the fit and proper test of Basel Core Principles.

To establish a local branch, the domestic bank must file the application to the MOF pursuant to the "Provisions Governing the Establishment, Relocation, and Closure of the Domestic Bank Branches."²⁸⁸ The MOF shall not permit any bank to establish more than 5 branches per year unless it operates efficiently, safely and soundly, and consistent with

²⁸³ New Bank Criteria, Art. 2 (1) and Art. 15

²⁸⁴ New Bank Criteria, Art. 2 (2)

²⁸⁵ New Bank Criteria, Art. 2 (3)

²⁸⁶ New Bank Criteria, Art. 11 (6)

²⁸⁷ New Bank Criteria, Art. 13

²⁸⁸ "Provisions Governing the Establishment, Relocation, and Closure of the Domestic Bank Branches", MOF, April 13, 1995

the national financial policies.²⁸⁹ The application for establishing the branches will be rejected or restricted if (i) the bank itself or the person in charge has transgressed the financial regulations or engaged in financial fraudulence activities within one year; (ii) the bank was subject to losses in the last fiscal year or its capital adequacy ratio is lower than 8 percent, or (3) the bank has an inadequate business plan or unqualified person in charge.²⁹⁰

The requirements for domestic banks to establish overseas branches are clarified in "Guidelines Governing the Establishment of Overseas Branches of Domestic Banks."²⁹¹ A bank whose operation is considered safe and sound under the current banking regime is eligible to run an overseas branch two years after its establishment of overseas department.²⁹² In order to fulfil the consolidated supervision in the Basel Core Principles, no overseas branches can be established without the prior consent of MOF,²⁹³ and internal auditing shall be conducted at least once a year while off-site supervision will be carried out every half a year.²⁹⁴ If the financial regulations and practices in host countries are incompatible with those in Taiwan, a subsequent report shall be filed to MOF.²⁹⁵

(b) Ownership Concentration

The regulations regards to the ownership concentration have been significantly amended in October 2000. Prior to this amendment, single person or enterprise can have

²⁸⁹ Provisions Governing the Establishment, Relocation, and Closure of the Domestic Bank Branches, Article 2 (1)

²⁹⁰ Provisions Governing the Establishment, Relocation, and Closure of the Domestic Bank Branches, Article 3 (2)

²⁹¹ Guidelines Governing the Establishment of Overseas Branches of Domestic Banks, MOF, Aug 23, 1995

²⁹² Guidelines Governing the Establishment of Overseas Branches of Domestic Banks, Art. 2

²⁹³ Guidelines Governing the Establishment of Overseas Branches of Domestic Banks, Art. 5

²⁹⁴ Guidelines Governing the Establishment of Overseas Branches of Domestic Banks, Art. 7 (4)

more than 5 % ownership of a bank, and the aggregate ownership of a bank by the same concerned party is limited to 15 % unless approved by the MOF.²⁹⁶ This requirement is more stringent than other countries following the Basel Principles.²⁹⁷ Another reason to relax the requirement is under the consideration that increasing the shares of major shareholders will benefit the banking operation by strengthening the common interest of the bank and major shareholders.

The latest amendment of the NBL requires that the single person or the same concerned party shall notice the bank and get the MOF's post-approval, if they have more than 15% ownership of a bank. The maximum ownership of a bank by the single person or the same concerned party is limited to 25% unless those shares are hold by the government or are essential to deal with problem financial institutions.²⁹⁸ The term "same person" includes both the natural person and legal person and the term "the same concerned party" refers to the principal, his/her spouse, blood relatives within second degree, and the enterprises of which the principal or his/her spouse is the responsible person.²⁹⁹

(c) Business Scope and Operational Restrictions

The NBL divides the banking services into three categories: (1) commercial banking, whose principal functions are to accept short-term/medium-term deposits and extend

²⁹⁵ Guidelines Governing the Establishment of Overseas Branches of Domestic Banks, Art. 7 (2)

²⁹⁶ 1992 NBL, Art. 25 (1)

²⁹⁷ Although the Basel Principles do not give clear definition of the "major shareholder," the countries in which Basel Principles strictly followed usually define the major shareholder as person holding 10% or more of a bank's equity capital. Thus, the 5% requirement of the same person holding the capital in 1992NBL is somewhat strict.

²⁹⁸ NBL, Art 25 (2) (3)

²⁹⁹ NBL, Art. 25 (4)

short-term/medium-term loans³⁰⁰; (2) trust and investment banking, whose principal functions are to manage and administer trust funds and property pursuant to specific trust arrangements, and to make investment for clients as intermediaries in the capital market³⁰¹; and (3) specialized banking, whose principal functions are to provide medium- and long-term lending to specific type of borrowers.³⁰² In contrast to the earlier legislation, the chapter of saving banking is completely deleted because there is no bank which exclusively conducts saving banking activities since the chapter was first introduced into the NBL in July 1976.

It is true that different types of banks have different scope of business (See Table 4.8). However, this segmentation is more apparent than real since the NBL permits cross-financial segment business opportunities. That is, a bank with a license to specialize in one type of banking activities can provide other financial products in NBL or non-NBL segments. For instance, under the NBL, the commercial and specialized banks may independently conduct trust and securities activities³⁰³, while trust and investment companies and specialized banks cannot engage in commercial banking activities³⁰⁴. Consequently, while compared with the restricted business scope of other types of banks, commercial banks are eligible to provide a wide range of businesses, which are almost as extensive as universal banking (See Table 4.9).

³⁰⁰ NBL, Art 70. The short-term credit refers to the credit which matures within 1 year.

³⁰¹ NBL, Art 100

³⁰² NBL, Art 87

³⁰³ NBL, Art 28

³⁰⁴ NBL, Art 101

Table 4.8 Business Scope of Domestic Banks

Business Scope - Art 3	Commercial Banking-Art 71	Trust/Investment Co.-Art 101
1 accept checking deposits	1 accept checking deposits	
2 accept various kinds of other deposits	2 accept demand deposits 3 accept time deposits	
3 manage Trust Funds under mandate		6 accept / manage / employ various Trust Funds 7 publicly offer mutual Trust Funds
4 issue financing bonds	4 issue financing bonds	
5 extend loans	5 extend short-term, medium-term and long- term loans	1 extend medium-term and long-term loans
6 discount bills and notes	6 discount bills and notes	
7 invest in securities	7 invest in government bonds /short-term notes/ corporate bonds and stocks /financing bonds	2 invest in government bonds /short-term notes / corporate bonds/ financing bonds/ listed stocks
8 invest in productive enterprises		
9 invest in residential/commercial construction		
10 handle domestic /foreign remittances	8 handle domestic / foreign remittances	
11 accept commercial drafts	9 accept commercial drafts	
12 issue Letter of Credit	10 issue foreign / domestic Letter of Credit	
13 guarantee domestic /foreign transactions	11 guarantee issuance of corporate bonds 12 guarantee domestic / foreign transactions	3 guarantee issuance of corporate bonds 4 guarantee domestic / foreign transactions
14 act as collecting and paying agent	13 act as collecting and paying agent	
15 underwrite and trade in securities for its own account / customers		5 underwrite and trade in securities for its own account / customers
16 manage issuance of bonds/debentures and provide advisory services		9 act as trustee for issuance of bonds
17 act as attestor for the issuance of stocks / bonds /debentures		10 act as attestor for the issuance of bonds and stocks
18 manage various kinds of property under mandate		8 manage various kinds of property under mandate 12 act as executor of will and administrator of estate of deceased
19 conduct businesses related to investment and trusts regarding securities		
20 buy and sell gold and silver bars /coins or foreign currencies		
21 conduct warehousing /custody/agency services related to businesses above	14 act as agent to sell government bonds / treasury notes/ corporate bonds and	11 act as agent for issuance, registration and transfer of securities and distribution of

	stocks 15 conduct warehousing / custody / agency services related to businesses above	interest and dividends thereon 13 act as supervisor for the reorganization of companies 14 provide consulting services in connection with issuance and offering of securities, and engage in agency services related to the businesses above
22 other business may be authorized by central competent authority	16 other business may be authorized by central competent authority	15 other business may be authorized by central competent authority

Source: compiled by author

Table 4.9 Overview of Cross-Financial Segment Business

	Commercial Banking	Specialized Banking	Trust / Investment Activities
Commercial Banks		X	O
Specialized Banks	X		O
Trust / Investment Co.	X	X	

Source: compiled by authors

Notwithstanding the extensive business scope, there are a number of operational prohibitions on commercial banking. Under the current NBL, the main capital source of commercial banks is short-term and medium-term deposit, such as checking deposits and demand deposits. Therefore, to ensure asset liquidity and to manage the operational risk resulting from the employment of short-term/medium-term capital to long-term investment, the following restrictions target longer-term investment of commercial banks, typically the investment on real estate and relevant transactions.

- i. Banks may extend medium- or long-term loans for the purchase of residential / commercial construction. However, the term of such loans shall not exceed 30

years.³⁰⁵

- ii.* The total amount of medium-term loans extended by a commercial bank shall not exceed the total amount of its Time Deposits.³⁰⁶
- iii.* Repayment of principal on the financial bonds issued by a commercial bank shall begin not less than 2 years after the date of issuance.³⁰⁷
- iv.* The total amount of loans extended for residential/commercial construction by a commercial bank shall not exceed 30% of the aggregate of such bank's deposits and financing bonds issued at the time such loans are extended. However, housing loans extended according to government's preferential policies are excluded. For example, housing loans approved by the Central Competent Authority for the encouragement of savings to purchase private homes shall not be included in such limitation.³⁰⁸
- v.* A commercial bank is eligible to invest in both financial and non-financial activities, if MOF's prior approval is obtained. The total amount of the investment cannot exceed 40% of its paid-in capital from which the accumulated loss is deducted. In addition, a commercial bank cannot invest in more than one financial institution unless the investment is approved by the MOF. If the investment is made in non-financial activities, the total amount of the investment shall not exceed 10% of the bank's paid-in capital from which the accumulated loss is deducted, and shall not exceed 5% of paid-in capital of the non-financial enterprise which has been invested. A commercial bank is not permitted to

³⁰⁵ NBL, Art 38.

³⁰⁶ NBL, Art 72

³⁰⁷ NBL, Art 72-1

³⁰⁸ NBL, Art 72-2

engage in the operation of the non-financial enterprises. ³⁰⁹

- vi.* A commercial bank must ensure that the total amount of the investment in real estate for its own use shall not exceed its net worth when the investment is made. However, in the case of warehousing for business use, the amount of the investment in warehousing shall not exceed 5 % of the total amount of its commercial bank deposits when the investment is made.³¹⁰
- vii.* A commercial bank is not permitted to invest in real estate that is not for its own use unless the major part of that real estate is used by the bank, or will be used in a short period. Total amount of such investment cannot exceed 20% of the bank's net worth, and cannot exceed the net worth of the real estate when combined with the investment in real estate for the bank's own use.³¹¹
- viii.* Real estate and stock acquired by a commercial bank through the foreclosure of mortgages or pledges shall be disposed of within 4 year from the date of acquisition unless provisions listed in *v*, *vi* and *vii* are followed.³¹²

Another series of prudential regulation relate to the capital, as well as deposit reserve. Traditionally, Taiwan held a conservative attitude towards banking services in the process of pursuing financial liberalization and internationalization. Even though several significant reforms towards liberalization have been conducted under external pressure in the past decade, the government still relies heavily on prudential measures to manage capital and reserve in consistent with. These operational restrictions include:

³⁰⁹ NBL, Art 74 (1) (2) (3)

³¹⁰ NBL, Art 75 (1)

- i.* The ratio of a bank's capital to its risk-weighted assets shall not be less than 8 %, unless otherwise approved by the MOF. If the ratio is below 8 %, the MOF may forbid such bank to distribute dividends.³¹³
- ii.* To maintain adequate liquidity, the CBC, after consulting with MOF, may from time to time prescribe a minimum ratio of current assets to various liabilities.³¹⁴ If a bank fails to comply with the minimum ratio, the MOF shall notify the bank to make due adjustment within a specified period of time.
- iii.* A bank is required to set aside 30 % of after-tax profits as legal reserve, and distribute as cash dividends no more than 15 % of its total paid-in capital unless such legal reserve equals or exceeds its total paid-in capital. In addition, a bank has an option to set aside a special surplus reserve in accordance with its Articles or a resolution of its shareholders.³¹⁵
- iv.* A bank shall provide reserve for different types of deposits in accordance with the reserve rates prescribed by the CBC.³¹⁶ Table 4.10 enumerates the range of deposit reserve rates after 1975. Within the range, the CBC is eligible to determine the rate based on the total deposits of each day.

Table 4.10 The Range of Deposit Reserve Rate (set by the CBC)

	Range of Deposit Reserve Rate
Checking Deposits	15 % - 40 %
Demand Deposits	10 % - 35 %
Savings Deposits	5 % - 20 %
Term Deposits	7 % - 25 %

Source: The MOF, Financial Supervision and Examination (Sep. 1997) at 58

³¹¹ NBL, Art 75 (2) (3)

³¹² NBL, Art 76

³¹³ NBL, Art. 44

³¹⁴ NBL, Art. 43

³¹⁵ NBL, Art. 50 (1) (2) (3)

³¹⁶ NBL, Art. 42 (1)

(d) Provisions Relating to Making of Loans

In the past decade, Taiwan has stressed the restrictions on granting loans to related parties and single borrower. First, the NBL requires that a bank shall not extend unsecured loans³¹⁷ to enterprises in which the bank holds 3 % or more of the total paid-in capital, to its staff members, to its major shareholders³¹⁸, and to any interested party of its own responsible person or of a staff in charge of credit extension.³¹⁹ The “interested party” has been clearly defined to include spouse, close relatives, and enterprises, who are invested or managed by insider, senior managers, major shareholders and their spouse or close relatives.³²⁰ However, the foregoing prohibition shall not apply to consumer loans and loans extended to the government. In the case of secured loans, if the credit amount exceeds the amount prescribed by the MOF, a bank needs concurrence of at least three-quarters of all of such bank’s directors present at a meeting attended by at least two-thirds of the directors to extend such credit.³²¹ The terms of such loans shall not be more favourable than those terms offered to other same category customers. Moreover, total lending to all insiders and interested parties cannot exceed 1.5 times a bank’s net value.³²²

The MOF also imposes amount restrictions on extending the credit to the same person and the same concerned party (Table 4.11). The definition of “the same person” and “the same concerned party” shall be in consistence with NBL, Art. 25 (2). Additionally, restrictions on extending loans to the same affiliated companies are for the

³¹⁷ Unsecured loan means a credit extend without having obtained any collateral. (NBL, Art. 13)

³¹⁸ Major shareholder refers to a shareholder who owns at least 1 % of the total issued share of the bank (NBL, Art. 32 (3))

³¹⁹ NBL, Art. 32 (1)

³²⁰ NBL, Art. 33-1 (1)-(5)

³²¹ NBL, Art. 33 (1)

³²² See The MOF, Regulation on Lending Ceiling, Aggregate amount, Terms, and Conditions to the

first time incorporated into the NBL under the impact of Basel Principles.³²³ The term “affiliated companies” is based on the definition provided in the Corporation Law.³²⁴

Table 4.11 Restrictions on Credit Exposures to The Same Person / The Same Concerned Party

	Limitations on the Total Amount of Secured Loans	Limitations on the Total Amount of Unsecured Loans
The Same Natural Person	3 % of bank's net value	1 % of bank's net value
The Same Legal Person	15 % of bank's net value	5 % of bank's net value
The Same Concerned Party	40 % of bank's net value	10 % of bank's net value
The Same Concerned Party (Natural Person)	60 % of bank's net value	2 % of bank's net value
State Owned Enterprises	100 % of bank's net value	100 % of bank's net value

Source: The MOF, Restrictions on Credit Exposures to the Same Person and the Same Concerned Party, Tai-Ts'ai-Jung-Tsu No. 821153840 (released on Sep 22, 1993)

(e) Evaluation

Since 1990, Taiwan has already incorporated much of Basel Principles into its banking guidelines. Although Taiwan is not a member of the Basel Committee, Taiwan's banking authority has participated in the conferences held by the committee and Taiwanese legislature has partly adopted the Basel Principles as laws or administrative guidelines. Among the regulations affected by the Basel Principles are those concerning licensing requirements, capital adequacy, ownership concentration, and those measuring and controlling credit exposures to single borrower and related parties.³²⁵ Nevertheless, the regulations governing the domestic commercial banks are still inadequate in the

Interested Part of Banks, Tai-Tsa'I-Jung-Tsu No. 821153859 (released on Sep 22, 1993)

³²³ NBL, Art 33-3 (1)

³²⁴ NBL, Art 33-3 (2)

³²⁵ See supra note 1, Lawrence L.C. Lee, "Integration of International Banking Supervisory Standards", at

following aspects.

First, prudential regulations in Taiwan have focused on assets, rather than liquidity. Such highly asset-based regulatory system is attributed to the traditional assumption that a company or a financial institution with substantial assets will never fail, as well as to the government's conservative attitude toward financial regulations. For instance, the average deposit reserve rate in Taiwan is around 13-14 %, which is almost 10 times higher than that in Japan.³²⁶ In addition, Taiwan has probably the highest amount of minimum capital requirement for domestic banks, amounting to 10 billion NT dollars. It is true that substantial assets will lower a bank's risk of failure by absorbing the operational loss. However, a highly asset-based system will simultaneously impair a bank's ability to create liquidity, which is paramount especially to those banks conducting short-term business, such as commercial banks in Taiwan.

In addition, despite the expansive liberalization of business powers, the prudential safeguards that are necessary for preventing conflicts of interest that arise from the commingling of these separate business powers are apparently absent in Taiwan. The conflicts of interest inherent in the commingling of trust / investment and commercial banking are manifold. For example, a bank might recommend certain investments to its client qua investors, and even provide them financing to facilitate these investments in order to raise the price of these securities in the bank's possession. The only safeguard required in NBL is that the trust and securities departments of commercial banks shall have independent capital requirements, operations, and accounting procedures, and shall prevent the flow of confidential information from one department to another.³²⁷ Thus, the

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³²⁶ The Industrial and Commercial News in Taiwan (22 October 1991)

³²⁷ NBL, Article (1) (3)

current regime for prudential safeguards is too simple and ineffective in preventing these conflicts of interest. Although the Basel Principles do not have prudential regulation targeted at resolving or preventing conflict of interest arising from universal banking model, Taiwan's compliance with consolidated supervision and internal control system cited in the Basel Principles will provide part of solution.

Finally, the regulations relevant to the making of loans are still not effective in preventing banking collapses. Table 4.12 selects several important banking collapses in the 1990s. Among four, three are directly related to loan issues, such as over-loan and insider loan. It demonstrates that Taiwan's adoption of Basel Principles, particularly related to the control of credit risk is not successful. The central competent authority still failed to detect the unusual credit risk prior to the banking collapses because of Taiwan's unsound credit culture and severe problem of moral hazard in extending the credit. Although the incorporation of "the same affiliated companies" in Article 33-(3) of NBL may provide a partial solution to the loophole in law, especially since the chapter of affiliated companies has already been appended to the Corporation Law in Taiwan, whether it is effective to deal with the loan related problem in Taiwan remains unknown.

Table 4.12 Selected Taiwanese Banking Collapses in the 1990s

Failure Banks	Date of Failure	Government Response	Statutes Violated	% of Deposit	Withdrawn Deposits
TaiTun Medium-Business Bank	Feb. 9-12, 1996	Bailout from CDIC Changed Director	Over-loan & Affiliate Loan	28.2	NT 330 million
Overseas Chinese Bank	Dec. 7-12, 1995	Bailout by CDIC and State-owned banks	Insider Lending	16.3	NT 513 million
Chungli Farmers' Association	Sept. 20, 1995	Bailout from State-owned financial institutions	Debt-bad Loan	n / a	NT 3.2 billion
Changhua Forth Credit Union	Aug. 1995	Takeover by Cooperative Bank of Taiwan	Bank Fraud	n / a	NT 6.4 billion

Source: 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 547

2 Foreign Commercial Banks

(a)Licensing Requirements

To be eligible to open a branch in Taiwan, a foreign bank must not have violated any Taiwanese laws during the five year prior to its application, and must either (i) rank among the world's top 500 banks in asset or capital one year prior to application, or (ii) have done business with the banks and enterprises in Taiwan amounting to 1 billion US dollars in three calendar years preceding its application, of which sum it must have granted 180 million US dollars as long- or medium-term credits.³²⁸ Similar but less stringent requirements apply to foreign banks that wish to open a representative office in

³²⁸ Guidelines for the Reviewing of Foreign Bank's Applications for the Establishment of Branches and Representatives Offices, MOF, promulgated on august 23, 1983. The latest amendment is on March 22, 1997. (hereinafter 1997 Guidelines). The licensing requirements are stipulated in Article 2 of the 1997

Taiwan. For instance, a foreign bank shall rank among the top 1,000 banks in the world one year prior to its application, or shall have done business with the banks and enterprises in Taiwan amounting to 300 million US dollars in three calendar years preceding its application.³²⁹

Moreover, once a foreign bank is approved to establish branches, it shall locate a minimum operating capital amounting to 150 million NT dollars for the first branch, and 100 million NT dollars for each additional branch.³³⁰ Such operating capital shall be booked together in the account of the first branch or the branch designed by the MOF. Any increase in remittance of the operating capital shall receive prior approval of the MOF and CBC.

(b) Business Scope and Operational Restrictions

After the amendment of the 1989 Banking Law, the MOF, upon consultation with the CBC, can determine the business scope of foreign banks to encompass the scope of commercial banking, savings banking, and trust and investment activities. Although this wider range is provided in law, the business activities that foreign banks can really conduct and the operational restrictions to which they are confined was not released considerably until 1994.

Prior to 1994, the permissible business activities of foreign banks consisted of 16 exclusive items list in 1990 Guidelines.³³¹ Even if the 1990 Guidelines extended the scope to permit the foreign banks to carry out savings deposits, long-term loans, and securities investment, the foreign banks' operation power was still limited because

Guidelines.

³²⁹ 1997 Guidelines, Art 4 (2)

³³⁰ 1997 Guidelines, Art 9 (1)

³³¹ 1990 Guidelines refers to the "Guidelines for the Reviewing of Foreign Bank's Applications for the

foreign banks could not engage in business other than those on the list. In October 1994, in response to the national treatment principle in GATS, the MOF amended the 1990 Guidelines and liberalized the operation of foreign banks in two ways. First, the MOF removed the exclusive list of business, and allowed the foreign banks to operate within almost the same scope as domestic banks.³³² Second, the deposit ceiling, which prohibited the foreign banks from accepting more than 15 times their paid-in capital, was removed.

In addition, the foreign banks have repeatedly requested the MOF to expand the geographic restrictions. Before 1986, each foreign bank was allowed to establish only one bank in Taipei. In 1986, the MOF permitted the foreign banks with branches in Taipei to establish a second branch in Kaohsiung, an industrial center in southern Taiwan and the largest container port in Taiwan.³³³ However, multiple branch network needs to be established to develop consumer banking and to compete with domestic banks. In 1995, the MOF allowed foreign banks to run one additional branch in any given city. Later in 1996, the geographic restrictions were completely removed, and, thus, foreign banks are eligible to open branches through out the entire island, subject only to MOF's approval.

(c) Provisions Relating to Making of Loans

In general, the previous administrative guidelines relating to making of loans do not apply to foreign banks. For example, in the case of restrictions on granting loans to the

Establishment of Branches and Representatives Offices" amended in 1990.

³³² 1997 Guidelines, Art. 10

³³³ See MOF, Letter of Oct. 11, 1988, Tai-Tsai-Jung No 770953456 (released on Feb, 1992)

same person, a foreign bank shall not grant credit amounting to more than 10 % of its total loans in NT dollars made by all of its branches within Taiwan. If the 10 % of its total amounts of loans in NT dollars is less than 500 million NT dollars, 500 million NT dollars shall be taken to replace the original standard. Finally, if the credit was made in foreign currencies, the total amount shall not exceed 25 % of its net worth.³³⁴

(d) Evaluation

To enhance Taiwan's bid for WTO membership, Taiwan has considerably concentrated its banking reforms on foreign access to the domestic banking market. Thus, as described previously, several significant amendments have been made to liberalize the foreign banking operation and to comply with the emerging GATS principles. However, some issues remain unresolved, particularly in those relating to the licensing requirements. In other words, the scale of foreign participation in domestic banking market is constrained to Taiwan's stringent licensing requirement, rather than its operational restrictions.

First, the status of granting branches or representative offices in Taiwan is still reciprocity-based, and violates the MFN treatment cited in Article 2 of GATS. According to Article 5 of the 1997 Guidelines, the MOF may favourably review the application filed by a foreign bank, if such bank is recommended by the banking competent authority of its home country, where Taiwan's overseas branches and representative offices also receive favourable treatment. To be in consistent with MFN principle, some legislature needs to be amended.

In addition, the foreign banks are confronted with a higher threshold while seeking to

³³⁴ See Hu Dong-Qing, "Financial Supervision and Examination", 3d ed, (Taiwan Academy of Banking

participate in the domestic banking market. For example, a foreign bank shall rank among the world's top 500 banks one year prior to its application for branches, and shall rank among the world's top 1,000 banks one year prior to its application for representative offices. Although these requirements cannot be judge as violation of national treatment, they constitute additional restrictions for market access. Thus, according to Principle 3 of the Basel Core Principles, the licensing requirements in Taiwan should focus on the sectors which will practically bear on the banking operation, such as internal control and financial projections, rather than international reputation.

Finally, corporate status of foreign banks also limits their operational powers. Under Article 116 of NBL, the permissible corporate status in Taiwan is "branch", not "subsidiary". The distinction between a foreign branch and subsidiary is that the former remains subject to the domestic laws of its home country, while the latter is treated as a legal entity and is wholly separated from its home regulatory regime. As a consequence, foreign banks from "non-universal banking regulatory regimes" are at a disadvantage. This is because they are subject to the domestic law of their home countries and not eligible to carry out universal banking activities. For example, Canadian banks cannot engage in trust banking in Taiwan since they cannot engage in trust banking in Canada. That is, the only foreign banks that can enjoy national treatment under Taiwan's universal banking model are those that came from universal banking jurisdictions, such as Germany, England, and Switzerland.³³⁵ Hence, it may indirectly infringe upon the MFN treatment in GATS.

and Finance 1997) at 55

³³⁵ See B.W. Semkow, "Taiwan's Financial Markets and Institutions: The Legal and Financial Issues of Deregulation and Internationalization" (Westport, London: Quorum Books, 1992) at 96-100.

3 Offshore Banking Activities

Taiwan established an offshore banking center in 1984 to attract foreign capital that can benefit and finance domestic enterprises, to encourage international financial service activities in Taiwan, and to promote Taiwan as an Asian-Pacific financial center.³³⁶ The term "Offshore Banking Unit" (OBU) refers to branches that are physically located within a specific territory but operate on an international scale. Usually, they enjoy preferential treatment, such as tax relief, and are subjected to fewer operational restrictions than other foreign and domestic banks. In Taiwan, the regime is designed to separate the offshore and on-shore banking activities owing to the conservative attitude towards financial deregulation of Taiwan government.

(a) Licensing Requirements

Under the OBA, the following types of banks may apply to the MOF for authorization to establish an offshore banking branch: (1) foreign and domestic banks that have been authorized by the CBC to carry out foreign exchange transactions; (2) foreign banks that have maintained representative offices under the MOF's approvals; and (3) qualified reputable foreign banks approved by the MOF.³³⁷ Type (2) and (3) banks shall comply with specific requirements to be eligible to establish OBUs. These specific requirements are the counterparts of the licensing requirements for establishing foreign bank branches stipulated in Article 2 of the 1997 Guidelines. In addition, after a foreign bank has been permitted to establish an OBU, it shall allocate minimum operational capital amounting to 2 million US dollars (equal to around 62.4 NT

³³⁶ See YA-Huei Chen, "Legal Aspects of Offshore Banking in Taiwan" (1984) 8, *Maryland Journal of International Law and Trade*, 237 at 238

dollars)³³⁸, which is much less than the requirement of foreign branches (150 million NT dollars).

(b) Business Scope and Operational Restrictions

Prior to 1997, the business scope of OBUs was limited. On the one hand, the items of permissible activities were constrained to traditional banking dominated by foreign currencies, such as foreign deposits, and failed to incorporate foreign currencies' financial debentures or relevant securities transactions. On the other hand, the permissible activities were only allowed to target at ROC non-resident individuals, legal entities, government agencies and financial institutions. The latter restriction on the separation of the onshore and offshore market was intended to eliminate the exposure of domestic economy to OBUs. The foregoing limitations prior to 1997 have made Taiwan's intention to become regional financial center less successful. By end-1997, there were only 71 OBUs. Among those, 38 branches were established by domestic banks, while other 33 branches were established by foreign banks.³³⁹

To overcome this problem, the business scope of the OBU has been significantly expanded in October 1997. The competent authority not only incorporated new items dominated by foreign currencies but also expanded the trading targets to include ROC resident individuals, legal entities, government agencies and financial institutions. (See Table 4.13) However, the policy to separate the onshore and offshore banking is still maintained. According to Article 7 of the OBA, an OBU shall not accept foreign

³³⁷ OBA, Art 3

³³⁸ Enforcement Rules of the OBA, Article 7. CBC and MOF jointly promulgated this act on April 20, 1984. The latest amendment of the act is on March 19, 1999. 2 million US dollars is almost equal to 62.4 million NT dollars.

currency in cash and permit the withdrawal of foreign currency deposits in NT dollars. Unless approved by CBC, an OBU shall not handle remittances and conversions between foreign currencies and NT dollars.³⁴⁰

Another major restriction is that an OBU may not invest in stocks. As mentioned earlier, if a foreign commercial bank establishes a trust and investment department according to Article 28 of NBL, it is eligible to invest in listed stocks. However, prohibiting OBUs from investing in stocks pale their competition. In addition, the total amount of securities invested by an OBU of a bank and all branches of such bank may not exceed the investment ceiling stipulated by the MOF.

Table 4.13 Business Scope of the OBUs

Trading target	Items
Targeted at <u>ROC resident and non-resident</u> individuals, legal entities, government agencies and financial institutions	(i) Accepting foreign exchange deposits
	(ii) Making credit extensions in foreign currencies
	(iii) Selling foreign currency financial debentures or other certificates of debt issued by the bank of which the OBU is part
	(iv) Conducting commission, brokerage and agency activities in connection with foreign currencies securities
	(ix) Operating a custody, agency, and consultation business relating to all permissible activities
Targeted at <u>non-resident</u> individuals, legal entities, government agencies and financial institutions	(v) Handling the issuance, advising, negotiation, and import/export collection of letter of credit dominated in foreign currencies
	(vi) Handling foreign currencies remittances and exchanges, borrowing and lending of funds, and foreign currencies securities
Others	(vii) Underwriting of offshore issued securities
	(viii) Debt management and record keeping for offshore loans denominated in foreign currencies
	(x) Other foreign exchange business approved by the competent authority

Source: OBA, Article 4

³³⁹ See Bureau of Monetary Affairs, ROC, Financial Statistics Abstract, (Aug 1999), at 38

³⁴⁰ OBA, Article 8

(c) Incentives to Establish an OBU

The advantages of conducting international banking operations through an OBU in Taiwan can be attributed to a number of exemptions from statutes or regulations. Pursuant to Article 5 (1), the operation of OBUs is not subject to the relevant restrictions prescribed in the Statute for Foreign Exchange Regulations, the Interest Rate Regulation Act, the Banking Law, and the Central Bank of China Law unless otherwise provided for in the OBA. In addition, the OBS specifically states that: (1) deposits in the OBUs are exempted from the deposit reserve requirements³⁴¹; (2) interest rates on deposits and loans of OBUs are determined between the OBU and its customer³⁴²; (3) unless the banking supervisory authority in the home country otherwise require, the OBUs are exempted from loan loss reserve requirements³⁴³; and (4) OBUs are exempted from several kinds of tax, such as business income tax and stamp duties.³⁴⁴ However, consistent with the policy to separate the onshore and offshore banking markets, tax exemption does not apply to interest paid to and income derived from the trading parties within Taiwan.

(d) Evaluation

Although Taiwan has been dedicated in promoting itself as a regional financial center since 1984, both the number and the total assets of the OBUs in Taiwan cannot compete with those in Hong Kong, Japan, and Singapore, which represent three crucial

³⁴¹ OBA, Art. 11

³⁴² OBA, Art. 12

³⁴³ OBA, Art. 17

³⁴⁴ OBA, Art. 13-16

financial centers in Asia.³⁴⁵ One reason for the little achievement is that Taiwan has rather stringent regulations governing the eligibility for opening OBUs by foreign banks. Any foreign bank seeking to operate the offshore banking activities shall follow the identical requirements for establishing a foreign branch. These requirements are focused on international reputation rather than prudential measures listed in the Basel Principles. Besides, if the purpose of creating an international financial center is to attract foreign capital, which will finance domestic enterprises, discouraging foreign banks with no branches in Taiwan from establishing the OBUs appears to be counter-productive.

Another major restriction on OBUs derives from the restrictions of domestic financial markets. While the GATS can require Taiwan to apply non-discriminatory regulations to both domestic and foreign banks according to the national treatment cited in its Article 17, it cannot release the foreign banks from the restrictions that domestic banks are also subject. Hence, unless the domestic financial market is further deregulated, the operation of OBU in Taiwan will still be constrained when compared to that in other regional financial center.

³⁴⁵ See J. Wang, "More Relaxation Needed for Offshore Banking Success," (Nov. 1997) *Business Taiwan*,

IV Moving Fowards: Challenges for Taiwan

Banking sector in Taiwan has undergone significant liberalization and internationalization in recent years in respond to its application for the WTO membership. Taiwan has almost completed its bilateral negotiations following the requests of 26 WTO members, including most Southeast Asian countries and US. Despite the technical completion, Taiwan's bid for WTO membership still greatly depends on China's attitude. However, regardless of if and when Taiwan will join the WTO, the efforts which have been made to deregulate the banking activities will continuously integrate Taiwan's financial market into global financial market.

In general, Taiwan's current GATS commitments on banking sectors simply formalized the status quo except it has promised to remove the following restrictions upon its accession.

The foreign exchange transactions will be subject to the limitation of "total foreign liabilities reserve" instead of "total foreign liabilities" upon the accession.

The five-year waiting period between the establishment of the first and second branch, and the limitation on total branches (3 branches) which can be established per year will be removed.

The 10 % restriction of the total numbers of foreign employee to total numbers of employee will be removed upon accession.

The restrictions on the NT dollar deposits accepted by foreign banks will be loosened.

The mid- and long-term government syndicated loans will be permitted to operate.

Foreign banks will be allowed to conduct the underwriting business of notes and bonds.

Greater liberalization and internalization of financial services is a drastic change for Taiwan's banks, which are traditionally under government protection and tight control. Although the recent banking reforms benefit Taiwan's financial growth by making Taiwan increasingly attractive to foreign capital, it creates potential risk for financial instability. Taiwan is a small and open-ended economy that is highly volatile in nature when compared to large and open-ended economies such as the United States. In addition, Taiwan's ambiguous international status and military threat from China aggravate possible contagion due to herding behavior.³⁴⁶ Therefore, Taiwan's top priority is to conduct more prudential regulations to create a safe and sound banking supervision system, which can maintain financial stability and prevent financial crisis.

First, the concept of market risk should be introduced into the current capital adequacy framework in Taiwan. Although Taiwan has enacted some of the Basel Principles into the Banking Law of 1989 by requiring 8 % of capital adequacy ratio, the lack of definition relevant to the risks for banking shareholders' equity creates confusion about the enforcement of this provision. Thus, it is essential to incorporate market risk into the formula for evaluating the risk of banking operation consistent with the Basel principles.³⁴⁷ For example, if the same assets were invested in two banks, the different risk environments of these two banks will require different risk management. Since bank management is variable, evaluating banking operation by a fixed ratio of assets does not

³⁴⁶ The herding behaviour is an economic term used to express the investors' irrational behaviour due to the lack of market confidence rather than the failure of the economic performance.

³⁴⁷ The Basel Committee, "The Prudential Supervision of Netting, Market Risk and Interest Rate Risk" (1993) (supplementing the International Convergence of Capital Standards)

reflect the bank's risk management. By re-evaluating the banking asset risk, the quantity restrictions based on fixed asset ratios will be in lieu of the quality assessment based on market risk. Hence, Taiwan's banking system will create additional competition, reduce the costs of ensuring capital adequacy, and improve the liquidity of banking operation.

Furthermore, mergers and acquisition among financial institutions should be encouraged. A rapid increase in the number of new private banks in the early 1990s, together with a continuous expansion in the number of branches, have created a over competitive banking system in Taiwan. This phenomenon of over-banking leads to unhealthy competition. For example, the interest rate spread for banks in Taiwan is currently one of the lowest in the world.³⁴⁸ Therefore, to achieve greater economies of scale and to compete with foreign financial institutions as well as to solve the problem of unsound community financial institutions, the government should take measures to encourage mergers among banking institutions. A specific law dealing with mergers and acquisitions is being drafted to provide a legal basis for such reforms. Both tax and non-tax incentive will be provided. The MOF is also considering model merger examples by merging some state-owned banks.

Another unsolved issue under current banking supervisory regime originates from the subdued role of the Taiwanese banking sector. Taiwan has come a long way from being just a manufacturing-based, labor-intensive economy focusing blindly on export promotion. The banking sector has been traditionally subordinated to industrial policy and under tight control. Taiwan government did not begin to take a more balanced approach to promote Taiwan as a regional financial center under its Asian-Pacific Regional Operational Center (APROC) Plan until 1995. As a consequence, the

³⁴⁸ See supra note 277, Jia-Dong Shea & Tsuen-Hua Shih, Taiwan's Financial Policies in Response to the

government should make every effort to ensure that banks are capable of operating independently. For example, the personal involvement of financial regulators shall be limited. It is commonplace that the mid- and senior- level officials of the CBC and MOF often become senior officers of the state-owned or state-invested banks. Even after the Civil Servant Law was enacted in 1996, the MOF still excludes previous circumstance from the Civil Servants Law, which requires a 5- year quarantine for public officials having regulatory responsibilities over some enterprises for which they intended to work.³⁴⁹ Such personal involvement presents a serious conflict of interest that may hinder an objective and efficient financial examination, as well as an independent operation from government intervention.

In spite of the foregoing inadequacies in Taiwan's banking supervisory regime and its political concerns, the future of Taiwan's banking market appears optimistic. Taiwan has high saving and low foreign liability ratios, as well as abundant foreign exchange reserves, which will facilitate Taiwan to absorb the high cost of financial restructuring. Additionally, stable economic growth and rapid development of its high-tech industries will continue to attract foreign capital that is essential to promote cross-border banking operations. In sum, Taiwan should continue to modify its relevant laws and regulations to fully adopt the Basel Principles to preserve a safe and sound banking environment, and move toward the GATS principles of comprehensive financial deregulation.

Asian Financial Crisis, at 29

³⁴⁹ See supra note 278, Lawrence. S. Liu, "Law and Political Economy of Capital Market Regulation in ROC", at 848-849

Chapter 5 Conclusion

It is clear that the process of globalization highlights the importance of international standards. GATS and Basel Principles, the most influential standards in the era of international banking, represent two different models of the regulatory regimes. GATS is a multilateral treaty which has formal and legal binding effect on all the contracting parties, and relies on a supernational organization, namely the WTO, to directly enforce the standards. The long-term purpose of GATS is to "unify" the banking regulations among different jurisdictions by applying the principles of MFN treatment and national treatment, although some exceptions and individual commitments will be permitted in the transition. In contrast to the GATS, Basel Principles are informal supervisory standards and practices which are internationally accepted but do not have legal power. The implementation of Basel Principles requires the national supervisory agencies to actively incorporate these general guidelines into the national legislation by considering the political, culture, and economic difference in different jurisdictions. In other words, the Basel Committee does not attempt to unify all national laws and practices, but rather links disparate regulatory regimes by ensuring that all banks are supervised under the common principles. It is difficult to conclude which model of international standards is more desirable, although some international legal scholars have for a long time promoted the adoption of the informal supervisory standards³⁵⁰, such as Basel Principles.

³⁵⁰ The model of the informal supervisory standards has various terms, such as "network governance", "the nationalization of international law", "soft law", etc. For more discussion, see Kanishka Jayasuriya, "Globalization, Law, and the Transformation of Sovereignty: The Emergence of Global Regulatory Governance," (1999) 6 *Ind. J. Global Legal Stud.* 425; Lawrence L.C. Lee, "Adoption and Application of a "Soft Law" Banking Supervisory Framework Based on The Current Basle Accords To The Chinese Economic Area" 16 (1998) *Wisconsin Int'l L. J.* 691

The importance of GATS and Basel Principles is obvious because no countries can conduct their banking activities in global market without the consideration of these two regimes. Both China and Taiwan are seeking to join the WTO and have almost completed the final negotiations with other WTO members. Once China and Taiwan become WTO members, they will be bound by GATS. Thus, GATS provides the impetus for China and Taiwan to improve foreign access to their domestic markets, as well as to liberalize their domestic banking sectors. However, a prudent and comprehensive financial regulatory structure should be developed before, or at least no later than financial liberalization. The lesson of Asian financial crisis has reminded China and Taiwan that their domestic banking markets need to be reconstructed pursuant to Basel Principles.

In the past decade, China and Taiwan have made a series of banking reforms under the impact of GATS and Basel Principles. Although different banking supervisory regimes that exist in China and Taiwan have been shaped by history, policies, and culture tradition, there are still some similarities. First, one can trace China's emulation in foreign banking accessibility to Taiwan. Prior to the recent liberalization, foreign banks in Taiwan can only conduct foreign currency business, and are subject to strict operational and geographic restrictions. Similar to Taiwan, government commonly intervenes in banking activities in China. Until recently, most foreign banks in China cannot engage in RMB business. Although a few foreign banks were entitled to conduct RMB business in 1999, they were subject to harsh geographic and operational requirements. Second, China's and Taiwan's financial policies are both conservative and depend on governments' long-term economic goals. Third, policy lending and preferential lending have traditionally occupied the majority of total loans granted by

domestic banks, and leads to the unsound credit culture and the problem of non-performing loan in both China and Taiwan. Finally, many banking laws and regulations are replete with vague passages that make the regulatory process unpredictable and opaque.

Considering China's and Taiwan's outstanding economic performance, it is not over-optimistic to expect their economies to perform well in the up coming years. In response to their bids for inclusion into WTO, the liberalization and globalization of their banking sectors will continue. However, the potential problems in their current banking regime demand immediate attention. Full adoption and application of Basel Principles will create a competitive and safe and sound financial regime within China and Taiwan.

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