

TAIWAN'S CURRENT BANKING DEVELOPMENT STRATEGY: PREPARING FOR INTERNATIONALIZATION BY PREVENTING INSIDER LENDING

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TABLE OF CONTENTS

I.	Introduction	167
II.	Taiwan's Emerging Banking Structure and Institutional Framework	174
	1. Progress Towards Achieving Stability: Taiwan's Banking Regulatory Schemes	174
	2. Taiwan's Banking Structure and Banking Regulators	178
	3. Various Banking Institutions in Taiwan	181
	4. Operation of Foreign Banks and Possibilities of Chinese Banks in Taiwan...	185
III.	Current Solutions to Banking Problems in Taiwan	188
	1. Simplification and Reduction of Banking Institutions.....	189
	2. Strengthening Internationalization of Taiwan's Banking System	193
	3. Deregulation of Taiwan's Banking Regulations	196

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- 4. Enhancing the Framework of the Banking Supervision System 199
- IV. Remaining Problems: Insider Lending Episodes in Taiwan 201
 - 1. Legal Aspects of Taiwan's Current Regulations Governing Insider Lending ... 203
 - 2. Impeding Political Influences Affecting Authorities' Ability to Monitor Insider Lending Offenses 207
 - 3. Ineffectiveness of Supervisory Authorities in Halting Insider Lending Offenses 208
 - 4. Efficient Control of Insider Lending Provisions of Developed Countries and Recommendations by the Basle Committee on Banking Supervision..... 209
- V. Improvement of Taiwan's Financial Regulations to Obstruct Financial Exposé 211
 - 1. Proposals for the Modernization of Taiwan's Banking System 212
 - 2. Maintaining Financial Stability: Prevention of Systemic Risk in Taiwan's Banking System 214
 - 3. Enhancing Regulatory Cooperation for Effective Regulation 220
 - 4. National Treatment: Elaborating Foreign Banking Institutions' Role in Taiwan 221
- VI. Conclusion and Observations 223

I. INTRODUCTION

The Republic of China (“ROC” or “Taiwan”)¹ liberalized financial markets and regulations in response to the challenge of liberalized and globalized financial sectors since the 1980s.² The

1. Unless otherwise indicated, the Republic of China [hereinafter “Taiwan” or the “ROC”] refers to the government of the Republic of China on Taiwan since 1949, after its defeat by the Chinese Communist Party in China’s Civil War. The full area of Taiwan under control of the Kuomintang (known as “KMT” or “Nationalist Party”) includes only the islands of Taiwan, Pescadores (P’eng-hu Islands), and the offshore islands Quemoy and Matsu. For more information related to Taiwan’s modern political history and the relationship between Taiwan and Mainland China, see James C. Hsiung, *The Paradox of Taiwan-Mainland China Relations*, in THE INTERNATIONAL STATUS OF TAIWAN IN THE NEW WORLD ORDER, LEGAL AND POLITICAL CONSIDERATIONS 209-20 (Jean-Marie Henckaerts ed., 1996).

2. See Alan Greenspan, *The Globalization of Finance*, 17 CATO J., and *A Survey of International Banking: On A Wing and A Prayer*, ECONOMIST, Apr. 17, 1999, at 4 (addressing that the changes in communications and information technology and the new instruments and risk-management techniques enabled the financial sectors to create a global financial system).

Taiwanese banking industry, after several decades of development and effort, has gained a great degree of acceptance and prosperity from Taiwan's depositors and has also performed well within the global financial system.³

Nonetheless, the internationalization and liberalization of global banking industries revealed the weaknesses in Taiwan's banking sector. Taiwan's inchoate financial regulations and conservative financial policy-making were unable to parallel the development of Taiwanese banking industries, prevent financial fraud, or satisfy the needs of customers.⁴ A sequence of financially devastating incidents shook the financial market of Taiwan and dispatched the economy into a tailspin in the 1980s.⁵ The past decade's banking failures exposed illegal lending to affiliates, which were not properly disclosed to the public and caused depositors to rush to withdrawal. The result was takeovers by the government.⁶ Furthermore, the existence of underground financial institutions⁷ and insider lending (or "connected lending")

3. According to a report of a global rating of financial institutions compiled by the International Institute for Management and Development in Lausanne, Switzerland, in July 1996, Taiwan's bank size was the world's eighth largest, with 13 banks ranking among the world's top 500 based on their net assets in 1994. Per capita bank deposit, totaling US\$19,489, was the third highest. However, Taiwan got a poor rating of 35th in banking regulations, indicating that Taiwan's financial rules are not comprehensive or sophisticated enough to regulate its banking operations and maintain financial stability. See Wallace W. Y. Wang & James T.Y. Yang, *Financial Institution in Taiwan: Analysis of the Regulatory Scheme*, 4 J. CHINESE L., 1, 8 (1990).

4. See Michael S. Bennett, *Unleashing a Tiger: Financial Deregulation in Taiwan*, 11 PAC. BASIN L. J.1, 1-2 (1992).

5. The following is a summary of Taiwan's four major financial scandals in the 1980s.

Failure of the Banks	Date of Disclosing Collapse	Government Response	Financial Institutions' Violation
Asia Trust Co.	Aug. 14-16, 1982	Bailout	Over-loan to affiliates
The Tenth Credit	May 25, 1983	Takeover	Insider Lending & Affiliate transaction
Cathy Trust Co.	Feb. 13, 1985	Terminated Management	Bankruptcy of affiliate transaction
Overseas Chinese Trust Co.	Sept. 5, 1985	Bailout	Over-loan to affiliates

For more discussion of Taiwan's major financial crisis in the 1980s, see Timothy H. Wan, *Ensuring a "Safe and Sound" Banking System in an Era of Liberalization and Internationalization: Critique and Recommendations for Reform of the Banking Prudential Supervision System of the Republic of China on Taiwan Chapter 4, VI* (unpublished dissertation on file with author).

6. See *id.* at 5 n. 1.

7. Having allowed the establishment of private commercial banks in 1991, Taiwan government's extremely conservative fiscal policies effectively restricted bank financing to priority sectors, such as the largest industrial borrowers. As a result of

hampered Taiwan's financial market and blocked economic progress. To overcome these inadequacies in the banking sector, Taiwan must have a sound, internationally competitive banking system to promote the economic vitality of Taiwan and the financial well-being of Taiwan's citizens.⁸

In order to progress under stable conditions, Taiwan attempted to liberalize financial markets and strengthen financial supervisory systems by amending banking regulations in the late 1980s. Since 1989, four consecutive revisions of the Banking Law of Taiwan ("Banking Law")⁹ have demonstrated the efforts of financial reforms by Taiwan toward banking liberalization and internationalization.¹⁰ The revision of the Banking Law of 1989, known as Taiwan's "big bang,"¹¹ lifted restrictions on interest rates and released limitations on cross-border capital flow. In addition, Taiwan disbanded the market access prohibition, which resulted in 16 new banks chartered since 1991. The purpose of Taiwan's financial reconstruction was to produce a favorable financial environment by further liberalizing Taiwan's financial

the government's tight credit policies, a large-scale underground financial sector developed in Taiwan, which catered to the needs of individuals and small and medium-sized businesses that had not been able to obtain financing from regulated sources. The underground sector includes loan sharks, underground investment houses, post-dated check discounters, and rotating credit clubs. Taiwan's government has made reducing the size and importance of the underground financial sector one of the goals of its liberalization program. See *The Bill of Indictment against 81 Accused of the Hung Yuan Investment Company*, LIEN HO PAO (UNITED DAILY NEWS), Dec. 29, 1990, at 6. (Chin).

8. Theoretically, banks, as intermediaries, could provide a safe investment place for depositors to keep their funds and earn interest. At the same time, bank lending of deposited funds has been an important catalyst for economic growth and development. See PETER HOWELLS ET AL., *FINANCIAL MARKET AND INSTITUTIONS* 5 (1990).

9. The Banking Law of Taiwan [hereinafter "Banking Law"] initiated on March 28, 1931 with fifty one articles, was passed while the KMT, the current ruling political party in Taiwan's administration, was in mainland China. To date, Taiwan has completely amended the Banking Law fourteen times. Except the 1947's amendment proclaimed in mainland China, the other thirteen amendments took place in Taiwan after the KMT withdrew to Taiwan in 1949. The promulgations of the fourteen amendments to the Banking Law were on September 1, 1947; January 16, 1950; November 11, 1968; July 4, 1975; December 29, 1977; July 19, 1978; December 5, 1979; December 5, 1980; July 17, 1981; May 20, 1985; July 17, 1989; October 30, 1992, June 29, 1995, and May 7, 1997. See the Banking Law, <<http://www.boma.gov.tw/english/p2-1.htm>>.

10. In order to respond to the pressure of financial international and liberalization, Taiwan has initiated the amendments of banking regulations toward Taiwan's financial liberalization since 1985. In addition, Taiwan amended Taiwan's Banking law in 1989, 1992, 1995, and 1997 to substantially advance Taiwan's financial regulation in accordance with the demands of Taiwan banking development.

11. The term "big bang" refers to the rapid liberalization of financial regulation. The term big bang was first produced by the British financial reform of October 27, 1986. See NORMAN S. POSER, *INTERNATIONAL SECURITIES REGULATION: LONDON'S "BIG BANG" AND THE EUROPEAN SECURITIES* (1991).

system and upgrading financial regulations to international standards.

Movement towards internationalization and liberalization of Taiwan's financial regulations and market impacted Taiwan's conservative financial polices, which were primarily compartmentalized into interventionism, growth promotion and stabilization.¹² Pursuant to financial liberalization, the establishment of private commercial banks encouraged comparative and qualified services.¹³ However, the new development also revealed the inadequacy of the banking regulatory framework and the mediocrity of the supervision over the banking system that was unable to prevent financial manipulation in Taiwan.

A series of financial scandals, which were the result of legal loopholes, rocked Taiwan's financial stability in the 1990s.¹⁴ Specifically, more than ten financial scandals occurred in 1995, equal to the number of financial scandals that had befallen Taiwan in the past four decades.¹⁵ Under these circumstances, Taiwan's banking regulators realized that financial fraud, insider loans, and capital flight weakened the financial services segment and industries and undermined the confidence of domestic investors. Accordingly, the strengthening of financial anti-fraud mechanisms is essential to ensuring a sound and safe financial system in Taiwan.

The most dramatic financial scandals resulted from insider lending offenses.¹⁶ Insider lending occurs when a bank provides loans to its own shareholders, managers, other employees, or their relatives. The term "insider lending" also includes banks that engage in large-exposure lending when it lends a large amount of money to one entity or several entities related to each other by shared ownership.

In addition, recent financial scandals exposed the weaknesses in Taiwan's financial regulations that were designed to

12. See Jia-Dong Shea, *Taiwan: Development and Structural Change of the Financial System*, in THE FINANCIAL DEVELOPMENT OF JAPAN, KOREA, AND TAIWAN 222 (Hugh T. Patrick et al. eds., 1994).

13. See G. BROKER, COMPETITION IN BANKING 95 (1989).

14. See ENCOUNTERING INSIDER LENDING EPISODE, *infra* notes 110-148 and accompanying text.

15. See *Financial Crisis Year of 1995*, WORLD JOURNAL (SHIH CHIEN JIH PAO) (New York), Dec. 19, 1995 (Chin.).

16. Insider lending (or insider loan or connection loan) refers to, in this article, a bank that makes loans to executive officers, directors, affiliates, or to stockholders owning more than a certain percent (for example 10 percent or 15 percent) of voting stock, unless such loans are on substantially equal terms to those granted outsiders. See WILLIAM A. LOVETT, BANKING AND FINANCIAL INSTITUTIONS LAW 159-60 (1992).

block insider lending.¹⁷ Given the close connections between family and business relationships that characterize Taiwanese economic and political life and the generally low standards for accounting and financial record-keeping, the possibility of insider lending by bank management in Taiwan is still very real.

Obviously, prevention of insider lending is essential for Taiwan to maintain a healthy banking system. Because Taiwan has no experience in combating insider lending, adoption of international standards and reference with other countries' experiences in preventing insider lending are likely to offer Taiwan an efficient and timely model with which to regulate insider lending. Hence, the Basle Committee on Banking Supervision's ("Basle Committee")¹⁸ suggestions on regulating insider lending¹⁹ and the American experience may serve as role models to be utilized by Taiwan's authorities.

Taiwan's financial market faces increased competition and diversity in financial activities. Subsequent to the liberalization

17. These three devastating financial scandals included: 1) the overdrawing of loans at the Tenth Cooperative Bank in 1985; 2) the illegal underground banking activities of the Hung-Yuan Investment Company in 1987; and 3) an allegation of insider trading and self-dealing involving a cabinet minister's family and local business leaders in 1995. In particular, with the activities of banks restricted and with profitable opportunities emerging in several sectors of the economy, many unlicensed deposit-taking institutions (known as "underground investment companies" in Taiwan) came into existence and expanded rapidly in the end of 1980s. These illegal investment companies received deposits at high interest rates and invested in real estate and securities markets. The underground investment companies' transaction continued until the amendment of Banking Law in 1989, which prohibited further operation by illegal investment companies. Hung-Yuan Investment Company was the pioneer huge illegal investment company that collected the equivalent of U.S.\$8 billion from more than a million Taiwanese investors. See Jane Kaufman Winn, *Banking and Financial in Taiwan: the Prospects for Internationalization in the 1990s*, 25 INT'L LAW., 907, 916 n. 51 (1991).

18. The Basle Committee on Banking Supervision [hereinafter the "Basle Committee"] is a committee of banking supervisory authorities established in 1975 and consisting of representatives from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Sweden, Switzerland, the United Kingdom, and the United States. The Basle Agreement guidelines were principally designed to level the playing field among international banks. They were established to "strengthen the soundness and stability of the international banking system" and to diminish "competitive inequality among international banks." For more information about the Basle Committee, see *International Convergence of Capital Measurement and Capital Standards*, reprinted in 1 Fed. Banking L. Rep. (CCH) ¶ 5403, at 3309 (July 15, 1988) and Lawrence L. C. Lee, *The Basle Accords as Soft Law: Strengthening International Banking Supervision*, 39 VA. J. INT'L L. 1, 4, n 14 (1998).

19. The Basle Committee, *Core Principles for Effective Banking Supervision* (Sept. 1997) <<http://www.bis.org>> [hereinafter "Core Principles"] (recommending 27 principles for banking authorities to supervise international banking activities, and urging, in Principle 10, the establishment of "requirements that banks lend to related companies and individuals on an arm's-length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks).

and globalization of financial industries, Taiwan's financial sector should also face increasing competition from foreign counterparts who already share a certain percentage of the market. Taiwan will likely change current policies that do not permit Chinese financial institutions²⁰ to operate in Taiwan's financial market under the General Agreement on Trade in Service ("GATS") if Taiwan becomes a member of the World Trade Organization ("WTO").²¹ The inevitability of allowing the entrance of China's financial institutions into Taiwan is likely to drive Taiwan to strengthen its financial supervisory frameworks.²²

In response to the approaching challenges, Taiwan may demand a clear mechanism for setting rules and for restructuring the financial supervisory system for successful functional banking regulations. The example of British Financial Services Authority²³ provides Taiwan with a certain mechanism to restructure current financial supervisory framework from multi-agencies to one competent agency. Moreover, Taiwan should learn from the 1997 Asian crisis and from the formations of a single financial supervision adopted recently among the most advanced coun-

20. See STEPHEN WOOKCOOK, *LIBERALIZATION OF FINANCIAL SERVICES 5* (1999) (addressing that under the WTO, removing all potential barriers to market access is the primary provision to allow member financial institutions to operate in the WTO countries).

21. General Agreement on Trade in Service [hereinafter "GATS"] brought the service industry into WTO, which had become the umbrella organization for the General Agreement on Tariffs and Trade [hereinafter "GATT"]. See GATS, Apr. 5, 1994, in 28 Uruguay Round of Multilateral Trade Neg. 22595 (1994), reprinted in 34 I.L.M. (1995); Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, GATT Trade Negotiations Committee Document MTN/FA II-AIB, General Agreement on Trade in Services (Marrakesh, as signed on April 15, 1994).

22. National treatment in financial services is also emphasized by the WTO under GATS. GATS recommends full market access and national treatment for WTO members. The WTO applies an impartial dispute-settlement mechanism to ensure the implication of the national treatment. See *Financial Services Talks Resume*, WTO FOCUS, May 1997, at 1, 8. Consequently, under the national treatment of which all WTO members must conform to national treatment standards in order to receive WTO approval. Taiwan inevitably should face the question about the entry of China's financial institutions into Taiwan's financial market.

23. To face the trend of financial variation, most industrialized countries such as the United States, Japan, and England proposed to combine current multi-agency of financial supervision to become one. For example, England organized the Financial Service Authority [hereinafter "FSA"] which has clear responsibilities and a close relationship with the Bank of England and the Treasury. In addition to the banking supervisors, the FSA also encompasses the regulators of securities, investment management, personal investment products, building societies (Britain's savings and loan industry), and insurers. The purpose of creating the FSA, effective in mid of 1998, attempts to ensure stability, avoid duplication, and enhance England's banking competitiveness. See Howard Davies, *A Policeman's Lot is not a National One*, in *THE WORLD IN 1998* 122 (Economist ed. 1997).

tries.²⁴ Although one of the reasons for the crisis was the extent of financial exposure, compounded by insider lending, Taiwan did not suffer as much as the rest of the Asian countries in 1997.²⁵

This article primarily focuses on the conditions under which the Taiwanese banks have prospered. In doing so, this article initially reviews the complexities of Taiwan's existing financial system and critiques the origins of the banking industry and the current problems encountered by Taiwanese banks. Afterwards, solutions to halt insider lending in Taiwanese banks will be discussed, as well as recommendations for the upgrading and revitalization of the state-run banking system and the implementation of a broad swath of banking regulatory reforms.

Furthermore, this article involves undertaking a comparative analysis of select national and international banking and financial regulations with a focus on the development of standards to combat insider lending. A viable supervisory system for the entire Taiwanese banking industry will also be discussed. This article also attempts to plot the development of the Taiwanese banking industry in future years. To review the prospects of Taiwan's banking sector, this article emphasizes evaluating the proposals to amend the banking law through international standards and concludes by emphasizing that the creation of a single supervisory authority over banks is necessary for Taiwan to achieve a superior banking system.

24. See *The Asian Crisis, Causes and Cures*, FIN. & DEV. June 1998, at 18-19 (concluding that probable factors that contributed to the Asian crisis were a lack of enforcement of prudent regulations and inadequate supervision of financial system, coupled with government-direct lending practice that led to a sharp deterioration in the quality of banks' loan portfolios). The Asian crisis also offered lessons to banking supervisory authorities to strength banking supervisory efforts. See John W. Head, *Lessons from the Asian Financial Crisis: The Role of the IMF and the United States*, 7 KAN. J.L. & PUB. POL'Y 70, 80 (1998) (believing six elements are especially important and should be expressly addressed in the legislation (or regulations) governing a country's banking sector (1) licensing of new banks or transfer of a bank's shares; (2) capital adequacy requirements; (3) insider lending and connected lending; (4) foreign currency exposure; (5) accounting and reporting requirements; and (6) legal authority to carry out examinations and impose corrective measures).

25. The 1997 Asian financial crisis was the result of several factors. Among these, external exposure involved the quasi-automatic guarantee of debts extended to local individuals or companies which had closer relationship to the failed financial institutions. For more information regarding the elements causing the crisis, see Berg Andrew, *The Asia Crisis: Causes, Policy Response, and Outcomes*, IMF Working Papers 99/138, (1999).

II. TAIWAN'S EMERGING BANKING LEGAL STRUCTURE AND INSTITUTIONAL FRAMEWORK

Taiwan's banking system has grown significantly since 1990 in response to the global trend of the financial liberalization and internationalization of the financial industry.²⁶ In order to achieve security, competition, credit allocation, and fair play, Taiwan's banking industry must have comprehensive banking regulations.²⁷ Adhering to conventional financial practices, financial institutions serve as public intermediators which deposit and loan money to customers.²⁸

In this regard, a primary objective of the financial sector in Taiwan was to phase out direct controls by the government while relying increasingly on commercial criteria. In the meantime, Taiwan organized banking regulators and enacted banking legislation, including preventive and protective regulations to secure a safe and sound banking system.²⁹

1. *Progress Towards Achieving Stability: Taiwan's Banking Regulatory Schemes*

The Banking Law of Taiwan,³⁰ which included nine chapters and 140 articles, is the primary banking statute in the Taiwan. The purpose of the Banking Law is to simplify the legislative purpose, streamline banking business, provide protection to depositors, facilitate the development of productive enterprises, and coordinate the operation of bank credit with national monetary policies.³¹ The Banking Law also prescribes the powers and du-

26. See DEPARTMENT OF THE TREASURY, *the USA*, in NATIONAL TREATMENT STUDY 458 (1998).

27. See NICHOLAS A. LASH, BANKING LAWS AND REGULATION: AN ECONOMIC PERSPECTIVE 22 (1987).

28. *Atherton v. Anderson*, 99 F.2d 883, 885 (6th Cir. 1938)(holding that a financial institution is a quasi governmental agency rather than a private corporation).

29. The methods of supervising financial institutions through authorities contain preventive regulation and protective regulation. The purpose of preventive regulation is to regulate the burden of banking risk, reducing liquidity and solvency ability. The preventive regulations refer to capital adequacy, liquidity, permitted business, limiting lending. Protective regulations assist banks and depositors as long as the bank implements risk management. The protective regulations encompass depositor insurance system and lender of last resort. See DELL SIDNEY, *THE INTER-AMERICAN DEVELOPMENT BANK: A STUDY IN DEVELOPMENT FINANCING* 55-68 (1984).

30. See Banking Law.

31. Banking Law Art. 1 (describing that the legislative purpose of enacting the Banking Law and the major designed intention of the Banking Law).

ties of all banks in Taiwan,³² applying to regulations governing Taiwan's banks' operations to both domestic and foreign banks.³³

The Banking Law has been amended 14 times to help the Taiwanese banking system's fostering of a sound financial system and a healthy economy, as well as to track the development of Taiwan's banking system. Unlike other advanced industrial countries, which allow banking development in accordance with market forces, Taiwanese banking policies took into consideration political elements that financially supported specific industries and state-owned companies. This political influence on the financial sector remained until the end of the 1980s. In 1989, pressures for liberalization and internationalization of the financial system of Taiwan, which resulted in the "big bang," eroded the traditionally close connection between political objectives and financial policies. On July 17, 1989, Taiwan ended the ban on the establishment of new banks by amending the Banking Law.³⁴ Under this new banking regulation, the Ministry of Finance ("MOF") authorized private appellants to acquire banking licenses that were previously only issued to state-owned banks and provincial banks. Currently, financial deregulation has opened the door, allowing private conglomerates to own a financial institution in Taiwan.³⁵

As a symbol of banking deregulation, the Banking Law of 1989 also changed the limits on lending and deposit interest rates and expanded the scope of business of foreign bank branches. Specifically, the Banking Law of 1989 also enhanced the power of the financial authorities to supervise banks and limited the extension of credit to banks' staff members or to any person who is an interested party of the banks' officers.³⁶

Under the amended Banking Law of 1989, Taiwan's Ministry of Finance can determine the criteria for entry into the banking industry by new banks.³⁷ On June 26, 1991, in the first round of applications for new commercial banks, the MOF approved 15

32. Banking Law ch. 1.

33. In addition to the Central Bank of China Act, foreign banks are governed by Chapter 7 of the Banking Law. See Banking Law ch. 7.

34. Art. 52 of the Banking Law permits the establishment of private commercial banks. The Ministry of Finance is authorized by the Banking Law to stipulate the "Standard for the Establishment of Commercial Banks" guiding requirements of application of a license of private financial institution.

35. *Id.*

36. Banking Law art. 3.

37. Art. 52 of Banking Law, amended on July 17, 1989, states that "[t]he requirements of establishments of a bank or a financial institution in accordance with this Law or other laws shall be prescribed by the central competent authority." On April, 1990, these criteria, named Criteria for Establishment of New Commercial Bank, were promulgated, and two days later, the MOF began accepting applications for the establishment of new commercial banks.

out of 19 applications, a much higher number of successful applicants than initially anticipated. In the second round of applications in 1992, the MOF only approved one license. In addition, two of Taiwan's trust companies were permitted to substantially convert into commercial banks.³⁸ Applicants for a new bank license must provide a minimum paid-in capital of New Taiwan Dollar \$10 billion (the equivalent of US\$380 million) in cash,³⁹ effectively limiting license applications to wealthy industrialists and conglomerates.

A further banking law revision implemented on October 30, 1992, and effectuated by the President's order on November 1, 1992, enhanced the power of the supervisory authority, and helped to improve the efficiency of the banking system in Taiwan.⁴⁰ The Banking Law of 1992 also expanded the scope of interested parties of financial institutions to prevent the possibility of insider lending.⁴¹ Furthermore, the Banking Law of 1992 provided for independent inspection of bank operations and financial status to ensure greater security for banking customers.⁴²

One trend of amending Taiwanese banking law is to reform banking regulatory structures to a more universal definition of banking services in which banks are allowed to engage in a wide variety of activities. The Banking Law's latest amendment was on June 29, 1995. The purpose of the amendment was to enlarge the scope of the banking business for financial liberalization and internationalization.⁴³ The Banking Law of 1995 also extended the maximum period for repayment from twenty to thirty years for the purpose of financing the purchase and construction of residential or commercial buildings.⁴⁴ However, the repayment period does not apply to first time mortgage borrowers.⁴⁵

38. The MOF approved China Trust Company, an affiliate of Koo's Group, on July 2, 1996 and Cathay Trust Company on September 5, 1994 to converted into commercial banks as the two trust companies raised their capitalization to over US\$ 380 million based on Banking Law's requirement. See *Taiwan: Taiwan to Approve Cathay Trust's Bank Conversion*, Reuter News Service-Far East, Sept. 5, 1995, available in LEXIS, ASPAC Library, Taiwan File.

39. Unless otherwise indicated, all amounts listed are calculated in U.S. dollars, rather in New Taiwanese dollars at a rate of US\$1 = NT\$31.7 as of December 1, 1999. See *Emerging - Market Indicators*, ECONOMIST, Dec. 4, 1999, at 120.

40. Banking Law art. 45.

41. Arts. 32, 33, 33-2, and 33-3 of the Banking was amended or enacted to expand the scope of interested parties to prevent insiders lending.

42. See BUREAU OF MONETARY AFFAIRS, THE ROC, *1992 Annual Report* 18-9 (July, 1993).

43. Banking Law, art 3 (governing that the conduct of a Taiwan bank can sell and purchase gold, silver, gold and silver coin, and foreign currency instead of old rule which could sell and purchase gold, silver, and foreign currency).

44. Banking Law art 38.

45. *Id.*

Nevertheless, the financial scandals exposed the weakness of Taiwan's financial regulations that were designed to block insider lending. In recent years, three devastating incidents shook the financial stability of Taiwan: the overdrawing of loans at the Tenth Cooperative Bank in 1985;⁴⁶ the illegal underground banking activities of the Hung-Yuan Investment Company in 1987;⁴⁷ and an allegation of insider trading and self-dealing involving a cabinet minister's family and local business leaders in 1995.⁴⁸

Taiwan also amended the Banking Laws of 1989 to internationalize the banking sector. Taiwan publicly stated that it wanted to replace Hong Kong as the new financial center of Asia after 1997, when the People's Republic of China assumed control of Hong Kong. To promote international financial activities, Taiwan encouraged foreign banks to establish offshore banking branches in Taiwan since 1984, in accordance with the Foreign Banking Act of 1983.⁴⁹ As of June 30, 1995, there were 39 foreign bank branches with sixty outlets and 26 representative offices of foreign banks from 19 countries.⁵⁰

Moreover, to meet financial service needs resulting from increased international activities, domestic banks have aggressively set up branches or subsidiaries in various overseas trading and financial centers.⁵¹ The operating of foreign banks in Taiwan, and Taiwanese banks operating abroad, present challenges for Taiwan's regulators. Foreign banks must be closely supervised to protect Taiwanese depositors and avoid the problems associated with the Bank of Credit and Commerce International ("BCCI")

46. The Tenth Credit scandal was discovered in October 1974 by the Cooperative Bank of Taiwan, the financial business supervisor of all credit cooperative societies. The Tenth Credit Union used "abnormal loans" to channel funds to the enterprises of the Cathay Related Group. Despite several warnings delivered by the MOF through the Finance Bureau of the Taipei municipal government, the local administrative supervisor of the credit cooperative societies, the total amount of abnormal loans of the Tenth Credit continued to rise. The size of abnormal loans increased to NT\$281 million in March 1976, to NT\$622 million in July 1977, and to NT\$ 1.499 billion in July 1979.

47. In particular, with the activities of banks restricted and with profitable opportunities emerging in several sectors of the economy, many unlicensed deposit-taking institutions (known as "underground investment companies" in Taiwan) came into existence and expanded rapidly in the end of 1980s. These illegal investment companies received deposits at high interest rates and invested in real estate and securities markets. The underground investment companies events existed until the amendment of Banking Law in 1989 which prohibited further operation by illegal investment companies. Hung-Yuan Investment Company was the pioneer and huge illegal investment company that abstracted the equivalent of US\$8 billion from more than a million Taiwanese investors. See Winn, *supra* note 17, at 916.

48. *Id.*

49. *Id.*

50. MOF, SUMMARY OF FINANCIAL BUSINESS STATISTICS (1994).

51. *Id.*

in 1991, which took advantage of various supervisory regulatory standards among the jurisdictions allowing the establishment of the BCCI branches.⁵²

2. *Taiwan's Banking Structure and Banking Regulators*

Taiwan designed two agencies to govern its financial institutions through direct supervision and the creation of regulations. The Ministry of Finance is the central authority in accordance with the Banking Law.⁵³ The MOF should cooperate with the Central Bank of China which dominates and approves any business relating to foreign exchange.⁵⁴ However, considerable overlap exists between the MOF and the CBC, creating a gray area for banking supervision.

According to the Banking Law and the Central Bank of China Act, the Taiwanese financial system, which is called the Central Bank of China ("CBC"), is an agency of the Executive Yuan.⁵⁵ As the Taiwan central bank, the CBC carries out a number of functions affecting the national economic well-being.⁵⁶ In this regard, the CBC is not only responsible for the formulation and conduct of the monetary policy but also the banking supervisory authority (in the name of the MOF).⁵⁷ Through the

52. The Bank of Credit and Commerce International [hereinafter "BCCI"] removed transactions from several global entities to shield the structure report transactions from banking supervisory and external audits. See Phyllis Solomon, *Are Money Laundering All Washed up in the Western Hemisphere? The OAS Model Regulations*, 17 HASTINGS INT'L & COMP. L. REV. 433, 437 (1994); GENERAL ACCOUNTING OFFICE, FOREIGN BANK: INITIAL ASSESSMENT OF CERTAIN BCCI ACTIVITIES IN THE U.S. (1992)(reviewing the BCCI's operation in the U.S. and discussing if the federal banking regulations can block such collapse repeatedly). For a discussion of the BCCI, see GENERAL ACCOUNTING OFFICE, INTERNATIONAL BANKING: STRENGTHENING THE FRAMEWORK FOR SUPERVISING INTERNATIONAL BANKS (1994); Her Majesty's Stationary Office, Inquiry into the Supervision of the Bank of Credit and Commerce International (the "Bingham Inquiry"), British Governmental Reports, Oct. 22, 1992; and Bank of England, Report of the Bingham Inquiry: Bank of England Responses, Press Notice, Oct. 22, 1992.

53. Banking Law art. 19.

54. Banking Law art 4.

55. According to Article 53 of the Constitution of the Republic of China [hereinafter "Constitution"], the administrative power of Taiwan is in the Executive Yuan. The Constitution, which was adopted in 1946 and amended in 1991, 1992, and 1994, provides for a central government with five branches. The government of the Republic of China is headed by the President of the ROC, who was popularly elected in March 1996. The president is the highest representative of the nation, possessing specific constitutional powers to conduct national affairs.

56. Art. 2(2) of the Central Bank of China Act (quoting that the CBC should foster economic development within the scope of the promotion of financial stability and maintaining of the stability of the internal and external value of the currency). The Central Bank of China Act of forty-four articles was promulgated on May 23, 1935, and amended on November 8, 1979 and May 21, 1997.

57. Banking Law art. 45.

CBC's monetary policy, which influences the availability of money and credit, the CBC plays a major role in keeping inflation in check while promoting Taiwan's economic growth. By supervising and regulating banks, the CBC fosters safety and soundness in Taiwan's financial system. In general, the CBC deals only with governmental agencies, banking and financial institutions, and international and foreign financial institutions.⁵⁸

The CBC is also responsible for issuing currency, managing foreign exchange reserves,⁵⁹ handling treasury receipts and disbursements, setting the interest-rate policy, overseeing the operations of other financial institutions, and serving as the "lender of last resort" for financial depository institutions.⁶⁰ By serving as a bank for depository institutions and the government of Taiwan, the CBC helps ensure that Taiwan's financial scheme of paying for different types of business transactions works efficiently. The CBC also conducts economic research that provides the President or Premier with advice for creating financial policy for Taiwan.⁶¹

The Ministry of Finance facilitates the Executive Yuan's administrative powers over financial institutions and markets primarily through the Bureau of Monetary Affairs ("Monetary Bureau"),⁶² comprising the regulatory heart of the MOF.⁶³ The Monetary Bureau, which was elevated from department status on July 1, 1991, is responsible for a number of regulatory functions, including designing, drafting, reviewing banking and financial laws and regulations, and supervising their enforcement.⁶⁴ The

58. Central Bank of China Act art. 12.

59. The legal basis for the CBC to enforce foreign exchange control is the Statue Governing Foreign Exchange of 1970, which was amended in 1978, 1986, and 1987.

60. Art. 19 of the Central Bank of China Act indicates that the CBC may provide re-discounts of eligible bills, temporary advances, and financing of secured loan to banks. As long as Taiwanese financial institutions find themselves temporarily short of reserves caused by unexpected credit demands, deposit drains, or seasonal economic factors, the financial institutions may be eligible to borrow from the CBC as the "lender of last resort." The availability of credit from the CBC is intended to stabilize individual financial institutions, as well as the Taiwanese banking and financial system as a whole, during times of liquidity stress.

61. Central Bank of China Act art 39.

62. Pursuant to the revised "Ministry of Finance Organization Law" and "Statute for the Organization of the Bureau of Monetary Affairs of the Ministry of Finance," which were put into force by the President on May 31, 1991, the Department of Money Affairs was upgraded to the Bureau on July 1, 1991. See Bureau of Monetary Affairs [hereinafter "BMA"], MOF, 1998 ANN. REP. [hereinafter "1998 Annual Report"], at 25.

63. Art. 19 of the Banking Law states "the term 'competent authority' referred to herein means the Ministry of Finance of the central government; and the Department of Finance of a provincial or municipal government."

64. See BMA, *supra* note 62, at 25.

Monetary Bureau, moreover, is responsible for managing and supervising banks and special institutions in order to establish a sound banking system.⁶⁵ In addition, the Monetary Bureau must support the development of the agricultural, industrial, and commercial sectors.⁶⁶

Pursuant to the Banking Law,⁶⁷ in September 1985, Taiwan instituted the Central Deposit Insurance Corporation ("CDIC"),⁶⁸ a subordinate agency of the MOF designed to, *inter alia*, safeguard the benefits of depositors in Taiwanese financial institutions and promote saving.⁶⁹ In addition to the MOF and the CBC, the CIDC shareholders are from insured financial institutions.⁷⁰ Insured financial institutions include domestic banks, foreign bank branches in Taiwan, trust and investment companies, credit cooperative associations,⁷¹ farmers' and fishermen's associations with credit departments, and other financial institutions as designated by the MOF.⁷²

Currently, 393 financial institutions, which are 86.3 percent of Taiwan's total 470 financial institutions, have enrolled in the CDIC. Taiwan's eight provincial banks did not participate in the CDIC until 1998 because of the opposition of the Taiwan Provincial Assembly, which believed the provincial banks would not go bankrupt under the supervision of the Taiwan Provincial Assembly.⁷³ Moreover, 15 foreign banks and fifty credit unions of farmers and fishermen did not join the CDIC.

An association of the CBC and the MOF has drafted a proposal to amend Banking Law and the Deposit Insurance Act to enforce all Taiwan financial institutions to participate in the

65. Banking Law art. 45.

66. See BMA, *supra* note 62, at 26.

67. Banking Law art. 46.

68. The Deposit Insurance Act [hereinafter "DIA"] promulgated January 9, 1985, in accordance with the Article 46 of Banking Law, mentioning that a deposit insurance organization may be formed by the government or banks in order to safeguard the interests of depositors. Based on Art. 1 of the DIA. The Central Deposit Insurance Corporation [hereinafter "CDIC"], a government-run corporation, was established in September 1985. Moreover, the DIA is also pursuant to Art 25 of the DIA, under which the Executive Yuan prescribed the Enforcement Regulation of the Deposit Insurance Act, promulgated on August 12, 1985 and revised on July 29, 1991.

69. Art. 5 of the Deposit Insurance Act, promulgated on January 9, 1985, notes that the competent authority (the MOF) cooperate with the Central Bank of China to establish a Central Deposit Insurance.

70. DIA art. 3.

71. The Credit Cooperative was promulgated by a Decree of the President on the third day of December, 1993 as amended by supplementing Article 49-1 by a Decree of the President on the fourth day of February, 1994 Chapter One General Provisions. See BMA, <<http://www.boma.gov.tw/english/p2-2.htm>>.

72. *Id.*

73. See BMA, *supra* note 62, at 26.

CDIC.⁷⁴ If the remaining uninsured banks meet the standard to enroll the CDIC within three years, the MOF will order them to merge, settle, or dissolve.⁷⁵

3. Various Banking Institutions in Taiwan

Compared with other industrialized nations such as Germany, the United States, and the United Kingdom, Taiwan has a complicated financial system.⁷⁶ The development of banking in Taiwan has been influenced by the Japanese banking system,⁷⁷ due in part to fifty years of Japanese control of Taiwan. Following Japanese colonial rule between 1895 and 1945, remnants of the Japanese financial system remain. For example, postal saving networks and local credit unions continue to operate much as they do in Japan.⁷⁸ In addition, due to Japan's advanced financial industry and its geographic proximity to Taiwan, Taiwan has referred to Japanese banking experiences more than to any other country.⁷⁹ This habit has adversely affected the structure of development of the Taiwanese banking system.

Because of the complicated history of the development of Taiwanese banks, in comparison with the aforementioned countries, there are a variety of financial institutions in Taiwan. In line with the historical development and practice of finance, Taiwan's banks, which are organized and registered in accordance with the Banking Law,⁸⁰ comprise four categories:⁸¹ commercial

74. Those concepts of amending the Banking Law and the Deposit Insurance Act were presented at a seminar for the Ability of Enforcing All Financial Institution to Participate into the Central Deposit Insurance Company held by the Central Bank of China, Ministry of Finance, and Central Deposit Insurance Company on October 30, 1996.

75. See BMA, *supra* note 62, at 26.

76. There are basically three categories of banks in Taiwan. Coincidentally, the development of the banking industry in Taiwan has also undergone three major phases. Banks under each category are not only similar in the general functions performed, but also in the developmental phase during which they were established. These three categories are (1) banks established during the Japanese occupation of Taiwan from 1895-1945; (2) banks founded in Mainland China and subsequently re-established in Taiwan after 1949; and (3) banks founded and established in Taiwan after 1949. See Kuo-Shu-Liang, *Banking Models and Operation Realities in Taiwan*, in INTERNATIONAL BANKING REGULATION AND SUPERVISION: CHANGE AND TRANSFORMATION IN THE 1990s 117, 117 (J. J. NORTON, et al. ed., 1994).

77. See Lawrence L. C. Lee, *The Development of Banking in Taiwan: The Historical Impact on Future Challenges*, in THE OCCASIONAL PAPER/REPRINTS SERIES IN CONTEMPORARY ASIAN STUDIES (1999).

78. See Lawrence S. Liu, *Taiwan: A Roadmap for Financial Reform in the Nineties?* EUROPEAN INT'L FIN. L., Aug. 3, 1991.

79. Although advanced financial countries included the United Kingdom, Germany, Canada, France, and the United States, Taiwan adopted the Japanese banking pattern because Japan has a similar banking system to Taiwan and geographic advantage. See Lee, *supra* note 67.

80. Banking Law art. 2.

banks, savings banks, specialized banks, and,⁸² pursuant to the Banking law, Taiwan has a number of specialized banks that provide specialized credit for certain important financial market segments. These specialized banks provide medium- and long-term industrial, agricultural, trade, real estate, and medium and small business credit. In some cases, a non-specialized bank has undertaken these specialized functions, or a specialized bank has undertaken two or more specialized functions.⁸³ Taiwan has other financial institutions which were established in accordance with other laws and special statutes,⁸⁴ which consist of bill finance companies, securities firms, postal savings systems,⁸⁵ insurance agents, offshore financial institutions, specialized financial marketing agents,⁸⁶ and basic-leave financial institutions, credit cooperatives,⁸⁷ credit departments of farmers' association and fishermen's associations.

From 1950 to the establishment of new banks in 1992, Taiwan licensed no major private banks, although several institutions relocating from mainland China were reactivated during the 1950s and 1960s. Although various institutions have been al-

81. Banking Law art. 20.

82. Art. 87 of the Banking Law (stating that to facilitate the availability of special credit for enterprises, the central competent authority [MOF] allows the establishment of specific banks or may designate an existing bank to extend such credit. Art. 88 of the Banking Law (indicating that special credit referred to in the preceding Article [Art. 87 of the Banking Law] is divided in to the following six categories: (1) industrial credit; (2) agricultural credit; (3) export-import credit; (4) medium- and small-size enterprise credit; (5) mortgage credit; and (6) local credit.

83. See also BRIAN WALLACE SEMKOW, TAIWAN'S FINANCIAL MARKETS AND INSTITUTIONS: THE LEGAL AND FINANCIAL ISSUES OF DEREGULATION AND INTERNATIONALIZATION 39 (1992)

84. Those regulations authorizing the establishment of financial institutions are the Cooperation Law, the Farmers' Association Law, the Fishermen's Association Law, the Regulation Governing the Dealers of Short-term Negotiable Instruments, the Rules Governing the Securities Finance Business, the Insurance Law and the Deposit Insurance Act. However, the Banking Law could govern any financial institution even those incorporated based on the other regulations, unless exception rules. See Banking Law art. 139.

85. The postal saving system [hereinafter "PSS"] was designed to encourage domestic consumer savings. The PSS has proven very popular largely as a result of the greater convenience offered by the large number of locations and longer working hours, 10 hours on Monday to Friday, and 4 hours on Saturday. See BMA, *The Financial System in the R.O.C.*, <<http://www.boma.gov.tw/english/efsroc.htm>>.

86. Specialized financial marketing agents in Taiwan currently are defined to those financial institutions including bill financial companies; general securities companies, including dealers, brokers, and underwriters; securities finance companies; interbank money center; and foreign currency call loan center. See BMA, *The Financial System in the R.O.C.*, <<http://www.boma.gov.tw/english/efsroc.htm>>

87. Credit department also found in farming and fishing associations throughout Taiwan. Such departments handle limited banking actives and credit extension services for their members. See BMA, *The Financial System in the R.O.C.*, <<http://www.boma.gov.tw/english/efsroc.htm>>

lowed to enter the margins of the banking system in Taiwan, government-owned banks have dominated Taiwan's financial market since 1949.⁸⁸

The majority of banks in Taiwan operate under the multi-office banking system.⁸⁹ Taiwan also devised a few specialized banks to provide industries with medium and long-term credit to accelerate the development of industries specified by the authorities engaged in multiple banking operations.⁹⁰ In order to create credit for specific developing industries, Taiwan formulated six categories of specific credit.⁹¹

As of June 30, 1998, there were 48 domestic banks, including eight medium business banks, 16 new private commercial banks set up since 1992,⁹² and two that were restructured from a trust and investment company.⁹³ Taiwan also had four trust and investment companies, 54 credit unions, 31 domestic and foreign life insurance companies, four bills finance companies,⁹⁴ and four securities finance company (see table 1).

After gaining permission from the Minister of Economic Affairs, foreign commercial banks that desire to do business in Taiwan must apply for a license from the MOF.⁹⁵ As of mid-1995, Taiwan had 38 branches of foreign banks with 58 outlets, and 26 representative offices of foreign banks from 19 countries.

88. See Winn, *supra* note 17, at 934.

89. Art. 57 of the Banking Law permits a bank to establish its branch with an approval and issuance of a business license issued by the central competent authority.

90. Banking Law art 87. See *supra* note 84.

91. Art. 88 of the Banking Law notes that [s]pecific credit referred to in the preceding [87] Article is divided into the following categories: 1) industrial credit; 2) agriculture credit; 3) export-import credit; 4) medium- and small-sized enterprise credit; 5) mortgage credit; and 6) local credit. See *supra* note 84.

92. The MOF approved fifteen out of nineteen applications—a much higher number of successful applicants than initially anticipated. These banks commenced operation in the first part of 1992, with significant capitalization, ranging from NT\$10 billion to NT\$13.5 billion in paid-in capital. The MOF allowed a second set of applications for new commercial banks from April 12-October 12, 1991, for which there was only one applicant, and approved its application. See WILLIS KE, *Banking on New Ideas Get Ahead*, BUS. TAIWAN, Jan. 13-18, 1992, available in LEXIS, AS-PAC Library, Taiwan File.

93. The Bureau of Monetary affairs, the MOF, issued an approval letter to the China Investment and Trust Company to change its status to a commercial bank on May 23, 1992. See Monetary Bureau, the MOF, 1992 ANN. REP., at 65.

94. See Economic Research Department, *the CBC*, Financial Statistics Monthly, Jan. 1992, at 97-98. The principal function of these companies is to facilitate the supply and demand of short-term funds in the bills market. This is achieved through the buying and selling of debt securities, such as treasury bills, bankers' acceptances, negotiable certificates of deposit issued by banks, and commercial paper and other certificates of short-term indebtedness as may be approved by the Minister of Finance, for their own account as dealers or on behalf of others as brokers.

95. Banking Law art. 116.

Table 1: Number of Financial Institutions in Taiwan District

	1992		1993		1994		1995		1996		1997		1998	
	Branches (Head Office)	%	Branches (Head Office)	%	Branches (Head Office)	%	Branches (Head Office)	%	Branches (Head Office)	%	Branches (Head Office)	%	Branches (Head Office)	%
Monetary Institutions	2,966	66.28	3,205	67.56	3,494	69.20	3,816	70.42	4,036	71.06	4,211	71.45	43,91	72.20
Domestic General Banks	897 (32)	20.76	1,030 (33)	22.41	1,174 (34)	23.93	1,361 (34)	25.74	1,464 (34)	26.37	1,685 (39)	29.25	2,052 (42)	34.43
Local Branches of Foreign Banks	50 (36)	1.92	55 (37)	1.94	57 (37)	1.86	58 (38)	1.77	65 (41)	1.87	69 (45)	1.93	72 (46)	1.94
Medium Business Banks	315 (8)	7.22	352 (8)	7.59	403 (8)	8.14	446 (8)	8.38	472 (8)	8.45	491 (8)	8.47	352 (6)	5.89
Credit Cooperatives	439 (74)	11.46	428 (74)	11.72	530 (74)	11.96	556 (73)	11.61	595 (73)	11.76	505 (64)	9.65	446 (54)	8.22
Credit Departments of Farmers & Fishermen Associations	803 (312)	24.92	822 (312)	23.90	865 (312)	23.31	930 (312)	22.92	972 (312)	22.61	991 (314)	22.14	1,007 (314)	21.72
Non-monetary Institutions	1,509	33.72	1,539	32.44	1,555	30.82	1,603	29.58	1,644	28.94	1,683	28.55	1,691	27.80
Trust & Investment Companies	55 (7)	1.39	61 (7)	1.43	53 (6)	1.17	49 (5)	1.00	55 (5)	1.06	61 (5)	1.12	43 (4)	.077
Postal Savings System	1,223 (1)	27.35	1,243 (1)	26.22	1,260 (1)	24.98	1,269 (1)	23.44	1,273 (1)	22.43	1,276 (1)	21.67	1,287 (1)	21.18
Insurance Companies	152 (44)	4.38	150 (50)	4.22	157 (50)	4.10	183 (51)	4.32	206 (55)	4.60	230 (56)	4.85	239 (56)	4.85
Bills Finance Companies	21 (3)	0.54	21 (3)	0.51	22 (33)	0.50	29 (10)	0.7	31 (12)	0.76	34 (14)	0.81	39 (16)	0.90
Securities Finance Companies	2 (1)	0.07	2 (1)	0.06	2 (1)	0.06	2 (4)	0.11	2 (4)	0.11	2 (4)	0.10	2 (4)	0.10
Total	4,475	100	4,744	100	5,049	100	5,419	100	5,680	100	5,894	100	6,082	100

Source: 1. Statistics Office of the Bureau of Monetary Affairs, Ministry of Finance (MOF), financial Statistics Abstract, December 1998.

2. Statistics Office of the Bureau of Monetary Affairs, MOF, Essentials of Financial Institutions, December 1998.

3. Economic Research Department of the Central Bank of China, Financial Statistics Monthly of Taiwan District of the Republic of China, January 1999.

4. Divisions 2 and 5 of the Bureau of Monetary Affairs, Ministry of finance.

Note: 1. The Central Reinsurance Company, Postal Agencies and Fishing boat Insurance Cooperatives are not included.

2. Institutions include domestic head offices and branches only.

4. *Operation of Foreign Banks and Possibilities of Chinese Banks in Taiwan*

In 1953, when Dai-Ichi Kangyo Bank of Japan established itself as the first foreign bank in Taiwan, foreign banks merely occupied a peripheral position in Taiwan's financial system. At that time, foreign banks provided only four percent of the domestic lending. As of October 1996, foreign banks still represented only five percent of the total assets held by all financial institutions in Taiwan. The character of capital markets has become increasingly integrated and international.⁹⁶ Expansion of international trade and the growth of multinational corporations have led Taiwan and foreign banks to open offices overseas to service customers of their home country and to seek new growth opportunities.

In 1998, 48 foreign banks had been permitted to establish 76 branch offices, and 26 foreign banks have been approved to establish representative offices in Taiwan's financial market (as show in Table 2). Branches were the most common foreign organizational form - accounting for 61 percent of foreign bank offices and percent of foreign bank assets at the end of 1995. Separately, chartered Taiwan's bank subsidiaries were slight - accounting for 14 percent of foreign bank assets.

Taiwan has generally increased the flexibility of operations of foreign banks throughout the island.⁹⁷ Under the Banking Law of 1989, foreign banks may offer savings accounts, make long-term loans, and engage in trust businesses like domestic commercial banks. Foreign banks are also permitted to apply for securities underwriting licenses, which has been highly profitable in recent years. The foreign banks may also be licensed to sell overseas collective investment securities.⁹⁸ Additionally, financial globalization has also encouraged more competition for Taiwanese banks, as the foreign share of the commercial and industrial loan market in Taiwan was approximately 4.0 percent in 1995.⁹⁹

To guarantee the success of establishing Taipei as a regional financial center, enlargement and liberalization of foreign commercial banks' participation in Taiwan's financial market is ur-

96. See *A Survey of Financial Centers, Capitals of Capital*, ECONOMIST, May 9, 1998, at 5 (analyzing financial institutions, such as wholesale banks, investment banks, insurance companies and fund management scramble to build global businesses).

97. See Michelle A. Silk et. al., *Banking: The Regulatory Aspects, in Taiwan Trade and Investment Law*, 353, 372 (Mitchell A. Silk ed. 1994).

98. See 1998 ANNUAL REPORT, *supra* note 62, at 58.

99. *Id.*, at 82

Table 2: Number of Foreign Bank Branches and Representative Offices (As of December 31, 1998)

Region	Country		Branches							Representative Offices
	Taipei City	Taipei Country	Kao-suing	Tai-chug	Tao-Yuan	Shin-chug	Tai-Nan	Subtotal		
North America	16	1	2	3	1	1	1	1	25	3
	4	0	0	0	0	0	0	0	5	2
	1	0	1	1	0	0	0	0	2	2
Europe	5	0	1	1	0	0	0	0	8	0
	2	0	1	1	0	0	0	0	4	1
	1	0	0	0	0	0	0	0	1	3
	1	0	0	0	0	0	0	0	1	1
	0	0	0	0	0	0	0	0	0	1
Asia	0	0	0	0	0	0	0	0	0	1
	0	0	0	0	0	0	0	0	0	1
	0	0	0	0	0	0	0	0	0	2
	2	0	0	0	0	0	0	0	0	1
	0	0	1	0	0	0	0	0	3	0
	0	0	0	0	0	0	0	0	0	0
	5	0	0	0	0	0	0	0	6	0
	1	0	1	1	0	0	0	0	3	3
	1	0	1	1	0	0	0	1	4	0
	4	0	0	0	0	0	0	0	4	3
Oceania	2	1	1	1	1	0	0	1	7	1
	2	0	0	0	0	0	0	0	2	2
	1	0	0	0	0	0	0	0	1	0
Africa	1	0	0	0	0	0	0	0	1	1
	19	2	10	9	2	1	3	76	26	

Source: Division Five of the Bureau of Monetary Affairs, Ministry of Finance.

Note: The above figures represent numbers already approved

gently necessary.¹⁰⁰ In addition, to obtain entry into the WTO, Taiwanese negotiators agreed in principle to relax restriction on the establishment of branches by foreign banks.¹⁰¹ Accordingly, Taiwan should level the playing field by requiring similar rules based on the application of international banking supervisory standards for foreign and domestic banks to ensure a new financial structure that is competitive, vigorous, and safe.¹⁰²

Subsequent to becoming a member of the WTO, Taiwan's banking sector will face the forceful competitiveness from not only foreign banks but also Chinese counterparts. Due to the post-1949 financial separation, Taiwan does not give national treatment to Chinese financial institutions. Taiwan instead designed a system of national security that prevents China from manipulating Taiwan's economy. Furthermore, Taiwan prohibits any direct banking connections with financial institutions from China. Nonetheless, Taiwan allows its banks to have direct connections with China's banks through overseas branches.

Although Taiwan prohibits the entry of Chinese banking operations, Taiwan has a much more amiable relationship with Hong Kong, which became a Special Administrative Region of China in July 1997.¹⁰³ However, Taiwanese banks have reservations about entering the Hong Kong financial markets due to Hong Kong's recent transfer to China. Taiwanese banks are also reluctant to open operations in China due to the dim prospects for the quick liberalization of banking policies in China. Because of these difficulties, Taiwanese banks seek to enter other markets besides those of Hong Kong and China.

Although trade between Taiwan and China closely connects both financial systems, Taiwan's financial policies do not allow

100. See Winn, *supra* note 17, at 924.

101. See Kelly Her, *Progress made toward WTO*, THE FREE CHINA J. Feb., 14, 1997, at 3.

102. See Bank for International Settlements, 69th Annual Report 1 April 1998 -31 March 1999, 151-7 (July 1999) (stating that the international organizations including the Basle Committee on Banking Supervision, the committee on the Global Finance System (formerly the Euro-currency Standing Committee), the Committee on Payment and Settlement System, and the Financial Stability Forum emphases in establishing a playing field for banking sectors, no matter what nationalism banks to promote safety and soundness in a national financial system).

103. In order to transfer the colony of Hong Kong, Britain signed the Basic Law of the Hong Kong Special Administrative Region of China [hereinafter "Basic Law"] with China at the Joint Declaration on the Question of Hong Kong in 1984. Under the Basic Law, Hong Kong is a Special Administrative Region of China, which is to retain its own financial and political system for at least fifty years. Therefore, Hong Kong is referred to in this article as an independent economic entity. See The Basic Law of the Hong Kong Special Administrative Region of the Peoples' Republic of China, April 4, 1990, China-G. Brit. 29 I.L.M. 1520 (ratified March 1990; adopted by the National People's Congress, April 1990).

mainland Chinese financial institutions to establish branches in Taiwan, which impacts financial integration between Taiwan and China. However, in order to encourage the Hong Kong government and mainland China to allow Taiwan-based banks to upgrade their existing financial institutions in Hong Kong and establish new branches in Hong Kong or mainland China, the Ministry of Finance approved Hong Kong banks, which owns mainland Chinese-held shares below the 20 percent ceiling imposed by Taiwan, to establish branches in Taiwan.¹⁰⁴

III. CURRENT SOLUTIONS TO BANKING PROBLEMS IN TAIWAN

Taiwanese financial regulators' fears about lax entrance standards for new banks have resulted in the call for more rules and regulations.¹⁰⁵ As a result, under this current conservative scheme, Taiwan's domestic and foreign banking institutions face numerous bureaucratic hurdles. The conservative financial policies delayed the privatization of government-owned banks and have postponed the introduction of new financial products into the Taiwanese financial market.¹⁰⁶

At this time, a deregulated financial market is crucial for the development of Taipei as a regional financial center under the purpose of the Asia-Pacific Regional Operations Center Plan ("APROC Plan").¹⁰⁷ A financial framework must be implemented to condense the current financial system, and Taiwan's banking laws need to be liberalized to provide enterprises the freedom to gain sufficient capital from various financial institu-

104. On October 15, 1996, the Ministry of Finance approved the Bank of East Asia [hereinafter the "BEA"], Hong Kong's largest bank, to upgrade its representative office to branch status in Taiwan. The BEA is the first bank with mainland Chinese investment to be permitted into Taiwan.

105. In addition to the precedent of the Mexican financial collapse in 1994, the lesson learned from the great inflation during the civil war against China Communist Party is still vivid in the minds of many Taiwan financial officers. See *Taiwan's Banking Reform*, FORBES, Jul. 24, 1989, at 201.

106. See Lames Leung, *Taipei Wavers over Reforms*, 31 ASIAN BUS., 72-75 (1995)

107. The purpose of the Asia-Pacific Regional Operations Center Plan [hereinafter "APROC PLAN"] is to build Taipei as an Asia-Pacific regional operation and to keep Taiwan a world-class economic participant. The APROC PLAN is designed to establish specific operation centers in Taiwan. The centers include financial services, telecommunications, air and sea transportation, manufacture and media centers in Taiwan from 1995 to the twenty-first century. The Coordination and Service Office for the Asia-Pacific Regional Operation Center, also known as APROC Window, is a specific office set up under the Council for Economic Planning and Development, Executive, by the ROC to achieve the APROC PLAN. See APROC WINDOW, IMPLEMENTING THE ASIA-PACIFIC REGIONAL OPERATIONS CENTER PLAN — from Aspiration to Action (Oct. 1995).

tions.¹⁰⁸ By limiting the amount of supervisory agencies, Taiwan can substantially improve the effectiveness of the competent authority's ability to efficiently monitor financial activities.¹⁰⁹ The multi-agencies' current supervisory framework hampers the ability to punctually cope with financial scandals. Therefore, a single regulatory supervisory agency should be created to consolidate the current multiple supervision system. Furthermore, Taiwan needs to update its regulations concerning the restrictions on Taiwan's financial institutions. The relaxation of out-of-date regulations will assist in the liberalization of Taiwan's capital market, thereby attracting the business of additional foreign investment institutions.

Taiwan must also reorient the culture of loan policies to be evaluated by creditworthiness rather than political connections or interested relations with financial institutions.¹¹⁰ These refinement efforts will facilitate the establishment of Taiwan as a financial center in the Pacific Rim.¹¹¹

1. Simplification and Reduction of Financial Institutions

After one hundred years of development, several different types of financial business organizations have existed in Taiwan. Although the diverse financial institutions provided customers with different services, in order to establish a simple financial supervisory system and promote a competitive atmosphere, Taiwan should consolidate to re-allot various financial organizations for the same catalogue of financial business. In this respect, the MOF has approved the transformation of four trust and investment companies into banks,¹¹² and has approved a merger allowing a mixed trust and investment company to establish itself as a commercial bank in 1995. The simplification of various financial institutions into commercial banks will increase competition in the Taiwanese banking industry and assist authorities in comprehensively supervising the activities of financial institutions.

108. See Paul C. H. Chiu, *Liberalization Priorities*, 46 FREE CHINA REV. 36, 37 (1996).

109. Art. 45 of the Banking Law notes that four competent authorities have charge with supervision of banks. These agencies are the Ministry of Finance, Central Bank of China, Central Deposit Insurance Company, and Taiwan Credit Cooperation Associate.

110. See *New Crisis, New Rules*, Economist, Apr. 12, 1997, at 17.

111. See APROC PLAN, *supra* note 107 and accompanying text.

112. See DEPT. OF THE TREASURY, *supra* note 26.

According to Article 20 of the Banking Law,¹¹³ Taiwan currently has four categories of banks: commercial banks, savings banks, trust and investment companies, and specialized banks.¹¹⁴ In reality, however, savings banks are often not autonomous banks but are branches of commercial, specialty banks, or even foreign commercial banks.¹¹⁵ In other words, a true savings banks does not exist in the Taiwanese banking market because the commercial bank already encompasses the function of saving banks.¹¹⁶ Unfortunately, this situation does not appear to be consistent with the functions of each of the banks described in the Banking Law. Moreover, to further complicate matters, the postal saving system itself functions as a *de facto* saving bank.¹¹⁷

Mergers, acquisitions, and conversion processes could assist uncompetitive financial institutions in facing competition.¹¹⁸ Due to the peculiar circumstances under which various types of financial institutions were created at different times and for different purposes, each type of institution has been restricted to performing only certain functions. These restrictions render each category of institutional and financial system less flexible, as a whole, to adjust to the rapidly and radically evolving social and economic conditions currently experienced in Taiwan. Customers' increased demands on universal financial services have caused several financial institutions to experience difficulties surviving, particularly the credit cooperative associations, trust and investment companies and local medium-sized business banks.¹¹⁹

Taiwan's credit cooperative associations furnish many of the same services as commercial banks. For example, credit cooperative associations are allowed to accept deposits and extend loans, as well as offer banking services such as checking, passbook, and time/saving accounts. Nonetheless, the overall scope of its activity remains narrower than of commercial banks. According to the Banking Law,¹²⁰ credit cooperative associations are only allowed to provide services to its own members, which may be

113. Art. 20 of the Banking Law states that the term "bank" referred to herein is classified into the following four categories: 1. Commercial bank; 2. Saving bank; 3. Specialized bank; and 4. Trust investment company unless set up by the government.

114. *Id.*

115. *See FFO Taiwan, Domestic Financing*, BUS. INT'L CORP., Feb. 1990, at 12.

116. *Id.*

117. *Id.* at 13.

118. *Id.*

119. *See* Charles Freedman and Clyde Goodlet, *The Financial Services Sector: Past Changes and Future Prospects*, Technical Report No. 82(Bank of Canada), 8-10 (March 1998).

120. *Id.*

either natural persons or public interest corporate persons.¹²¹ Credit cooperative associations are therefore precluded from dealing in investments and enterprises.

The business of credit cooperative associations has recently been further limited to specific geographic regions by the Taiwan Banking Law revision of 1992.¹²² Moreover, the MOF announced a prohibition on establishing new credit cooperative associations in 1994.¹²³ Under these restrictions, the continued prosperity and role of credit cooperative associations are in doubt. After the deepening troubles of farmers' and fishermen's credit departments in 1995,¹²⁴ the MOF is encouraging several credit cooperative associations to merge into commercial banks.¹²⁵ In addition, the announcement of the Guideline for the Change of Credit Union into Commercial in April 1995 provoked a transition from a credit union to a commercial bank.¹²⁶

Trust and investment companies ("trust companies") are not enacted under any special statutes and are governed by the Banking Law.¹²⁷ Trust companies are a unique financial institution to Taiwan, extending medium- and long-term loans, managing trust and retirement funds, and offering various kinds of custodial and trustee services.¹²⁸ Trust companies are also permitted to underwrite and manage securities, engage in credit card business, and provide certain kinds of financial and corporate advice.¹²⁹

121. Uniform Regulations Governing Credit Cooperative Association art. 11 (reformed on March 18, 1964).

122. Banking Law art. 99.

123. See BMA, 1994 ANNUAL REPORT 46 (1995).

124. The government alleged that Cathay Plastics executives had obtained the identification cards and chops (personal seals) of Cathay employees under the pretext of opening accounts for them at Tenth Credit, then used the employees' names to obtain loans to finance the operations of Cathay group companies. See Bob King, *Financial Troubles Deepen at Tenth Credit and Cathay Plastics*, FIN. TIMES, Feb. 26, 1985, at 15.

125. By merging into commercial banks, credit cooperative associations can avoid the pressures applied from local politicians. Further, the merger enhances the MOF's ability to effectively supervise the financial institutions.

126. A Taiwanese credit union became a commercial bank in the end of September 1996. After the considerable review of the Ministry of Finance, Taipei Third Credit Union has been approved to change its organization to become a commercial bank called "Ho-Hsin Commercial Bank."

127. Banking Law art. 100(2). Because no appropriate regulation governing the trust business activities and the increased competition from commercial banks which allowed to perform trust business since 1989, the resulting deterioration in trust companies' performance significantly strengthened trust companies for conversion into a commercial bank.

128. Banking Law art. 101.

129. *Id.*

Trust companies however, cannot, accept checking deposits and low-interest saving deposits.¹³⁰ By accepting only high-interest saving deposits — thereby limiting the amount of outstanding guarantees — trust companies are placed in a far less competitive position than commercial banks.¹³¹ The loans granted by trust companies are therefore at a higher interest rate and are a higher risk.

To offset these deficiencies, trust companies often require the value of mortgaged property to be significantly higher than the loan that it secures. Trust companies also actively seek higher returns for their capital and invest heavily in the stock market. Unfortunately, due to the recent fluctuation in the Taiwanese stock market, great gains and losses are realized from trust companies' investments, resulting in instability for these companies.

Local medium business banks provide medium and long-term credit to both small and medium-sized enterprises to assist them in improving their productive equipment and financial structure and to strengthen their management and operations. Otherwise, they are restricted by the Banking Law¹³² to conduct business in designated areas and with designated enterprises, making it difficult to expand business. This clearly places these medium business banks in a competitively disadvantageous position vis-à-vis the commercial banks.

Given the above-mentioned problems, the current variety and complexity of financial institutions cannot persist. Some of these financial institutions will either fail, merge with or become acquired into other institutions, or be allowed to evolve and adapt. Ultimately, these institutions will become similar, allowing them to compete on equal footing.¹³³ Consequently, financial rules will be simpler and the playing field more level.

Regulators in Taiwan will be faced with the challenge of choosing a suitable system for financial institutions of the future.

130. Banking Law art. 101.

131. The outstanding guarantees can not exceed ten times its equity. Uniform Regulations Governing Trust and Investment Companies art. 27(reformed on February 19, 1987).

132. Article 96 of Banking Law states: "The scope of business of medium- and small-sized enterprises shall be prescribed by the central competent authority of economic affairs and submitted to the Executive Yuan for approval."

133. Under this scenario, the MOF currently permits regional banks to be expanded into national banks, with the Taipei Bank, the Medium Business Bank of Taiwan. The MOF hopes the enlargement of setting up branches could diversify financial service and compete financial markets. Furthermore, the local-level credit cooperative can now also be converted into commercial banks. See Willis Ke, *Taiwan: Domestic Bank- Diversifying Service, Enhancing Automation*, BUS. TAIWAN, Feb. 13, 1995, available in LEXIS, ASIAPC Library, Taiwan File.

Regardless of whether one current system is selected over another, or whether attributes of various systems are combined for the future, a new financial legislative framework must meet the demands of modern society. Clearly, financial institutions that are not capable of adapting will not be able to compete and are doomed to fail. By the same token, a financial system not capable of adapting to the realities of the modern society will also meet the same destiny.

2. *Strengthening Internationalization of Taiwan's Banking System*

Competitive pressures and technological advances have changed the structure of the international banking industry and will continue to change it. The modern banking industry, which allows financial businesses to engage in the full range of both cross-border and national financial activities — from traditional banking to securities activities and insurance — should provide the benefits of increased services and lower prices to customers.¹³⁴ Banking regulators are beginning to address fundamental financial reform¹³⁵ in order to retain strict supervision over banks, non-banking financial entities, and financial conglomerates.¹³⁶

Under the conservative policy of the state-owned financial institution, Taiwan's banks did not keep up with the international

134. See ROSS CRANSTON, *PRINCIPLES OF BANKING LAW* 2 (1997) (finding that large banks typically become multi functional institutions, engaged not only in traditional banking activities but in a range of other financial activities).

135. See 2 JANE W. D'ARISTA, *THE EVOLUTION OF U.S. FINANCE* 395-412 (1994) (illustrating that the Bush Administration, for example, proposed a financial reform which called for modernizing the financial system and made recommendations for safer, more competitive banks to meet the approaching challenge of diversified financial development).

136. The terms "financial conglomerates" or "mixed conglomerate" mean an industrial or commercial operation with at least one financial component. For more information about financial conglomerates, see George A. Walker, *The Law of Financial Conglomerates—The Next Generation*, 30 *INT'L LAW.* 57, 73 (1996). Financial conglomerates conduct an array of activities, including: investment banking, insurance, and the sale of mutual funds and derivatives. Derivatives are financial contracts whose value depends on the values of one or more underlying assets or indexes of asset values. For more information about financial derivatives, see GLOBAL DERIVATIVES STUDY GROUP, *DERIVATIVES: PRACTICES AND PRINCIPLES* 2 (1993) (a series of studies by the Group of Thirty "explaining derivatives and their uses" and "formulating and disseminating recommendations about their management"); *supra*, at APPENDIX I (presenting the working papers of various subcommittees of the study group); *supra*, at Appendix II: Legal Enforce ability: Survey of Nine (compiling legal memoranda discussing issues of Enforce ability in Australia, Canada, England, France, Germany, Japan, Singapore and the United States); James A. Leach, et al., *Global Derivatives: Public Sector Responses*, Group of Thirty Occasional Paper No. 44 (1993) (speeches by three regulators and one legislator, commenting on the Group of Thirty's 1993 study on global derivatives).

expansion of banking until 1989. Prior to deregulating banking regulations, foreign banks were not able to have the same treatment that the domestic banks received. In the meantime, Taiwan's banks could open branches abroad upon receiving permission from the MOF. Along with the deregulation of Banking Law and incentive to invest overseas, Taiwan's banks established branches overseas, which primarily improved the service and facilitation to Taiwan's companies to expand overseas markets.¹³⁷ Taiwan banks branches also created specific loans for certain overseas purchasers who imported Taiwanese merchandise.

With the emergence of financial conglomerates, the line between banking and non-banking financial institutions will become increasingly blurred. Banks are no longer the only major players in the world of financial intermediation. In the past decade, non-bank financial institutions, including securities firms, financial companies, and insurance companies, have joined the intermediation process and have become major competitors of banks.¹³⁸

Internationalization of Taiwan's banking system involves privatizing government-owned banks,¹³⁹ encouraging domestic banks to establish overseas branches, and attracting foreign financial institutions to Taiwan. In order to expedite the process of the privatization of state-run banks, Taiwan amended the Constitution in 1994¹⁴⁰ and 1997¹⁴¹ to provide legislative resources.

137. See Winn, *supra* note 17, at 933.

138. See ROBERT E. LITAN & JONATHAN RAUCH, *AMERICAN FINANCE FOR THE 21ST CENTURY* 26 (1997) (mentioning that non-banks' invasion of banking has prompted banks to seek the freedom to counterattack by entering other financial business such as securities and insurance).

139. See Kevin Muehring, *Goldstein's One-Man Campaign*, INST. INVESTOR, May, 1997, at 21, (reporting an interview with Mr. Morris Goldstein who emphasizes greater transparency of state ownership and involvement in banking sector to increase banking competitiveness and supervision.)

140. The National Assembly of Taiwan [hereinafter the "National Assembly"] passed a Constitutional amendment on July 29, 1994 to liberalize the management system of government-run banks. To avoid bureaucratic dominion, the target of the Constitutional amendment requires the MOF to draft a special regulations to loosen unnecessary control on government-run banks. Currently, the government-run banks are supervised by the Executive Yuan for management right, the Control Yuan for auditing authority, and the Examination Yuan for personnel supervision.

Art. 9(3) of the Additional Articles of the Constitution of the ROC, promulgated by the ROC's President on August 1, 1994 (indicating that the States shall manage government-run financial organizations in line with the principle of business administration. The management, personal, begets, final accounts, and audit of the government-run financial organizations shall be specially regulated by law).

141. The National Assembly re-amended the Constitution on July 18, 1997. Although the primary goal of the 1997 Constitutional amendments was focused on the modification of the multiple governmental organization, which included the downsizing of the Taiwan Provincial Government, which, in turn, launched the pro-

To strengthen international financial activities, Taiwan promulgated the extension of offshore banking services by allowing banks located within the national boundaries to establish offshore banking units ("OBU"s). However, by the end of 1995, Taiwanese banks had established a mere 85 offshore branches and representative offices.

Financial conglomerates have also been on the rise in Taiwan since the Banking Law amendments of 1989. Currently, 16 new commercial banks in Taiwan are owned by large corporations or by entities with close ties to the ruling Kuomintang Party. Furthermore, banking liberalization in Taiwan has opened the door for private conglomerates to own banking institutions.¹⁴² In accordance with the new trend of financial development, Taiwan drafted the Bill of Financial Institutions Merges/Acquisitions and proposed a plan to permit banks to operate insurance and securities via holding companies, and vice versa.

The integration of Taiwan's national banking industry with the international financial market requires consolidated supervision of both national supervisory policies and the Basle Accords in order to strengthen Taiwan's banking supervisory system.¹⁴³ The expansion of banking activities, the changing nature of banks, and the increased complexity of international banks present a challenge to banking supervisory regulators who must oversee ever more complex banking functions. Effective coordination of international banking supervision will help Taiwan to meet this challenge.

The recent series of international banking failures demonstrated the high risk of cross-border banking activities.¹⁴⁴ International cooperation concerning global banking supervision will compensate for the inadequacy of super-national regulation to monitor all international banks.¹⁴⁵ However, because the resulting combinations of financial services will be complex, difficulties

gress of privatization of government-run banks. After the freeze of provincial level organization, the MOF will take over Taiwan's major commercial banks owned in the province.

142. Art. 52 of the Banking Law permits the establishment of private commercial banks. The Ministry of Financial is authorized by the Banking Law to set the "Standard for the Establishment of Commercial Banks" which sets out the guiding requirements for application for private financial institution license.

143. See Y.D. Sheu, *Current Objectives toward Developing Taipei into a Regional Financial Center and the Importance of Strengthening Regional Financial Cooperation*, 300 ECO. REV., Nov.-Dec. 1997, at 2.

144. See *A Survey of International Banking, A Comedy of Errors*, ECONOMIST, Apr. 10, 1999, at 9.

145. See PECCHIOLI, *supra* note 16, at 37 (emphasizing the importance of improving communications between different national supervisory authorities and seeking agreement on common approaches to international supervisory practices and techniques).

may occur in supervising the various financial institutions by an individual official agency.

In order to supervise both banking and non-banking activities, Taiwan needs to apply the recommendations released by the Basle Committee which cooperated with non-banking financial supervisors including securities and insurance industries to recommend a supervision principle based on a consolidated basis.¹⁴⁶ The Basle Accords stress that the effective supervision of a bank's foreign establishment calls for ongoing contact and collaboration between host and home banking supervisors.¹⁴⁷ Under the Basle Accord of 1992,¹⁴⁸ home countries are responsible for supervising the global operations of international banks in their jurisdictions. The recent banking collapse of BCCI,¹⁴⁹ Barings,¹⁵⁰ and the closure of Daiwa Bank's New York office¹⁵¹ make coordination among international banking supervisors and between securities and banking supervisors even more desirable.

3. *Deregulation of Taiwan Banking Regulations*

Since the presence of financial institutions is a necessary contribution to the economic growth of Taiwan, a greater variety of financial services is required. The development of Taiwan's financial system must keep pace with the development of Taiwan's economy;¹⁵² therefore, increasing the amount and level of financial activities is an urgent priority for Taiwan. The contribution of banks to the economic development of Taiwan is directly

146. See The Basle Committee, *The Ensuring of Adequate Information Flows between Banking Supervisory Authorities* (supplement to the Concordat of 1983) (April 1994) (suggesting prudential use of information received; confidentiality of information received; and reciprocity).

147. See The Basle Committee, *Principle for the Supervision of Banks' Foreign Establishments* (the replacement of the *Supervision of Banks' Foreign Establishment* of 1975) (May 1983).

148. The Basle Committee, *Minimum Standards for the Supervision of International Banking Groups and Their Cross-Border Establishment* (Sept. 1992) (setting out four minimum standards governing the supervision of cross-border banking).

149. See The BCCI, *supra* note 52.

150. The collapse of Britain's Barings bank resulted from an unexpected loss of derivative's trade. Mr. Nick Lesson, a senior derivatives trader of Barings Bank's Singapore branch, was unable to disguise huge losses, U.S.\$1.24 billion, which resulted from an orgy of un-authorized futures and options trading in 1995. See Laura Proctor, Note, *The Barings Collapse: A Regulatory Failure, or A Failure of supervision?*, 22 *BROOK. J. INT'L L.* 735, 737-42 (1996).

151. See Toshihide Iguchi, *White-Collar Confession*, *TIMES*, Feb. 10, 1997, at 16-23; *I Didn't Set Out to Rob a Bank*, *TIMES*, Feb. 10, 1997, at 24-25 (detailing that in 1995 after Daiwa Bank lost more than U.S.\$1 billion due to an incredible 12 years of unauthorized trading by bond trader Toshihide Iguchi, Daiwa was expelled from the U.S. financial market by the Federal Reserve Bank).

152. See LOH JEN-KONG ET AL., *CREDIT AND SECURITY IN THE REPUBLIC OF CHINA: THE LEGAL PROBLEMS OF DEVELOPMENT FINANCE* 167 (1973).

proportional to the commercial services a bank provides. This effect may be illustrated through comparison with the advanced financial systems of the U.S.¹⁵³ and Germany.

Germany, in contrast to the U.S., adopted a universal banking system. In addition to traditional business and personal services, German banks are allowed to trade securities, underwrite insurance and even broker real estate transactions. Furthermore, banks are allowed to simultaneously establish branches anywhere in the country. The underlying philosophy of this system is to allow the banks to assist in economic growth. Obviously, the German banking system appears superior to that of the U.S. in better positioning its economy for future competition, thereby contributing to the economic growth of Germany.

In contrast, the Taiwanese Banking Law has limited flexibility in allowing banks to conduct some banking business that the competent agencies permit. Traditionally, banks in Taiwan have tended to follow the universal bank model¹⁵⁴ rather than the U.S.'s restricted banking activities. A universal bank system provides multiple financial support services to corporate customers and thus contributes to the overall growth of the economy.¹⁵⁵ However, this principle of the universal banking model conflicts with the permitted activities allowed under the Banking Law.¹⁵⁶ Therefore, Taiwanese banking authorities need to amend the Banking Law to expand the financial activities of the banking industry. In doing so, Taiwan's banks will have the freedom to create and develop new financial products and services, which

153. The U.S. banking system is a dual banking system, comprising federally chartered banks (national banks) and state chartered banks (state banks). In addition, banks in the United States are restricted in two major legal regulations. Obviously, the McFadden Act of 1927 limits a bank's ability to establish branches outside of its home state. Pursuant to the Glass-Steagall Act of 1933, U.S. banks also cannot engage in the underwriting and dealing in corporate securities. The Glass-Steagall Act places a "firewall" between commercial and investment banking, forcing a separation between commercial banking and investment banking. The banking restrictions in the US prevent the concentration of clout and of financial institutions within a few major banks. For a description and discussion of the dual banking system, see Geoffrey P. Miller, *Banking Regulation: The Future of the Dual Banking System*, 53 BROOK. L. REV. 1, 1 (1987) and Kenneth E. Scott, *The Dual Banking System: A Model of Competition in Regulation*, 30 STAN. L. REV. 1, 8 (1977).

154. Banking Law art. 4.

155. The term universal banking system refers to commercial banks that are able to grant loans, underwrite corporate debt, securities-related services, and also take equity positions in corporate securities. For a theoretical justification of universal banking system, see Helen A. Garten, *Universal Banking and Financial Stability*, 19 BROOK. J. INT'L L. 159, 172 (1993).

156. See Brian W. Semkow, *A Synopsis of Current Financial Deregulation and Internationalization of Financial Markets and Institutions in Taiwan*, 9 J. INT'L BANKING L. 353, 353 (1991).

should attract foreign investment into the Taiwanese financial market.

Moreover, privatization of government-run banks will encourage competition in the financial market. The inadequate management system of the government-run banks results in increased costs, which are passed along to customers. As a result, government-owned banks, occupying fifty percent of banking assets, are unable to compete with aggressive private and foreign banks. The deregulation of banking regulation to privatized state-owned banks also improves financial market efficiency of the state-owned banks.

On an international front, the U.S. banking system may eventually evolve to, and possibly be replaced by, a system similar to that existing in Germany. Such a radical change would undoubtedly take time and vision. This type of evolution is also very likely in Taiwan, which may embrace a more universal banking model legislated on Articles 71, 78, and 101 of the Banking Law. The field of banking activities would then be enlarged, with laws and regulations being reformed to complement the current trend.

In reforming Taiwan's banking laws and regulations to accommodate the evolution of its banking system, particular attention must be paid to protect the safety and stability of the banking industry on Taiwan. The need for capital sufficiency must first be addressed. This concern has already influenced the legislators. Article 44 of Taiwan's Banking Law requires that banks' assets be no less than eight percent of their risk and weighted assets, which accord to the standards of the Basle Committee.¹⁵⁷

The protection of financial safety and stability must also be enhanced from within the individual banks, which may be accomplished by strengthening the banks' management, internal inspection, and precaution systems.¹⁵⁸ Efforts can also be expended on the systemic front, influenced by the overall quality of the banking system, the breadth of the banking business, the integrity of the banking network, and the actual experiences of the industry.

157. In conjunction with the Basle Committee, which issued a risk-based capital framework in December 1987, art. 44 of the Banking Law states in order to provide for a sound financial standing for banks, the ratio of bank's shareholder's equity to its risk weighted assets shall not less than eight percent unless it is otherwise approved by the central competent authority.

158. Banking Law art 35-2 (governing that the qualification for a bank's responsible officer shall be prescribed by the central competent authority).

4. *Enhancing the Framework of the Banking Supervision System*

In addition to unifying financial institutions, enhancing the framework of the banking supervision system is one of the current critical issues for Taiwanese financial regulators. The consolidation of Taiwan's current system of multiple financial supervisory agencies to a single agency is necessary for the uniform enforcement of banking activities. Along with allowing the establishment of new private banks, it is increasingly important to create a single financial regulatory supervisory agency to concentrate on fracturing the huge informal financial market of money-lenders and pawnbrokers.¹⁵⁹

Multiple agencies have made banking supervisory matters inefficient. Currently, banking supervisory authorities are divided into three competent agencies: Center Bank of China, Ministry of Finance, and Center Deposit Insurance Company. In early April 1995, authorities took steps to streamline regulation of financial institutions. The cabinet ordered the MOF and the Central Bank of China to put one government agency in charge of examining all financial institutions within six months.

While the single financial supervisory regulator has become mainstream in the international financial sector, such as the British FSA¹⁶⁰ the uniformity of financial supervision agencies is still in the air in Taiwan. The Central Bank of China is responsible for examining the state-run banks and other, older banks, while the MOF is responsible for the 16 new private banks founded after 1992, trust companies, and foreign bank branches. The CDIC administers examinations for credit co-operatives and farmers' and fishermen's credit unions and insured financial institutions.

The examination of the basic level banking institutions was the responsibility of the Cooperative Bank of Taiwan.¹⁶¹ Starting in July 1996, the Cooperative Bank of Taiwan no longer carried out examinations, and its responsibilities for cooperatives and farmers' and fishermen's credit unions were assumed by the CDIC. Furthermore, the cabinet has also directed that the Ministry of Interior and the Council of Agriculture take over supervision of the farmers' and fishermen's credit unions, increasing the

159. Scholars have estimated that Taiwan's underground financial system accounts for 57 percent of the overall GNP, which underwent financial stability and damaged depositors' confidence to Taiwan's financial institutions. See *The China Lever - Taiwanese Finance*, ECONOMIST (U.S.), Dec. 16, 1998, at 72.

160. See FSA, *supra* note 32.

161. See Executive Yuan Administrative Notice T'ai (81) Ts'ai No. 34055 (October 9, 1992).

number of financial supervisory agencies. Historically, Taiwan's supervisory authority was a single regulatory agency belonging solely to the Ministry of Finance before 1971. The MOF had delegated financial supervision to the Central Bank of China.¹⁶² The CBC's banking supervision was adequate since most of the institutions were government-owned, thus facilitating the monitoring before the establishment of new private banks in 1992. However, unfamiliar with cooperative businesses, the CBC, in turn, handed over supervisory responsibility to the Cooperative Bank of Taiwan ("CBT") in 1971.¹⁶³

Initially, the CBT controlled the supervision of cooperation associations, and subsequently expanded its control to the farmers' and fishermen' credit departments in 1972 and 1973, respectively. However, the emergence of the Center Deposit Insurance Cooperative into the financial supervisory system in 1985,¹⁶⁴ along with the establishment and supervision of new banks by the MOF, complicated the situation, ultimately leading to financial scandals.¹⁶⁵

In addition to the inspection of credit cooperative associations, CBT is also charged with the responsibility of "moderating" the capital of the credit cooperative associations, which is difficult and seldom appreciated. Due to personal affairs and capital communications between the CBT and credit associations and farmers' and fishermen's credit departments, the simultaneous role of cooperation and supervisor as "player and umpire" played by the CBT caused disputes between these financial institutions.

Moreover, the establishment of 16 new private banks in Taiwan since 1992 has increased the need to return to a single financial supervisory authority. Most of these new banks are connected with private enterprises or political parties as their majority shareholders. Consequently, the private banks are essentially the same as their financial departments in substance. In other words, new banks are tools of their affiliate companies for accumulating capital from the populace for the benefit of their conglomerates.

Adhering to financial internationalization, Taiwanese supervision must be coordinated with financial supervisors in other countries, using the standards practiced by the Basle Commit-

162. Banking Law art. 45.

163. Central Bank of China Act art. 38(2).

164. Since deposit insurance is voluntary, only forty percent of Taiwanese banks have elected to participate, thereby increasing the deposit risk in non-insured banks.

165. CHUNG YANG JIH PAO (CENTRAL DAILY NEWS) (overseas edition), Apr. 20, 1996, at 2.

tee.¹⁶⁶ For example, domestic banks that operate abroad must be regulated to prevent funds transfers designed to escape legitimate taxation. Further, domestic banking regulations must seek to identify problem institutions in time to avoid costly bank failures.

Therefore, granting the MOF broad discretionary power is essential towards upgrading the supervisory standard in Taiwan - otherwise, the Taiwanese supervisory system would be considered inadequate in the eyes of major developed countries. In accordance with the Revised Concordat of the Basle Committee,¹⁶⁷ major developed countries may discourage their banks from setting up branches or subsidiaries in Taiwan, which will both directly and indirectly obstruct the efforts of Taiwan's government to establish Taipei as one of the major regional financial centers in Asia.

Obviously, Taiwan's financial regulators face the challenge of not only amending inappropriate supervisory regulations to create a single supervisory agency in Taiwan but also of applying the standards of the Basle Committee or of another similar international financial treatise. Amendment of current financial supervisory regulations should encompass several regulations and agencies at a time to offset the costs associated with the lengthy duration of the amendment process. Although a difficult road awaits, Taiwan has to create a sound and safe supervisory system for its financial markets to achieve financial liberalization and internationalization.

IV. REMAINING PROBLEMS: INSIDER LENDING EPISODES IN TAIWAN

Taiwan has confronted several insider lending crises since 1980.¹⁶⁸ Insider lending has debilitated Taiwanese public confi-

166. The Basle Committee, in accordance with IOSCO and IAIS, has approved international consolidated supervision in 1993, which should include bank, insurance, and securities for financial conglomerates. The Basle Committee was established at the end of 1974, after the failure of Bankhaus Herstatt in West Germany, by the Central Bank Governors of the Group of Ten Countries for the primary purpose of providing its members with a regular forum for cooperative discussion and efforts in the prudential banking supervision areas. In fact, the G-Ten has twelve countries: Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Sweden, Switzerland, United Kingdom, and the United States.) See, *inter alia*, JOSEPH NORTON, *DEVISING INTERNATIONAL BANKING SUPERVISORY STANDARDS*, ch. 4 (1995).

167. See Basle Committee, *The Revised Basle Concordat, Principles for the Supervision of Banks' Foreign Establishments*; RICHARD DALE, *THE REGULATION OF INTERNATIONAL BANKING* 188-194 (1986).

168. Insider lending scandals occurred in 1980s were Asia Trust Crisis, the Tenth Credit Crisis, Cathay Trust Crisis, and Overseas Chinese Trust Crisis. See *supra* note 5.

dence in financial institutions and in the financial regulators who are supposed to maintain the safety and soundness of the financial system. Individual financial institutions, as well as the government, must affirmatively satisfy the public's questions regarding the soundness of the financial system by protecting depositors' expectations of security, thereby protecting a viable and efficient economic system. As an intermediary and fiduciary,¹⁶⁹ a financial institution assumes an obligation to act solely for the benefit of the depositor's trust and to avoid any activities or situations involving conflicts of interest.

Because of distrust by depositors, Taiwan has been plagued by a series of deposit runs on financial institutions which started in the summer of 1995, sparked by troubles in the real-estate market, rising bad loans and rumors of management fraud.¹⁷⁰ At the end of 1995, bad debts had risen to a historic high of 3.1 percent of total loans outstanding at all lending institutions.

In response, Taiwan hopes to solve the overdue loan problem, and the local governments are in the closest position to monitor those grassroots financial institutions via farmer's and fishermen's credit unions.¹⁷¹ In its letter to county and city governments, the MOF asked local authorities to focus monitoring activities on those institutions with bad loan ratios above five percent. In addition, the MOF has ordered local governments to set up special ad hoc committees to monitor troubled financial institutions in their districts.

The Asian financial crisis forced Taiwan to realize the importance of preventing insider lending at Taiwan's banks. The reasons for the failures of banks during the Asian crises fell into three categories - central bank independence, modern interna-

169. In addition to intermediary function, financial institutions own the backup source of liquidity for individual or corporate customer, and transmission function for monetary policy. See CORRIGAN, FEDERAL RESERVE BANK OF MINNEAPOLIS ANNUAL REPORT OF 1982, ARE BANKS SPECIAL 7 (1982).

170. Indeed, Taiwanese are fond of describing their country as a 'mini-Japan': many things which happen to Japan sooner or later seem to happen to Taiwan too. The asset inflation bubble of the late 1980s followed by a painful collapse in share and property markets is just one instance where Taiwan fell into the pattern set by Tokyo. Despite some similarities, Taiwan officials say that the woes in the banking industry are not as serious as those in Japan. Interview with Mr. Sean Chen, Delegate of the Ministry of Finance (mentioning that in the summer of 1997 when the problems began, Taiwan was concerned that there might be some systemic risk, but later it became obvious that some financial institutions have problems with internal controls).

171. The overdue loan problems are especially severe among the country's smaller financial institutions, mainly the credit co-operatives and farmers' and fishermen's credit unions - which, ironically, are a relic of Japan's 1985-1945 colonial rule in Taiwan. See Lee, *supra* note 83, at 2.

tional banking standards, and the inadequacy of rules and procedures for handling troubled or insolvent banks.¹⁷²

1. *Legal Aspects of Taiwan Current Regulations Governing Insider Lending*

Insider lending occurs when a financial institution extends unsecured credit, other than consumer credit, to responsible persons at financial institutions¹⁷³ at an improved rate and favorable credit terms compared to ordinary borrowers.¹⁷⁴ Because of halting shortages in Taiwanese banks,¹⁷⁵ the supervision of banking operations and the protection of bank depositors became an indispensable and significant national issue for Taiwan's financial regulators.¹⁷⁶ Limiting the extension of credit to interested parties of financial institutions may block the illegal disbursement of funds into interested parties.¹⁷⁷

Based upon the experiences derived from the MOF's handling of the series of insider lending crises in the 1980s, the Banking Law was amended in 1985 to prevent insider lending practices¹⁷⁸ and to increase the crisis management power of the

172. See Head, *supra* note 24, at 74-5 (analyzing that avoiding bank failures requires a strong national financial system that will have a central bank that is independent from short-term political pressures, although ultimately accountable to political authorities, commercial banks should be required, under laws enforced by the central bank as supervisor, to observe international standards on making loans, maintaining capital, reporting operations, and the like, and banks that fail should be restructured or liquidated under strict and special rules that protect depositors and penalize managers and owners).

173. Banking Law art. 33 (stipulating that responsible persons of a financial institution includes any member of its staff, any person who is an interested party of its responsible person, and any credit officer).

174. See Patricia A. Murphy, Note, *Insider Loans: How Restricted is The Banker?* IX Fordham Urban L. J. 431, 432-3 (1980).

175. Most countries have adopted appropriate methods to prevent insider lending offenses: existence of theories to limit insider lending are principle of prohibition; principle of avoidance; principle of separation; principle of independent; principle of equivalent; principle of proportion; principle of decision by the board of directors meeting; principal of report and disclosure to competent authorities; principle of approval; and principle of return

176. See Li-Chung Lee, *What Next for Banking in Taiwan?* AM. U., LL.M. INT'L BULL., Summer, 1994, at 12, 13.

177. See Lissa Lamkin Broome, *Redistributing Bank Insolvency Risk: Challenges to Limited Liability in the Banking Holding Company Structure*, 26 U. C. DAVIS L. REV. 937, 941 (1993).

178. Art. 33-2 of the Banking Law refers to the term "interested party" denoting anyone in any of the following situations:

- (1) Where the interested person is the spouse, a lineal relative by blood within the third degree or a relative by marriage within the second degree of the bank's responsible person or any credit officers;
- (2) Where the bank's responsible person, any credit officer, or any of the first category interested party is operating his business as a sole proprietorship or partnership;

MOF.¹⁷⁹ To prevent insider lending, Taiwan does not allow banks to extend unsecured credit other than consumer credit to the bank's responsible person, any member of the bank's staff, or any person who is an interested party of the bank's responsible person, or of any of banks credit officers.¹⁸⁰ Moreover, when a bank extends secured credit to a bank's responsible person or to any member of its staff, or to any person who is an interested party of the bank's own responsible person or of any credit officers, the terms and conditions of the credit shall not be more favorable than those terms of credit to other borrowers.¹⁸¹

Taiwan's principal measure to cope with affiliate transactions practices was the creation of five categories of "interested parties."¹⁸² When the Banking Law was further amended in 1989, the scope of the categories of "interested parties" was expanded to cover the organization in which the first category of interested parties was involved in 1992.¹⁸³ Further, the amendment of the Banking Law in 1992 prohibited the exchange of loans among the responsible officers and the major shareholders in cross-bank transfers which avoided the limiting loan provision. This amendment prevents the granting of favorable loans to responsible persons with whom the bank has business relations.¹⁸⁴

As a result of the lessons learned from the Asia Trust Crisis and the Cathay Trust Crisis, which involved the investment of trust funds into the manufacturing and real estate businesses of their affiliates, the Banking Law included a provision limiting the abuse of investment powers by trust companies in the establish-

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- (3) Where the bank's responsible person, any credit officer, or any of the first category interested party holds more than ten percent of shares issued by the particular company or owns more than ten percent of the total authorized capital of the company;
 - (4) Where the bank's responsible person, any credit officer, or any of the first category interested party is a director, supervisor or managerial officer of the particular company unless by virtue of investment the concurrently acts as its director or supervisor or serves as a managerial officer of the particular company under the approval of the central competent authority; or
 - (5) Where the bank's responsible person, any credit officer, or any of the first category interested party acts as the representative or manager of a legal entity or other form of organization.

179. The amended Banking Law of 1989 gave more power to competent agencies for risk management. Art. 62 of the Banking Law mentions that competent authorities may suspend a bank which is unable to pay its debts or jeopardy depositor's interest or ceases part of its business for reconstruct and the competent authorities points an inspector to supervise the bank, take over the bank.

180. Banking Law art. 32.

181. Banking Law art. 32, 33.

182. Banking Law art. 33-1.

183. Banking Law art. 32-1 (2).

184. Banking Law art. 33-2.

ment of a trust company's business empire.¹⁸⁵ The investment power of the trust company in productive enterprises or in the construction of residential and commercial buildings was limited to the use of non-trust funds only.¹⁸⁶

In order to reinforce the crisis management power of competent agencies, Article 62 of the Banking Law was revised in 1985 to eliminate the shortcomings of the experiences gained from the Tenth Credit Crisis.¹⁸⁷ Article 62 was further refined in 1989 to overcome the threat of being sued by the shareholders of the intervened banks in the Cathay Trust Crisis. When supervising or taking over a bank, the central competent authority may suspend all or part of the rights and functions of shareholder meetings as well as the board of directors or supervisors. Regulations governing the above mentioned supervision and take-overs shall be as prescribed by the central competent authority.¹⁸⁸

The Banking Law sanctions violators of insider lending regulations, which is a breach of trust, with no more than three years in jail or \$66,000 fine.¹⁸⁹ However, the Banking Law is a specialized law regulating the banking system. The imposition of criminal sanctions under the specialized law must be harsher than the corresponding section in the Criminal Code. Therefore, the Banking Law should be amended to accord with traditional Chinese legal philosophy and conform with Article 342 of the Criminal Code which penalizes offenders of breach of trust with a jail term of no more than five years.¹⁹⁰ However, the amended Banking Law uncovered some conflicts with enforcement. Several "gray areas" are present which provide conflicting enforcement mechanisms and sanctions to insider lending offenses,¹⁹¹ which must be reconciled.

To complement the sound legislation of the Banking Law, enactment of legislation prohibiting any type of trade between banks and insiders other than lending is required.¹⁹² Therefore,

185. Banking Law art. 101(2).

186. Banking Law art. 101.

187. Art. 62 of the Banking Law describes that "[i]n any of the following situations, a bank may be ordered by the central competent authority to suspend its business and settle its liabilities within a prescribed time limit:

- (1) Where the bank is unable to pay the difference of amount payable on the negotiable instruments drawn on the bank itself and is prohibited by the Central Bank of China from clearing negotiable instruments.
- (2) Where the bank is unable to pay off its debt which have become due and payable in a manner to the detriment of the bank's sound operations."

188. Banking Law art. 62.

189. Banking Law art. 127-1.

190. See Winn, *supra* note 17, at 937.

191. *Id.*

192. *Id.*

an avoidance clause needs to be promulgated forbidding directors who desire a loan from participating in the board of directors' meeting on the decision of that loan.¹⁹³ The Banking Law also needs to expand into the "related parties" of major banking shareholders already enumerated in the Banking Law.¹⁹⁴ The addition of parties exposed to insider lending regulations may foreclose the legislative loophole being manipulated by insiders benefiting from Taiwan's financial institutions.

Financial lending should be determined by a function of the market without any intervention by personal relationships to meet depositor and business credit needs. As a result, Taiwan needs to enact firewall legislation to block the continued abuse of insider lending practices.¹⁹⁵ The reforms should prevent financial institutions from lending funds to related enterprises and affiliates. These amendments must expand upon the current regulations to encompass both public and political entities.

In hindsight, most of Taiwan's financial crises could have been prevented before the problems occurred. However, Taiwan lacked the necessary experience and training to recognize a potentially dangerous situation. In the past, Taiwanese banks used unsavory means to escape scrutiny from supervisors, such as persuading the competent authorities from reporting the transgressions. Furthermore, Taiwanese financial institutions would conceal the banks' illegal activities by hiring the entire senior official supervisory board to prepare the bank's own report about the infraction, thus leaving inexperienced officers to handle the investigation. In response, an independent supervisory system needs to be created to supervise banking activities in Taiwan.¹⁹⁶

Part of the difficulty in addressing the problem of lax internal controls stems from the fact that responsibility for monitoring and examining financial institutions is spread among several government agencies. Moreover, the difficulties of obtaining loans from the government and the private banking system have forced Taiwanese businesses to resort to insider lending or informal financial systems which provide "bank-like" services at a lower

193. See Winn, *supra* note 17, at 937.

194. Despite numerous improvements in the Banking Law of 1992, the definition of "related party" is vague. According to Article 25 of the Banking Law, a single person's and related person's shareholding of a bank are restricted to five percent and 15 percent respectively, unless otherwise approved by the Ministry of Finance. The definition of related persons for corporations, however, does not include subsidiaries or associates. As such, many new private banks are effectively controlled by a single corporation. Similarly, restriction single-party lending are also circumvented.

195. See Lee, *supra* note 206.

196. See Lawrence Liu, *Creating an International Financial Center: The Case of Taiwan, R.O.C.*, in INTERNATIONAL BANKING OPERATIONS AND PRACTICES: CURRENT DEVELOPMENTS (Chia-Jui Cheng et. Al, ed.) 71, 120 (1994).

cost with a higher rate of return.¹⁹⁷ Corrupt politicians are also joining the financial fracas and are using their inherent powers as legislators to gain favorable loans. As a result, insider lending practices have created a series of financial crisis in Taiwan (see Table 3).

Table 3: Selected Taiwanese Banking Collapses in the 1990s.¹⁹⁸

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

2. *Impeding Political Elements Affecting Authorities' Ability to Monitor Insider Lending Offense*

For Taiwan to block insider lending episodes, the enactment of an avoidance clause prohibiting politicians and retired financial senior officials within a limited period to work for financial institutions is essential. Taiwan's politicians have prevented Taiwan's banking system from attaining the level of soundness and safety needed to become a financial center. Taiwan's local credit unions and some commercial banks, including private and government-run, have often become local politicians' "family banks" or "the last resource of credit," posing a threat to the credit rating of Taiwan's entire banking system. Moreover, retired financial senior officers have reduced the efficiency of financial

197. Many private banking institutions were forced to channel the funds to their affiliate enterprises. Moreover, some private banks require more mortgage than the true value of loan.

198. In addition to the selected banking scandals, several more banking failure cases exploded and occurred large amount withdraw in 1990s encompassing Kwa-in Farmer's Credit Union (enormous bad loans, Feb. 17-24, 1996); Kiman Farmer's Credit Union (over loan limit rate, Dec. 12-15, 1995); Hsin-Fon Farmer's Credit Union (unperfected loan, Oct. 30-Nov. 1, 1995); Hsi-Kon Farmer's Credit Union (untrue rumor, Oct. 7, 13, 1995); Wan-ron Farmer's Credit Union (untrue rumor, Sept. 11-15, 1995); Overseas Chinese Bank (misconduct management, Jan. 19-20, 1995); Nan-Long Fisherman's Credit Union (personal affair disputes, Sept. 27-Oct. 3, 1994); Ho-Long Farmer's Credit Union (untrue rumor, Mar. 8-19, 1994); To-Kan Credit Associative (untrue rumor, Feb. 24-Mar. 2, 1994); Hsin-Da Fishermen's Credit Union (personal affair disputes, Mar. 11-15, 1993); Kwa-in Farmer's Credit Union (personal affair disputes, March 5, 1993); Citibank's Taipei Branch (untrue rumor, Aug. 9, 1991). See CDIC, ANALYSIS OF WITHDREW FROM TAIWAN'S FINANCIAL INSTITUTION IN 1990s (1996)(Taiwan).

supervisory performances for their new work places by placing severe obstacles in the way of the competent agencies that monitor the retired officers' new employers.

To avoid financial regulations restricting banking loans to affiliates and to reduce the of chance of being discovered, Taiwan's politicians are attempting to participate in local and central financial committees to influence financial policy-making. Taiwan's politicians utilize surrogate accounts, overvaluation of collateral and false accounting statements to cover up the insider lending and affiliate transactions.¹⁹⁹ Moreover, some banking employees who acknowledge the power of politicians, conspire with outside sources to illegally lend money with high interest rates to influence figures in Taiwan's banking system.

In addition to establishing new regulations to prevent insider lending and affiliate transactions, Taiwan should also guard against "money politics."²⁰⁰ In Taiwan, the term "money politics" refers to the bribes that candidates offer the electorate to ensure their election. In return, the newly elected officials provide favorable services to the voters.

3. *Ineffectiveness of Supervisory Authorities in Halting Insider Lending Offenses*

The Taiwanese financial system was recently rocked by several scandals in which the staffs of financial institutions had conspired with borrowers to over-lend.²⁰¹ The lesson learned from these financial scandals suggested that the financial supervisory system may be under-monitored and that improvements are necessary.

There are two main methods by which a government supervises financial systems. Some countries, including the U.S., adopt an official system by which the monitoring is conducted by officials appointed and maintained by the state. Other countries, such as the United Kingdom, Germany and the Netherlands, rely

199. See *Taiwan: Runs, Scandals Cause Credit Rating of Taiwan Banks to Slip*, China Economic News Service, Apr. 6, 1996, available in LEXIS, World Library, Allwld File.

200. According to a source of the Department of Civil Affairs of Taiwan Province on November 12, 1995, thirty of the entire forty-two speakers (including vice speakers) of twenty-one county councils in Taiwan Province have been charged in civil or criminal litigations to this date. See Lawrence L. C. Lee, *Combating International Illicit Narcotic Traffic, A Solution for the Drug Epidemic in Taiwan: The Proposed Money Laundering Control Act*, 4 TULANE J. INT'L & COMP. L. 191, 238-92 (1996).

201. A recent Taiwan financial scandal involving a cabinet minister's family and local business leaders illustrates the problems involved with detecting and proving self-dealing. See Mark, *Taiwan Government Scandal Exposes Ties between Politic and Big Business*, ASIAN WALL ST. J. Mar. 18. 1991. at 19.

on a less formal regulatory structure, possessing an unofficial system whereby financial institutions are monitored by private sector accountants.²⁰² These accountants, in turn, are regulated and monitored by government agencies.

Fundamentally, the current Taiwanese financial supervision system is similar to that of the United States, whose official agencies are responsible for financial supervision.²⁰³ However, the amendment of the ROC's Banking Law in 1989 specifically transplanted the Western European financial supervisory system to improve the Taiwanese financial supervision process.²⁰⁴ And if necessary, the MOF may appoint professionals and technical experts to examine financial institutions.

However, successful banking supervision in Taiwan is hampered by inadequate manpower.²⁰⁵ Consequently, the MOF has recently been actively planning a system allowing certified public accountants to help banking regulators examine the financial institution's books.²⁰⁶ Taiwanese financial regulators anticipate that the assistance from the external financial supervision system could enhance the quality of banking supervision and overcome the shortage of official banking examiners.

4. *Efficient Control of Insider Lending Provisions of Developed Countries and Recommendations by the Basle Committee on Banking Supervision*

Insider lending and affiliate transactions damage the functions of the credit channel because financial channel deposits could not meet the credit demands of businesses and consum-

202. See PHILIP R. WOOD, *MAPS OF WORLD FINANCIAL LAW 7* (1997) (analyzing that even belonged to different jurisdictions by group, the U.K., Germany, and Netherlands supervise banking operation through comprehensive accounting system rather regulator system).

203. *Id.*

204. Banking Law art. 45 (stating that the central competent authority may at any time assign officials or create a committee which is able to audit banking business activities or direct the local competent authority to assign officials to audit a bank and its account or may direct the bank to prepare and submit, within a prescribed time limited, its balance sheet, inventory of property or other reports for auditing. The purpose of adopting the CPA could help the MOF in examining the financial institution's books to make up for the shortage of banking examiners and enhance the function of banking supervision).

205. Taiwan has close to 500 financial institutions at more than 3,500 locations. The manpower for banking supervision is not enough to examine all the financial institutions. The CBC, the largest of the four supervising agencies, has slightly over 100 officers, while the TCB has only about 50 examiners. However, increasing the numbers of examiners is constrained by the tightened budget.

206. See Bureau of Monetary Affairs, 1998 ANNUAL REPORT, *supra* note 62, at 69 (reporting that the MOF entrust CPAs to audit financial institutions).

ers.²⁰⁷ Insiders may include the directors, executive officers, and principal shareholders of the bank. The insiders are very powerful and influential in the decision making process, and use their influential abilities to obtain preferential loans with the bank.²⁰⁸

Enactment of firewall legislation based on the U.S. model²⁰⁹ by Taiwan, which is supported by a few Taiwanese scholars, will block related interested individuals and enterprises from borrowing funds from banks in Taiwan.²¹⁰ Taiwan should enact firewalls legislation such as the Bank Holding Company Act of U.S. to prevent affiliate transactions. Firewalls are systems of controls that are meant to keep bank resources from being improperly used to support other activities, such as securities underwriting, to protect against potential conflicts of interest.²¹¹ Ensuring that appropriate firewalls are established and maintained and that regulators have the authority to take action when fire-walls are breached, is an important part of a bank's supervision under a functional regulation approach.²¹²

Furthermore, in view of the recent experiences of the German adoption of the universal banking system,²¹³ Taiwan must also determine to what degree, if any, the new banks should be permitted to perform securities activities on the stock market. Taiwan may emulate the American model by segregating banks and securities and affiliates.²¹⁴

207. See Vincent Di Lorenzo, *Public Confidence and the Banking System: the Policy Basis for Continued Separation of Commercial and Investment Banking*, 35 AM. U. L. REV. 647, 652 (1986).

208. An example of preferential treatment would be receiving beneficial terms for loans.

209. U.S. firewall imposed by the Proximate Financial Modernization Act of 1988 which created a framework for expanded securities activities of banking institutions utilizing the separating affiliate concept. The content of U.S. firewall consists of restriction on capital adequacy, extensions of credit, and other relationship between financial institutions.

210. In this article, firewall legislation refers to a regulation segregating the activities of the member bank from those activities of its affiliates.

211. See LOVETT, *supra* note 16, at 159

212. *Id.*

213. The German universal banking system places limitations on banks engaging in assorted financial activities, such as the investment business and the issuance of insurance policies. See EKKEHARD BAUER, *Regulation in Germany*, in REGULATION OF FOREIGN BANK - UNITED STATES AND INTERNATIONAL, 13.07 at 13-12 to 13-14 (Michael Gruson & Ralph Reisner eds., 1991).

214. The History and Purpose of legislating firewall regulations, Section 23 of Federal Reserve Act.

The U.S. Congress passed the 1933 Banking Act (hereinafter "Banking Act") in response to a banking system that had failed along with the stock crash and financial crisis of 1929. Part of this crisis was due to the abusive practices of the banks in extending credit and making their financial resources available to affiliates without the benefit of careful scrutiny and unbiased consideration. The purpose of the

The enactment of a comparable holding company regulation led Taiwan to detain loans from banks to their affiliates because insider lending also occurs in transactions involving affiliates. The affiliates reside at the corporate entity level, such as the banks' parent holding companies and the banks' subsidiaries. Because of the close relationship with the bank, the affiliates are able to benefit from the bank much more easily than an ordinary customer, which endangers those banking institutions that take deposits from the public.²¹⁵ Obviously, the insider lending and affiliate transactions resulted in Taiwan's banking failures, but they also caused many of the overall problems of the Taiwanese banking system. The funds lent from financial institutions to insider affiliates were invested in the stock market, real-estate, and individual businesses, and the failure of these investments prevented the financial institutions from regaining the loans from the affiliates.

In addition to local credit associative and credit unions, as a practical matter, only large-scale enterprises can afford to meet the high capital requirements of the 1989 Banking Law. New Taiwanese banks' processing policies are distinctly different from those of their counterparts. The minimum capital requirement of newly-chartered banks is roughly US\$385 million. The Taiwanese government hopes to use these criteria to elevate Taiwan onto the international financial stage. However, since Taiwan has already demonstrated a lack of experience in operating even smaller banks, the sudden establishment of those newer and larger banks could be a risky venture.

The new Taiwanese banks are privately run and lack a healthy system of deposit protection. The government has no other choice but to increase its regulation of the new banks to keep these ambitious banks from suffering great losses or even bankruptcy. The current legislation is inadequate to prevent banking affiliates from engaging in transactions to related enterprises and interested parties. Therefore, legislation monitoring the aggressive new banks needs to be tightened to eliminate the inside loans to affiliates and strengthen the deposit securities.

V. IMPROVEMENT OF THE TAIWAN FINANCIAL REGULATIONS TO OBSTRUCT FINANCIAL EXPOSÉ

Taiwan's banking industry stands at a crossroads today. In March 1997, Taiwan instituted a Financial Reform Task Force

Banking Act was to ensure a safer use of the assets of the banks, to regulate interbank control and to prevent the diversion of funds into speculative operations.

215. See LOVETT, *supra* note 16, at 159.

which proposed to deregulate all constrained capital movement by the year 2000.²¹⁶ The intention of deregulating restriction on capital movement accomplishes Taiwan's goal of establishing Taipei as a financial center in Asian-Pacific region, facilitating Taiwan's economic development, and entering the World Trade Organization.²¹⁷

With more developed capital markets and capital movement in accordance with the philosophy of "freedom as the principle, approval as the exception," the MOF has cooperated with the CBC closely in revising the existing banking regulations, preventing system risk and management risk in Taiwan financial system; enhancing regulatory cooperation for effective functional regulation; and elaborating foreign banking institutions' role in Taiwan based on national treatment.

1. Proposals for the Modernization of Taiwan's Banking System

Amending banking regulation enables Taiwan to meet the demands of banking development. Appropriate banking regulations will simplify banking industries and organize a comprehensive supervisory framework which is likely to build a sound and safe banking system. In contrast, improper banking regulations could become oppressive or unduly restrictive and therefore inimical to the public interest.²¹⁸ Accordingly, Taiwan should modernize banking regulations to keep pace with the development of the banking industry.

In order to prevent financial scandals and maintain efficiency in the Taiwan industry, the MOF held a hearing to discuss the guidelines of improving the Banking Law, as the proposal for

216. Lien Chan, Vice President of the ROC, Taiwan's Capital Market by the Year of 2000, Address Before the 1996 Asian Securities Industry Institute Annual Conference, the International Organization of Securities Commissions Asian-Pacific Regional Committee Meeting, and the Emerging Market Workshop Federation International des Bourses de Valeurs (June 17, 1996).

217. Taiwan and the United States have concluded a multilateral negotiation necessary for Taiwan's eventual acceptance into the WTO. The resulting agreement, including both immediate market access and phased-in commitments, provides substantially increased access for U.S. goods, services and agricultural exports to Taiwan. See The U.S. Trade Representative, *The United States and Taiwan Conclude Comprehensive Market Access Agreement*, Feb. 20, 1998. Additionally, based on the WTO's principles, Taiwan will treat other WTO members the same as the United States.

218. *Consolidation of Banking Examining and Supervisory Functions: Hearings on H.R. 107 and H.R. 688 Before the Subcomm. on Bank Supervision and Insurance of the House Comm. on Banking and Currency, and Before the House Comm. on Banking and Currency*, 89th Cong. 120 (1965) (statement of Archie K. Davis).

the fifteenth amendment to the Banking Law, on July 7, 1999.²¹⁹ The recommendation of the hearing significantly proposed enhancement of the power of authorities to supervise financial business activities. The proposed amendment of the Banking Law requires severe punishments to violators against financial regulations, with no more than seven years in jail and fine of no more than NT\$30 million (the equivalent of US\$109,090).²²⁰ Furthermore, the Banking Law is being revised to abolish the chapter on savings banks, enlarge the business scope of commercial banks, and encourage banks to develop new financial products as a means to promote the development of the secondary financial market.

To further deregulation and internationalization of Taiwan's banking sector with a strong supervisory system, Taiwan organized a Financial Reform Task Force to update Taiwan's financial system. The Financial Reform Task Force streamlined the nation's financial systems including banking, securities and insurance, and capital markets in line with the Task Force's suggestions.²²¹

The goal of the Financial Reform Task Force is to maintain financial market order and prevent irregularities.²²² Although Taiwan's banks have usually received good ratings by prestigious international research organizations, Taiwan's securities market lags behind, due mainly to insider trading issues. Nonetheless, Taiwan recently eased restrictions on banking, securities and bond market operations as long as the financial institutions can meet international requirements on risk management and capital availability.

The Financial Reform Task Force proposed raising ceilings on bank investment in securities and in other businesses. At present, Taiwan's banks are required not to invest more than 15 percent of their net assets in stocks, and the ceiling for investment in other businesses is set at forty percent of their net worth. In addition, the Financial Task Force suggests that banks should

219. Amendment of the Banking Law is one of the plans to restructure Taiwan's financial structure. In order to cope with the new challenges resulting from a more liberalized financial market, measures were adopted to ensure that adequate financial regulations and supervision were in place. The Banking Law, the Securities and Exchange Law and the Insurance Law are proposed to be amended significantly. The banking, securities and insurance regulatory agencies were reorganized and greatly enlarged accordingly. See THE BMA, THE MODERNIZATION OF THE R.O.C. FINANCIAL SYSTEM 1-3 (1999)

220. See BMA, *supra* note 240, at 41.

221. See Sofia Wu, *Financial Reform Task Force to Be Formed Soon*, Central News Agency, Feb. 11, 1997, available in Lexis, World Library File.

222. See BMA, *supra* note 236, at 30 (stating the Financial Reform Task Force Recommendations suggested to establish a compliance officers).

be allowed to invest in stocks traded on over-the-counter markets.²²³ The Task Force considered several major topics: proposed reforms of grassroots financial institutions; the efficiency of state-run financial institutions; the credit ratings of various financial institutions; and various methods to assist small- and medium-sized enterprises in obtaining low-interest loans, financial inspections, and the improvement of the bank deposit insurance system.²²⁴

One of the major reform recommendations made by the Financial Reform Task Force was for Taiwan to adopt the remaining Basle Accords. The Financial Reform Task Force suggested that Taiwan learn from the past experiences of other countries such as the United Kingdom and the United States and the success they have had in supervising their banking systems using the framework of the Basle Accords.²²⁵

The Basle Core Principles for Effective Banking Supervision ("Core Principles") recommend a comprehensive set of basic supervisory principles for international banking supervisory authorities.²²⁶ The Financial Reform Task Force recommended adoption of the remainder of the Basle Accords including maintaining the liquidity of banking assets (solvency ability), avoiding excessive exposure, ensuring capital adequacy, and strengthening surveillance of banking managers.

The regulatory amendments symbolize Taiwan's attempt to create a sound and safe banking system and enhance the authorities capability to deal with the ongoing challenges to Taiwan's banking industry. The continuous efforts to restructure the banking framework are also evidence that Taiwan is moving towards the modernization of its banking system in accordance with the globalization of globalization of banking.

2. *Maintaining Financial Stability: Prevention of Systemic Risk in Taiwan Banking System*

With the innovation of the technology for the instantaneous global transfer of payments for, and settlement of, securities trading, the financial payment system becomes fragile compared to the previous ones.²²⁷ Moreover, the integration of international financial services merges each nation's financial system into one

223. See BMA, *supra* note 236, at 30 (mentioning that the Reform Task Force Recommendations advised of enlargement of participants into securities market and future market development of new financial innovations).

224. See *id.*

225. See *id.* (quoting that the Financial Reform Task Force addressed that Taiwan should be internationalization of the banking system).

226. See Basle Core Principles, *supra* note 19.

227. See Greenspan, *supra* note 2.

international financial system²²⁸ and causes each nation's financial authorities to face international financial systemic risk.²²⁹

Systemic risk occurs when a major banking participant fails, triggering imitative runs on other banks or a chain reaction of failures through the payment system or through defaults on inter-bank obligations.²³⁰ Banks are special because ill-liquidity loans funded by short-term deposits results in potential market failure and a need for public intervention. Moreover, a bank failure could eventually trigger questions about the solvency of other banks, leading to a systemic crisis.²³¹

In comparison to traditional financial services, which are normally simple and domestic, the world's current financial services are varied and allow the movement of capital without any limitations across borders.²³² As a result of capital liberalization, an international bank's failure will affect the entire international banking system through the international payment system.²³³ In this respect, as a member of the international financial community, Taiwan must remain vigilant to protect its financial system against systemic risk.²³⁴

As of today, a knowledgeable society and increased competition among financial service providers have forced banks to reevaluate the scope of banking business. The widespread avail-

228. See WILLIAM F. SHEPHERD, *INTERNATIONAL FINANCIAL INTEGRATION, HISTORY, THEORY AND APPLICATIONS IN OECD COUNTRIES* 31 (1994) (concluding that the restoration of currency convertibility in the late 1950s promote growth in international private enterprise, which in turn sparked an increase in both multinational corporations' international financial movement and cross-border investment in general.)

229. See *Final Report for International Convergence of Capital Measurement and Capital Standards*, reprinted in 1 Fed. Banking L. Rep. (CCH) ¶ 5403, at 3309 (July 15, 1988).

230. See Cynthia C. Lichtenstien, *International Standards for Consolidation Supervision of Financial Conglomerates: Controlling Systemic Risk*, 19 BROOK. J. INT'L L. 137, 139 (1993) and see SYDENY J. KEY & HAL SCOTT, *INTERNATIONAL TRADE IN BANKING SERVICE: A CONCEPTUAL FRAMEWORK* 13 (1991) (noting that systemic risk can create a chain reaction (domino effect) of an entire banking system when a bank is unable to meet the depositors' and other institutions' withdrawal demands).

231. See GROUP OF THIRTY, *GLOBAL INSTITUTIONS, NATIONAL SUPERVISION AND SYSTEMIC RISK* 6 (1997).

232. See OECD, *INTERNATIONAL TRADE IN SERVICE: BANKING, IDENTIFICATION AND ANALYSIS OF OBSTACLES* 27 (1984) (opining that the liberalization of banking resulted in the free movement of cross-border transactions).

233. See Lichtenstein, *supra* note 230, at 138 (detecting that unlike national payment systems, such as the U.S. Federal Reserve, which guarantees payment to each bank receiving a payment if the sending bank fails, no bank participating in the international dollar payment system through the Clearing House Interbank Payment System can be assured to receive payment from a failed bank).

234. See RICHARD DALE, *INTERNATIONAL BANKING DEREGULATION* 10-13 (1992) (discovering that for the proposition to arise system risk, governments do requisite acts to prevent system risk, for example, to prevent failure of their largest banks).

ability of information and the ability of firms to rapidly imitate profitable strategies will continue to put pressure on banks to stay competitive and on regulators to adopt regulatory strategies that allow the banks to keep up.

Modern banks conduct diversified operations across borders to vary their earning sources and enhance their profits. Advances in data processing and telecommunications have enabled banks to offer global services easily, without even establishing a physical presence in some markets. The liberalization of restrictions on capital flows across national borders has increased international lending and deposit-taking activities. The globalization of financial markets benefits international capital flows and facilitates economic development.²³⁵

Taiwan has attempted to maximize systematic regulatory efforts as its financial sector modernizes.²³⁶ In 1995, weaknesses in the Taiwanese banking system were exacerbated by problems at a major credit cooperative, a leading commercial paper financing company, and several agricultural cooperatives.²³⁷ These financial scandals accounted for, in part, a 27 percent decline in the stock market in 1995 and highlighted the need for Taiwan to re-vamp the overseeing system of its financial institutions.

Taiwan's efforts to detect systemic banking problems early and promptly respond should address both financial and operational restructuring of banks. But any change in Taiwan's banking regulations will require strong political support, a clear institutional framework, and thorough diagnosis of potential problems. Taiwan's establishment of a deposit protection scheme will reduce concern about systemic risk and consumer protection as it helps to ensure the stability of the banking system.²³⁸

235. In 1996, net international capital flows to developing countries amounted to \$235 billion—an impressive 0.8 percent of world GDP, and more than two percent of developing country GDP. See Stanley Fischer, *How to Avoid International Financial Crises and the Role of the International Monetary Fund* (October 14, 1997) <<http://www.imf.org/external/np/sec/mds/1997/mds101497.htm>>.

236. In order to face the approaching challenge, Taiwan proposed "Financial Reform that Go Beyond the 20th Century," which includes four "Major Missions of Financial Reform Task Force:" 1. Efficiency: Improve the financial system and enhance the operating efficiency of financial institutions; 2. Discipline: Establish financial discipline; 3. Products: Develop new financial products and expand business scope and increase market participants; and 4. Competition: Enhance the competitiveness of financial markets. See BMA, *Financial Reforms that Go Beyond the 20th Century* <<http://www.boma.gov.tw/english/mof-980709.htm>>

237. *Recent Development in Banking and Finance in the People's Republic of China, Hong Kong, and Taiwan: Hearing before the Committee on Banking and Financial Services*, 104 Cong., 20 (1996).

238. See SYDENY J. KEY & HAL SCOTT, INTERNATIONAL TRADE IN BANKING SERVICE: A CONCEPTUAL FRAMEWORK 11 (1991) (noting that systemic risk can cre-

In an effort to provide depositors with transparent information about the management status of banks, Taiwan's first commercial credit rating company was inaugurated in March 1998. The commercial credit rating company evaluates the credit status of major local enterprises that plan to issue corporate bonds or commercial papers in order to raise funds in the local capital market,²³⁹ and is expected to help maintain good order in the local bond and securities markets.

A liberalized financial market, the most important condition for an ideal regional financial center, is characterized by its ability to accommodate new financial innovations. Therefore, foreign banks in Taiwan have consistently urged the MOF to remove the current requirement that each new product or service be pre-approved by a time-consuming administrative evaluation process. Under the suggested system, all services and products should be permitted except those that are expressly prohibited.

However, the MOF has been reluctant to respond to this request because it does not have sufficient risk prevention power under the current Taiwan Banking Law to handle the unpredictable risk that might arise from innovative financial products. Nonetheless, under Article 56 of the Banking Law of 1992, the MOF still acknowledges that it possesses the discretionary power to prevent risk from occurring.²⁴⁰

With regard to banking licenses, Article 56 of the Banking Law requires a bank to apply for a "banking permit" before incorporation and a "banking license" after the bank has been incorporated as provided under Article 54 of the Banking Law. While the MOF can revoke a license for misrepresentation on the application, once the bank has been licensed, the MOF can only discipline a bank that is engaged in unlawful banking practices.²⁴¹

According to the current Banking Law, the MOF may suspend a bank only in four situations.²⁴² Significant changes to a

ate a chain reaction (domino effect) of an entire banking system when a bank is unable to meet the depositors' and other institutions' withdrawal demands).

239. Banking Law art. 56 (stating that after a business license has been issued to a bank, the Central Competent Authority may revoke the bank's permit if the particulars in the original application are discovered to have been materially untrue).

240. Pursuant to Article 11 of the Establishment Criteria (stating that after approval of business operations, if any statement in the original application submitted by a foreign bank for approval of its business operations was untrue or if the foreign bank branch engages in any business activity which is in serious violation of the law, the Ministry of Finance may order the foreign bank branch to stop all or any portion of its business).

241. Banking Law of 1992 art. 56.

242. The four situations include: 1) bank mergers, or any proposed amendments to the type of bank, the name and type of company, the total capital, and locations

bank's lending practices or organizational structure without the permission of the MOF can be grounds for suspension, as can severe losses or failure to pay previously assessed fines. However, none of the above situations expressly justifies the MOF to prevent a bank from doing unlawful banking business.²⁴³

If the MOF were to discover that the new financial products were conducted in an unlawful way, the MOF could claim that the application for adding new items of business was materially untrue. The MOF would also say that the banking permit should be revoked according to Article 56 of the Banking Law. However, the MOF generally takes the more lenient measure of suspending business temporarily so as to allow banks to correct the situation within a prescribed period of time.

A more difficult situation for the MOF is one where a scandal is implemented by a lawful scheme, such as in the "Tenth Credit Crisis."²⁴⁴ Nevertheless, Taiwan's banking authorities have some power to address scandals through Article 11 of the Establishment Criteria, which gives the MOF a risk-preventive power to deal with various new financial derivative products whose arrival on the market is imminent and urgent.²⁴⁵

of the bank's head office or any of its branches without prior approval from the MOF; 2) the crisis management power after a bank effects "obvious adverse changes in its business or financial status" as mentioned in Article 62 of the Banking Law; 3) if a bank suffers losses which exceed one third of its capital and fails to correct such deficit within the time period prescribed by the MOF; and 4) if a bank fails to pay a fine within the prescribed period of time. On this latter ground, the bank is first to pay an additional surcharge for late payment within the second prescribed period of time.

243. The MOF claims that the source of its authority to suspend or revoke for unlawful banking business arises from both Article 56 of the Banking Law and Article 11 of the Establishment Criteria. The MOF asserts that Article 56 of the Banking Law requires any new financial services and products undertaken by foreign banks to be pre-approved by the MOF. After the new financial products are approved, their new business items would be added to the list of authorized business activities on the "re-issued" banking license.

244. The Tenth Credit scandal was discovered in October 1974 by the Cooperative Bank of Taiwan, the financial business supervisor of all credit cooperative societies. The Tenth Credit Union used "abnormal loans" to channel funds to the enterprises of the Cathay Related Group. Despite several warnings delivered by the MOF through the Finance Bureau of the Taipei municipal government, the local administrative supervisor of the credit cooperative societies, the total amount involved in abnormal loans of the Tenth Credit Union continued to rise. The total amounts involved in the abnormal loans increased to NT\$281 million in March 1976, to NT\$622 million in July 1977, and to NT\$ 1.499 billion in July 1979.

245. As analyzed above, Article 56 applies only to the time immediately after the banking license is "issued," and should not be applied to the situation in which a banking license is "re-issued." Since the Establishment Criteria is an administrative regulation derived from Taiwan Banking Law, the legal power of the Establishment Criteria should not be greater than that under Taiwan Banking Law. Thus, the legal basis of Article 11 of the Establishment Criteria is extremely questionable.

Even where a foreign bank is conducting an alleged unlawful business, the MOF is not allowed to prevent the bank from conducting such business; the suspension power granted to the MOF under Taiwan Banking Law does not cover such situations. Instead, the MOF would have to request a court to order the foreign bank to stop doing such unlawful business. In addition, the court would require substantial evidence to grant such an order.

Optimally, Taiwan should address the inevitable development of banking scandals by overhauling the current Banking Law to adopt the "safety and soundness" frameworks of the Basle Committee and to incorporate them into the law as "core values."²⁴⁶ In this way, the entire banking industry (including foreign banks and local banks), and banking supervisors will recognize the importance of a "core value."²⁴⁷ This statutory supervisory safety net should then be reinforced with wide discretionary risk-preventive powers in order to prevent any risk from turning into a notorious scandal or a major financial catastrophe. This statutory core value should also maintain the integrity of Taipei as a sound financial center, a crucial element to creating a viable regional financial center.

However, equipping the MOF with wide discretionary risk-prevention powers is a double-edged sword. Although the MOF is the agency best suited to prevent a risk from turning into a financial crisis, the MOF may also obstruct the normal operation of the banks if the MOF abuses the wide discretion it may be given. Therefore, creating adequate remedial procedures is essential for the banks to prevent the MOF from arbitrary abuse of power.

Establishing measures of capital adequacy and systemic risk evaluations is a basic component of any approach to regulating Taiwan's banking market.²⁴⁸ Risk-based capital standards reflecting all major risks is an important safeguard for both func-

246. The "core value" is a constant reference point, an anchor, for maintaining the stability and integrity of a banking system. On the other hand, it is a progressive definition that "commits [itself] . . . to the expertise of the appropriate regulatory regime." See *Groos National Bank v. Comptroller of the Currency*, 573 F. 2d 889, 897 (5th Cir. 1978). In order to structure a sound and safe banking system, highly developed countries and their banking systems have given their supervisory authorities broad discretion in formulating, applying, and enforcing the core value in relevant ways. As a result, the core value itself in these systems is often called "prudence" or "safety and soundness."

247. The banking system in a nation must be examined against the surrounding commercial, social, and economic environment in order to determine whether the banking laws have satisfactorily performed their role in the larger context of their society.

248. See JAMES L. BOTHWELL, *FINANCIAL REGULATION, MODERNIZATION OF THE FINANCIAL SERVICES REGULATORY SYSTEM* 5 (1995).

tional and consolidated regulation.²⁴⁹ In addition, regulators need to assess the risk management system for each component of the banking institution as well as the institution as a whole.²⁵⁰

3. *Enhancing Regulatory Cooperation for Effective Regulation*

While Taiwan empowers banking supervision in three agencies, a streamlined banking supervisory system should rely on the cooperation among these banking supervision agencies. To ensure that the functional regulations on Taiwan's banking industry are enacted, it is important to have a clear mechanism for setting rules and to establish mechanisms that regulate cooperation. In this matter, to ensure the safety and soundness of financial institutions and maintain the stability of the overall financial system, the CBC not only strengthens bank supervision, but also cooperates with the MOF and Deposit Insurance Company to review the current system of banking regulation and supervision.

In addition, Taiwan's banking supervisory authorities have also emphasized mechanisms for enhancing regulatory rules effective since 1998. Because panic runs on financial institutions resulted in the failure of financial institutions, in 1998 the CBC and MOF coordinated to timely cope with two bills to finance companies that experienced financial difficulties and a commercial bank which engaged in inappropriate loan activities.

Prevention of banking failure is one of the appropriate policies pursued by banking supervisory offices. By enhancing the reporting system for early-warning signs, Taiwan is attempting to discover any possible questions based on the CAMELS method.²⁵¹ Starting in October 1988, Taiwan required domestic banks and bills finance companies to increase the frequency of their reporting of non-performing loans and other credit information from a quarterly basis to monthly one. Additionally, reports on asset evaluation must be submitted every quarter instead of every six months.

Supervising the internal auditing of commercial banks is also an essential mechanism in monitoring banking activities. In addition to routine banking supervision, Taiwan's banking authorities also supervise and evaluate commercial banks' internal auditing

249. *Id.*

250. *Id.*

251. This bank rating system, known by the acronym "CAMELS," considers the following factors: capital adequacy, asset quality, management ability, earnings, liquidity, and sensitivity (to interest rate, exchange rate, and derivative risk). CAMELS ratings determine how often a bank is examined by regulators. See Lawrence G. Baxter, *Administrative and Judicial Review of Prompt Corrective Action Decisions by the Federal Banking Regulators*, 7 ADMIN. L. J. AM. U. 505, 531 n.138 (1993).

and control system in relation to financial security, based on the "Guideline on Evaluating the Internal Auditing of Domestic Banks, Investment and Trust Companies, and Bills Finance Companies." The result of the foregoing evaluation serves as an important reference for evaluating commercial banks

4. *National Treatment: Elaborating Foreign Banking Institutions' Role in Taiwan*

Measures adopted by Taiwan to promote liberalization and internationalization include deregulation of interest rates, foreign exchange rates restrictions, liberalization of new establishment of banks²⁵² and foreign entry, and enlargement of the business scope of financial institutions, as well as internationalization of financial market operations. Among the mechanisms responding to banking internationalization and liberalization, the increase of foreign banking institutions' participation in Taiwan financial markets will promote the standards of Taiwan's financial operation and allow Taipei to become a financial hub in the Asian regime.

In addition to the Banking Law,²⁵³ the landmark legislation governing the activities of foreign banks in Taiwan is the Guidelines for the Screening and Approval of the Establishment of Branches and Representative Office by Foreign Banks ("Guidelines"),²⁵⁴ Although foreign banks' branches and representative offices in Taiwan are subject to substantially the same laws and regulations as those governing Taiwanese banks, Taiwan places

252. To liberalize the establishment of financial Institutions, from the securities industry, banking industry, and the insurance industry, Taiwan has undertaken concrete measures to lift the long-standing ban on the new establishment of new financial institutions since 1988. As a result, with many more new financial institutions, the markets have gained momentum for further expansion. Rules and regulations adopted for the liberalization are as follows:

- Regulation Governing the Standards for Incorporation of Securities Firms of 1998;
- Regulation Governing the Standards for Incorporation of Commercial Banks of 1990;
- Rules for Administration of Securities Investment Trust Fund Enterprises amended in 1991;
- Rules for Administration of Securities Financial Enterprises amended in 1992;
- Guidelines for Establishing New Insurance Companies of 1992;
- Rules for Administration of Firms Engaging in Money Market Instrument Operations of 1994; and
- Rules Governing the Establishment Criteria of Futures Brokerages Firms of 1997.

253. See Banking Law ch. 7 (governing foreign banks' operation in Taiwan).

254. See Guidelines for the Screening and Approval of the Establishment of Branches and Representative Office by Foreign Banks [hereinafter "Guidelines"], promulgated by the Ministry of Finance in August 23, 1983. The Guidelines have fourteen articles and four amendments in 1985, 1986, 1990, and 1994.

some restrictions on foreign banks on business opportunities,²⁵⁵ as well as on the granting of reciprocity for branch offices or of representative status.

Further, according to the Guideline, foreign banks can only operate in Taiwan under two organizational forms: branches and representatives.²⁵⁶ Taiwan deeply believes that big foreign financial institutions can more safely establish their business in Taiwan than can small foreign financial institutions. Because of the foregoing restrictions, foreign banks have accused Taiwan of not according national treatment.²⁵⁷

National treatment is important because it accords foreign banks the opportunity to compete in Taiwan on the same basis as Taiwanese banks.²⁵⁸ However, national treatment does not mean identical treatment. The policy recognizes that foreign branches and representative offices also operate under the regulations of their home countries, which may differ from those in Taiwan. Adaptations of Taiwan laws and regulations were therefore necessary.

In 1994, in accordance with GATS, Taiwan significantly revised the Guidelines. The market access for the entry of foreign banks into the local market was liberalized without discrimination and distortion. Furthermore, foreign banks have been accorded national treatment to compete on an equal footing with local banks.

Consequently, Taiwan anticipates that foreign banks will play a more active role in the domestic market and has thus made a number of improvements in its treatment of foreign banks. A ban on foreign investments in local banks was lifted in June 1994, although the individual investor limit is capped at five percent of the bank's equity. Also, restrictions on the geographic location of banks and the number of bank branches were eliminated in August 1994 when the MOF decreased the restrictions

255. See Guidelines Article 3. The entry requirements for foreign banks are provided under the 1990 Guidelines, and represent an improvement of the entry conditions under the 1986 Guidelines. For example, a foreign bank with a representative office needs only one, rather than two years of prior representative office experience, and have ranked assets of at least the top of 500 banks in the free world, rather than the top 150, to open a branch in Taiwan.

256. See Guidelines Article 1 (listing only two branches and representative offices which are allowed to apply license for operation in Taiwan).

257. See BRIAN WALLACE SEMKOW, TAIWAN'S FINANCIAL MARKETS AND INSTITUTIONS: THE LEGAL AND FINANCIAL ISSUES OF DEREGULATION AND INTERNATIONALIZATION 98 (1992) (mentioning that foreign banks in Taiwan felt Taiwan treated them unlike their domestic counterparts).

258. See Brian Wallace Semkow, *The American Trade Deficit with Japan: Whether the Role of Japanese Financial Deregulation and Liberalization?* 13 MD. J. INT'L L. & TRADE, 53-54 (Fall, 1988)

on foreign bank branch entry. Waiting periods for sub-branching were reduced from five to two years. However, this remains a discriminatory practice since domestic banks are not subject to the same delay.

While Taiwan envisions greater foreign bank involvement, the activities of these bank branches continue to be restricted by the amount of their local capital as compared to their parent company's global capital. In addition, access to local funding continues to pose a problem, forcing foreign banks to rely heavily on a continually non-liquid inter-bank market because of restrictions on the terms of foreign exchange liabilities and position taking. Foreign banking institutions are also subject to limitations on guarantees of commercial paper that do not apply to their domestic competitors. In anticipation of Taipei becoming a financial center, Taiwan should encourage more foreign banks to open in Taiwan by treating foreign banks as domestic banks.

VI. CONCLUSION AND OBSERVATIONS

Financial markets are the underpinnings of all other markets and industries.²⁵⁹ As a result of financial market instability, a financial crisis shock wave could result and detrimentally affect the others. Because of this, keeping a sound and safe financial market is a priority for governments who must offer a myriad of financial service to facilitate economic growth.²⁶⁰ In the meantime, to prevent systemic risk, international coordination among financial legal authorities of each government is needed to increase crisis containment efforts.

In order to establish Taipei as a regional financial headquarter according to the Asia-Pacific Regional Operations Center Plan,²⁶¹ Taiwan needs to create a viable infrastructure possessing adequate regulations, telecommunications, and other facilities.²⁶² Accordingly, the soundness of Taiwan's entire finan-

259. See Anthony D. Taibi, *Banking, Finance, and Community Economic Empowerment: Structural Economic Theory, Procedural, Civil Right, and Substantive Racial Justice*, 107 HARV. L. REV. 1463, 1466 (1994).

260. Smorgasbord of financial services is, in this article, referred to as a financial market which is able to satisfy with the need of individual and institutional customer offer ways of raising money, either through debt or equity (for example, through syndicated bank loans or listing on the local stock markets); institutional trading of bonds or foreign exchange; means of access to a wide variety of short- and long-term investment, such as bonds or futures, for both individual and institutional customers; and mechanisms enabling investors to risk exposure to interest and foreign exchange rates.

261. See APROC PLAN, *supra* note 107.

262. See INSTITUTE OF INTERNATIONAL BANKERS, GLOBAL SURVEY 1998 168-174 (Sept. 1998) (analyzing the requirements of becoming an international financial center illustrates the success of London as a financial center, which can be attributed

cial system and regulations is vital for Taiwan to build Taipei into an Asian-Pacific region financial center.²⁶³

However, the conservative orientation of Taiwan's financial authorities delays the attraction of foreign banks. Moreover, the Taiwanese government's failure to aggressively regulate the banking sector creates another formidable obstacle towards the establishment of Taipei as an international financial center. In order to remain consistent with the world-wide banking reform movement and to simultaneously develop Taiwan's economy, various measures of financial liberalization must be installed to facilitate the price mechanism of the financial market and increase the overall efficiency of financial institutions.²⁶⁴

In response, Taiwanese banking reform must address three interrelated aspects of problems associated with amending outdated and inadequate regulations which have failed to keep pace with the developments in Taiwan's financial market: the simplification and enhancement of financial supervisory agencies to prevent financial scandals; the deregulation of inappropriate restrictions which block the development of financial institutions in Taiwan; and the creation of open financial policies to bolster financial institutions up developing new financial products for Taiwan customers.

Taiwan's conservative financial policies impeded the progress of the financial market by solely operating traditional deposit-taking and lending rather than focusing on international financial operations. Therefore, the reduction of governmental control would proportionately increase the liberalization of the Taiwanese financial market. In turn, the financial market — including money markets, capital markets, foreign exchange markets and hedging instruments — directly influences the economical and societal development of Taiwan's businesses. According to the Banking Law,²⁶⁵ Taiwan's banks should have

to such elements as time zone, language, professional expertise, skilled work force, advanced technological infrastructure, cultural adaptability, quality of life, and political stability).

263. See Christopher Fruean, *Banking on Finance*, 46 *FREE CHINA REV.* 35, 35 (1996).

264. Economic liberalization of the Taiwanese banking industry has not come without costs. The societal costs include increased risk to depositors and financial instability caused by inexperienced supervisory agencies, lax regulations, multi-financial supervisory agencies, and a disregard for sound fiscal practices.

265. The nature of Taiwanese banks to engage in universal banking activities which cross over into the securities and insurance business is based on Article 3 of the Banking Law.

provided capital for business, like banks in Germany²⁶⁶ and Japan.²⁶⁷

Improvement of the foreign exchange market and hedging instruments will also assist Taiwan's financial market in establishing itself a member of the international financial market. The development of financial products, also known as financial derivatives,²⁶⁸ will further allow the financial market to prosper. Meanwhile, the policy of financial internationalization will gradually integrate Taiwan's financial market with global financial markets, thus enabling Taipei to become a financial center. However, the establishment of Taipei as an international financial center begs potential system risks of which a cascading sequence of defaults could culminate in financial implosion.

Finally, along with the enforcement of GATS, the changing dynamics of a modern global financial system²⁶⁹ requires that Taiwan's financial regulators address the inevitable increase of potential systemic risk to the global financial industry to avoid the possibility of a domino reaction. As international financial markets become more internationalized, the effectiveness of Taiwan's regulators will increasingly depend on the collaboration to prevent or resolve a global financial crisis. Besides the international coordination for financial supervision, Taiwanese financial authorities must provide a precautionary safety net to ensure that financial institutions do not engage in reckless behavior.²⁷⁰ The unavoidable reality is that with the emergence of financial globalization, Taiwan has no other choice but to seriously review its banking regulation to meet foreign competition.

266. See Theodor Baums et al., *The German Banking System: System of the Future?* 19 BROOK. J. INT'L L., 101, 106 (1993).

267. See Thoma F. Cargill et al., *Japan's Financial System Reform Law: Progress toward Financial Liberalization?* 19 BROOK. J. INT'L L., 47, 51 (1993).

268. Financial derivatives include interest swaps, currency swaps, options, futures, warrants, securities, convertible securities and other derivatives. For the past two decades, financial derivatives have emerged as a major part of financial markets in world. Basically, the purpose of using derivatives is to avoid potential losses. For more information of financial derivative, see GENERAL ACCOUNTING OFFICE, FINANCIAL DERIVATIVE: ACTIONS NEEDED TO PROTECT THE FINANCIAL SYSTEM (1994); and ROBERT W. KOLB, FINANCIAL DERIVATIVES (1993).

269. Remarks by Roger W. Ferguson, Jr., before the International Banking Conference, Federal Financial Institutions Examination Council, Arlington, Virginia, July 20, 1998 (addressing that conceptually, global banking, both direct entry and cross-border inter-bank lending, may influence macro-stability in both positive and negative ways. As a result, the importance of adopting such core principles of sound banking and banking supervision in the international banking system, and also the need to develop a workable mechanism for enforcing the implementation of an international banking supervisory standards).

270. See *A Survey of International Banking: On A Wing and A Prayer*, ECONOMIST Apr. 17, 1999, at 4.