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Financial System Reform in Taiwan

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Abstract

To promote the competitiveness of Taiwan's financial institutions, and to build Taiwan as a regional financial service center, the government has initiated the second financial reform. In this paper, some suggestions on the second financial reform have been made. First, the improvement of current financial supervisory commission is required to perform. Second, the moral hazard index of banks after M&As should be regulated. Third, bank mergers that may result in the sharp increase of the market power should be rejected to sustain fair business competition. Fourth, the restrictions on financial institutions and the ban on Taiwanese banks operating in Mainland China should be lifted. And last, at least a state-owned bank should be left alone for policy concerns.

Keywords: Second Financial Reform, Functional Management, Financial Supervisory Institution, Financial Affairs Foundation

1. Introduction

After her Congress passed the Gramm-Leach-Bliley Act" on Nov. 5, 1999, the U.S.A. is going into a new era of financial cross-function operations. Since then, the fences across among securities, insurance, and banking sectors have been removed, and the financial supervisory system consequently was adjusted drastically. Because the global trend of financial liberalization and modernization, financial markets already have no geographic boundaries, and the system of financial supervision and management has changed from the emphasis of local management to international competition.

In order to meet the world financial trend, Taiwan government has devoted to build up a stable and efficient management environment to attract global investors and financial institutions coming into the local financial markets. Because financial supervision and management environment has lots of impact on financial system and financial competitiveness, many countries devote themselves to the revolution of financial management system in order to improve the financial performance and operating efficiency. In 2004, Taiwan also set up an independent Financial Supervisory Committee under the Executive Yuan to react to this trend of financial revolution of supervision and management system.

To address the challenges from the changes in financial environment, the Taiwan government conducted the "258 financial reform" in 2002. The first stage of the financial reform program was successfully completed in the end of 2004, and the non-performing loan (NPL) ratio has decreased from 7.48% in June 2002 to 3.22% in November 2004 and to 2.8% in September 2005[1]. However, the dramatic increase in new banks has led to the overbanking problem, and the market concentration is low relative to that in developed countries. The total assets market share of the three largest banks as of 2002 was 63% in South Korea, 83% in Hong Kong, 72% in Singapore, 68% in Australia, but only as low as 16% in Taiwan[2]. Besides, the state-owned banks in Taiwan hold the major market share (about 60% of market share), lacking international competitiveness, so there is a need for radical change to further the financial reform. In June 2004, the Executive Yuan set out procedures to implement the second stage of the financial reform, of which the main goal is to build Taiwan as a regional financial service center[3].

In October 2004, the President adopted and pronounced four suggestions made by the Council for Economic Planning and Development. The four goals of market consolidation are: (1) three banks with market share over 10% by the end of 2005; (2) halving the number of state-owned banks by the end of 2005; (3) reducing FHCs; and (4) financial institutions with foreign investment. From the above goals, it is understood that the government, by means of encouraging financial institutions consolidation, wants to achieve the goals of state-owned banks privatization, increase in the scale of financial institutions, and financial institutions globalization and, in doing so, service and performance of financial institutions in Taiwan are expected to improved and the international competitiveness of Taiwan's financial institutions can be further strengthened. However, some controversies arise from the inspection of these four goals.

First, from the perspective of consolidation progress, the problem is that whether the request made by the government for cutting the number of financial institutions by half within a given period of time overrides the market mechanism. If there is an overbanking problem which carries razor-thin profits, there naturally comes an incentive for banks to merge. The optimal market structure of an industry should not be man-made but naturally obtained by the market power. Second, though the first

[1] Financial Supervisory Commission Press Release, issued on Oct. 25, 2005.
[2] Data Source: Polaris Group
[3] Executive Yuan Press Release, issued on Oct. 19, 2005.

two goals have been achieved with the three state-owned banks mergers (both parties of the mergers are state-owned banks) conducted by the Ministry of Finance right by the end of 2005, there is still a need to justify the fairness of some mergers involving both state-owned banks and private ones. The state-owned banks are primarily set up for public policies; if the state-owned banks are to be acquired by family banks just because of their poor performance, the objectives of the state-owned banks might not be attained. Further, to fulfill the goals in a short period of time, there might be a chance of releasing the shares in the state-owned banks at a big discount, establishing the problem with the transfer of benefits to family owned banks.

Third, from the perspective of consolidation consequences, by the existing literature, there may be some external effects. (1) With the increased market share after consolidation, it is possible to exercise the market power to create adverse effects on customers, e.g. to lower deposits interest rates and raise loan rates. (2) It may reduce the loans to small businesses. (3) After consolidation, the institutions can enter into different segments of the financial industry. Hence the government must expand the financial safety net that may increase the supervision costs. Furthermore, as the scale of financial institutions becomes larger, the financial conglomerates are able to reinvest in other industries of the economy, and to exert monopolistic power in those industries, increasing inequality in income distribution. These problems will be analyzed and solved (at least partially) in the following sections of this paper.

In section 2, we will examine the improvement of Taiwan's Financial Supervisory Commission. In section 3, the consolidation effect, including the effect on participants' market value, on customers and on loans to small businesses, will be analyzed. The research on the second reform and further development of Taiwan's financial industry and the problems above will be clarified, and suggestions on the financial industry policies in Taiwan will be made in section 4. The conclusion is drawn in section 5.

2. The Improvement of Taiwan's Financial Supervisory Commission

2.1.The Improvement of Taiwan's current Financial Supervisory Commission

Establishing a Financial Supervisory Commission or Financial Services Authority can integrate the examining personnel of banks, insurance, and securities and can examine these functions of a financial institution simultaneously. Thus can eliminate the blind points that will happen in the separated examinations of function. In Taiwan, the financial supervisory system is always under the restrictions of budget and personnel problems. This constrained supervisory system can no more handle the complicated affairs of financial management. Under the political environment of Taiwan, because of the intervention coming from the politicians and the restrictions of current regulations, we must hold professional ideas, political and regulatory reality to establish the financial supervision institution. To exercise its functions well, the supervisory institution must have independent powers of personnel, budget, and examination. The alternative proposals for the options of government are: (1) special non-governmental Financial Supervisory Commission, (2) Financial Supervisory Commission or Financial Services Authority under the Executive Yuan, and (3) Mixed system of Financial Services Authority plus Financial Affairs Foundation.

Among all the alternative forms of financial supervisory institutions, the Financial Supervisory Commission (FSC) under the Executive Yuan has been adopted in 2003 by the Legislative Yuan. The FSC under the Executive Yuan will still have the problems of budget and personnel constraints. Because the committee makes decisions, the efficiency of the FSC is lower than that of the FSA. At the end, the chairman of the Commission may have a strong power as the Governor of Authority has, and the other members may become rubber-stamps. Because of the structure of commission, the members are not necessary to have the qualification of public servant. Therefore, the Commission can appoint experienced professionals from non-governmental sectors into this supervisory framework.

However, the current design of financial supervisory commission has brought many debates about whether we should put the financial policy and implementation under the same organization. Under the current system, the Financial Supervisory Commission under the Executive Yuan will have the problems of budget and personnel independence. Therefore, an improvement of current financial supervisory system must be performed to satisfy the professional considerations and the political reality. In terms of financial considerations, the system should be able to get rid of the intervention from the Legislative Yuan and can let the financial authority to operate its functions under the independence of budget and personnel and the protection of term. In terms of political reality, the Authority should be a governmental agency. The Authority is still under the supervision of the Legislative Yuan and it can satisfy the regulations of budget, audit, and personnel. Thus, this can eliminate the barriers of financial reconstruction.

2.2. Other Issues Related to Financial Reconstruction

2.2.1. Function and Position of the Central Deposit Insurance Corporation

In the developments of financial reform of other nations, the relationships between financial supervision and deposit insurance are very close. In those countries that have integrated their financial supervisory functions, such as Canada, U.K., Japan, etc., these two systems of financial supervision and deposit insurance still stick together. Even in those countries that have not yet integrated their financial supervisory functions, for example USA, the deposit insurance system is playing an important role in the system of financial supervision. USA consolidates the functions of supervision and deposit insurance, instead of implementing the pure system of integrating financial supervision. Therefore, the integration of financial supervision is only part of the effort to enhance the financial supervisory efficiency, not all of the financial revolution, and the financial supervision can not substitute for deposit insurance to stabilize the financial situations and protect the rights of depositors. By investigating the development and the experience of Japan, Canada, U.K., and USA, it is helpful for Taiwan to setup the position and the function of deposit insurance when we reconstruct the financial supervisory system.

In Taiwan, the CDIC is a public financial institution. It lacks the independence and transcendence to operate its supervisory functions. It is under the Minister of Finance, and its budget and expenses are under the supervision of the Legislative Yuan and other governmental agencies, including the Financial Supervisory Commission. Besides, it is still regulated by the related regulations and laws. Compared with the FDIC of USA, the independence and the transcendence of the CDIC are much lower than those of the FDIC. In Taiwan, so far, the financial authorities hold the powers to correct and punish the problem financial institutions. The CDIC cannot actively close or correct the problem financial institutions to control its insurance risks. The insurance premiums are not based on the risk assessment and the CDIC cannot intervene the operations of problem institutions in advance. These will make the CDIC take excessive risks.

2.2.2. Adjustment of the Examination Power of the Central Bank

Since the financial institutions, the financial markets, and the payment system are the critical elements for the Central Bank to transmit the policies of money, credit, and foreign exchange, the stability and the sound operation of these elements have impacts on the policy effects and the economy development. Therefore, if it is needed, the Central Bank must examine the financial institutions to understand the operations of financial institutions, financial markets, and payment system. This is helpful for the Central Bank to make policies. Besides, the Central Bank is responsible for the money market and the foreign exchange market. It can effectively supervise and stabilize the operations of these markets by examinations. Newly established financial supervisory Commission is responsible for supervising the industries of banks, securities, and insurance. Their objects are to guide the sound operation of individual institutions, to protect the rights of depositors, and to ensure the safety of transactions. The examinations include financial situation, performance, operation, internal control, and risk management. However, these reports have fixed and specific time intervals and the information may not satisfy the needs of the Central Bank to make decisions. Therefore, the Central Bank needs the power to examine and inspect some specified items of the financial institutions to obtain the latest financial information.

In summary, the ranges and objects of examinations of financial supervisory institutions and the Central Bank are different. The functions will not overlap. Besides, if having the appropriate powers of inspection and commissioned examination, the Central Bank can operate the function of re-check. And when financial institutions ask the Central Bank to satisfy their demands of liquidity, the Central Bank can immediately verify whether their demands are necessary or not. The Central Bank can take the precise and effective actions to deal with the problem of liquidity. Based on the previous discussions, to operate the monetary policies effectively, the Central Bank should keep the appropriate power of commissioned examination of specific objects, such as money, credit, and foreign exchange.

3. The Effects of Financial Institutions Consolidation on the Financial Industry

3.1 The Consolidation Effects on the Participants' Market Value

It is expected that the financial institutions consolidation can bring about four positive effects: First, consolidation creates economy of scale, economy of scope and managerial efficiency, and reduces cost outlay. Second, after consolidation the financial institutions can expand market share, and banks' market power increases, the financial institutions can raise profitability through rising loan rates or lowering deposits rates. Third, if the financial institutions can expand operation area and enter into other segment of financial industry through consolidation, they have the opportunity to lower operating risk and enhance firm value through diversification. Fourth, it is helpful for financial innovation.

The financial institutions are highly similar in Taiwan; if a bank wants to be competitive it must carry on the product differentiation, which depends on the financial innovation. If the bank scale expands, it has more funds to invest in financial innovation research, carries on product differentiation, and creates profits. If consolidation brings about positive effects above, it is reasonable to anticipate that after consolidation, the participants' shareholder value will increase. If the stock market is efficient, the market will have the merger effect in response to the merger announcement. In empirical studies, the financial institutions consolidation effect on the participants' market value can be understood by observation of participants' stock price returns within several days or months after the merger announcement less the industry average returns (i.e., by observation of abnormal returns).

According to Nail and Parisi (2005), in literature there are two kinds of scales, namely short-term event study and long-term abnormal return study, commonly used to measure the shareholder wealth changes after consolidation. These two kinds of scales are essentially similar, because both will adjust the differences due to banks' scale by comparing participating banks with some indices such as the industrial index, the market index, or competitor performance. In the early 1990s, it was rarely found that the increase in aggregate profits accompanied with consolidation in the research on US domestic bank mergers cases. Typically the target banks' shareholder wealth increased, while the acquiring banks' shareholder wealth decreased (Houston and Ryngaert; 1994). Madura and Wiant (1994) found that the abnormal return of acquiring bank shareholder is negative, probably due to the high acquiring price. And the abnormal return of acquiring bank shareholder is still negative after a month of the merger announcement, suggesting that the market adjusts the prediction toward the merger downward. Siems (1996) and Frame and Lastrapes (1998) also found that on average the abnormal return of acquiring banks' shareholder is negative, and the abnormal return of target banks' shareholder is positive. The study conducted by Zhang (1995) is one of the few exceptions. In Zhang's study 107 merger cases during 1980-1990 were included, and he found that the aggregate wealth increases apparently, though the major part of wealth increase is gained by the target banks' shareholders, the acquiring banks' shareholder wealth increment is significant too.

With the liberalization of financial regulation, the level of wealth increase and the distribution of wealth among shareholders also changes after bank mergers. Recent researches, such as those of Becher (2000) and Houston, James and Ryngaert (2001), have found that capital market responds to bank mergers more positively. Both researches demonstrate that the return of acquiring banks' shareholders is not only higher than ever, but also is positive rather than negative. Brewer, Jackson and Jagtiani (2000) studied the return of the target banks' shareholder and found that the takeover premiums have increased by almost 35% in the post-Riegle-Neal Act period. For merger involving cross border banks, distribution of wealth is somewhat different. Waheed and Mathur (1995) investigated the impact of foreign expansion on the market value of US banks during the period of 1963-1989. Their findings indicate that US banks undergo significant changes in wealth when they announce to engage in foreign expansion. Biswas et al. (1997) compared the wealth effects of domestic bidders (target banks) with those of foreign bidders (target banks) involved in acquisitions of financial institutions during the period of 1977-1987 and found dramatic differences between domestic and cross-border mergers. Domestic acquisitions experience a significant loss of 0.39% while cross-border acquisitions do not experience any loss at all. Kiymaz (2004) investigated 207 cross-border acquisitions by US bidders and 70 acquisitions of US target banks by foreign bidders during the period of 1989-1999 and discussed wealth changes and factors influencing wealth effects after the merger announcement.

Table 1 shows the stock price movement within 4 days after domestic merger announcements. The first three cases involve state-owned banks merged by private banks, and the last three cases involve acquisitions of private banks by other private banks. Since, among these banks, Macoto Bank is not a listed or an OTC bank, there's no registration statement concerned and the acquisition benefit may be attributed to its bidder. From table 1 we can understand that the stock return of the private bank, whether acquires a state-owned bank or a private one, appears to be negative, while the stock return of the target banks appears to be positive, within 4 days after the merger announcement, and the phenomenon are irrelevant to financial index returns. Moreover, in some of the cases, the stock price of the acquiring banks falls by close or that of the target banks rises by close, indicating the consistency between the market expectations of domestic bank mergers in Taiwan and foreign literature reviews. What is worth noting is that the stock price of the private banks still falls or increases by a ratio less than the financial index return when it acquires a state-owned bank. This suggests shareholders of private acquiring banks never earn excessive profits from M&As and implies there's no evidence showing that the state-owned shares are sold at a big discount.

3.2 The Impact of financial institution mergers on economies of scale and economies of scope in financial industry

As Amel et al. (2004) indicated that there had been 34,147 mergers occurring in major industrialized countries during 1996-2001 and 19,996 mergers during 1990-1995. The reasons for the prevalence of mergers and acquisitions are the same in most of these countries. To address the indigenous change of regulations and techniques, financial institutions try to improve their operating efficiency and attract new customers by expanding their coverage of products and geographic regions. And the concept of retaining the decreasing net profit margins by gaining more market shares and attracting new customers can be realized by means of M&As, because M&As help financial institutions enlarge their scales and leverage their expertise in developing new products and markets rapidly or adjust their investment portfolios or gain more market shares.

Besides, M&As provide the possibility for financial institutions to obtain diversification benefits by cross-sector, cross-industry investment or expansion into new industry. Lowered risk may increase shareholders' wealth, because cost arising from involvement in financial crisis, insolvency, or deprivation of concession is extremely high. However, the extent of scale economies and scope economies is less than generally perceived, and more favorable management efficiency may disappear in a large, sophisticated organization.

M&As can help institutions increase profits by adjustment of scale, scope, or product mix. The enhancement of efficiency is obtained through adjusting the input or output volume to save costs, earn more profits, or reduce risk under a given price, underscoring cost analysis. The impact of mergers and acquisitions, refers to a business using the enhanced market power after mergers to raise the price and make profits, focusing on revenue analysis.

In some empirical studies with 1980s data, assume that the cost function is translog, we may find that the average cost function is a quite flat U-shape curve, and medium sized banks have more scale efficiency than large or small banks. The overall study results suggest that the increase in scale efficiency is insignificant, and large banks may see slight scale efficiency losses after M&As (Peristiani, 1997; Amel et al., 2004).

Peristiani (1997) studied 4900 mergers of US banks in 1980-1990 to see if mergers improve the operating efficiency of U.S. banks, in which he used x-efficiency and scale efficiency to measure banks' operating cost and asset scale efficiency. The study findings indicate that x-efficiency of a bank within 2-4 years from mergers increases by a small but significant amount, but banking holding companies may have x-efficiency drop significantly after mergers. Amel et al. (2004) studied the efficiency of M&As of financial institutions (commercial banks, investment banks, insurance companies, and asset management companies) in major industrialized countries during 1990-2001 and found that these financial institutions, particularly the commercial banks and insurance companies, merely obtained little economies of scale after M&As.

The measurement of scope efficiency involves the comparison of expected cost for a financial institution to provide diversified financial services and the sum of costs for a group of financial institutions to provide respective financial service by their profession. Empirical study results indicate that neither scope efficiency nor product portfolio efficiency can save much cost. Humphrey and Vale (2004), for example, examined if there's any economy of scale occurring after M&As of 131 Norwegian banks during 1987-1998 with the linear spline and Fourier cost functions. The analysis suggests the average cost of a bank will drop by 2-3% (drop by less than 1/15%, estimated by the traditional translog cost function), if we regard total assets as output. Higher economies of scale, estimated by regarding either business loans or individual loans as the output, will be produced, even if the business loans have higher marginal cost.

After consolidation, financial institutions have opportunities to be engaged in diversification for diversifying risks. The lowered operating risk is also regarded as one of the cost-effects that consolidation brings. Berger, Demsetz and Strahan (1999) proposed that, in some studies, bank managers behave like risk averters who will measure risk and expected returns and also tolerate additional cost/expenditures to keep risk under control (Hughes et al., 1996, 1997; Hughes and Mester, 1998). A bank with a larger scale is capable of diversifying risk by providing comprehensive financial services and expanding operating regions, so it can prevent financial crisis with fewer resources.

A number of papers find that a bank with higher capital ratio will also invest more resources in risk management. For those large banking organizations in the US, the cost is relatively low, which is consistent with scale efficiency (Hughes et al., 1996, 1997; Hughes and Mester, 1998). Another paper indicates that large banks are more likely engaged in diversification business but the risk is not lower than the risk for small banks, because large banks would increase high-risk loans for lowering capital ratio to earn higher expected returns (Demsetz and Strahan, 1997). At last Hughes et al. (1999) examined US large banks' evaluation of expected profits, profit volatility, profit inefficiency, and insolvency cost in the early 1990s, so as to find benefits from diversification. They found that when an institution grows big enough to diversify its business regions, particularly interstate consolidation diversifies macroeconomic risks, efficiency will be lifted while insolvency cost will be reduced.

3.3. Impact of financial institutions consolidation on customers

With enhanced market shares and strengthened market power after consolidation, a bank may exercise the improved market power, which may have adverse effects on its customers. According to *The Merger Enforcement Guidelines as Applied to a Bank Merger* (Competition Bureau, Canada)[4], the term "market power" refers to the ability of firms to profitably influence price, quality, variety, service, advertising, innovation or other dimensions of competition. The exercise of market power by a bank or banks could be manifested in numerous ways, including a reduction in interest rates of demand deposits or an increase in the service fees charged on credit cards, RRSPs, brokerage fees or other investment vehicles; an increase in interest rates on loans or mortgages or a tightening of the conditions for obtaining financing; an increase in the fees charged to retail businesses for point-of-sale terminals or for credit card purchases; or an increase in the price of other services. An exercise of market power can also result in a lowering of product quality or service and a loss in the variety of available products. In all cases, the prices used in the analysis are actual transaction prices, rather than posted price.

In addition, Amel et al. (2004) indicated that financial institution mergers may aggravate individual risk (due to diseconomies of scale) and the industry's systematic risk for business operators. For this reason, discussion about consolidation effects requires the increase in efficiency and potential boomerang effects. In the following sections are external effects, impacts of financial institution M&As on financing for SMEs, and on deposits and borrowers.

Why do we need to discuss the impact of financial institutions consolidation on small and medium-sized enterprises (SMEs)? Takats (2004) believes there are three factors contributing to the question: 1. For modern economic entities, SMEs are very important; two-thirds of the labors in EU are hired by SMEs and a half of the labors in the US are employed by SMEs. 2. SMEs rely on bank loans; loans to SMEs are twice as much as loans to larger businesses. 3. Rapid bank mergers have led to high

[4] Competition Bureau, 2003, The Merger Enforcement Guidelines as Applied to a Bank Merger. See http://www.competitionbureau.gc.ca/internet/index.cfm?itemID=1253&lg=e

concentration of the banking sector; about one-third of European and US banks have disappeared over the past decade.

According to some empirical findings, large banks participating in mergers tend to cut bank loans to SMEs but, in contrast, small banks prefer to increase loans to SMEs. But, the fact is, large banks hold the majority of assets, thus loans to SMEs will be reduced after bank consolidation. For instance, Sapienza (2002) studied 90 bank mergers in Italy during 1989-1995 and found that SMEs engaging in a transaction with target banks are not likely to continue to obtain loans from the surviving banks, while the policy rejecting credit to SMEs is irrelevant to debtors' observable characteristics. Karceski, Ongena and Smith (2005), based on the cases of Norwegian listed companies from 1983 to 2000, discovered that creditors of target banks have a tendency toward termination of loans after banks mergers, small bank consolidation particularly, and the loan may be continued if the creditors have low excess returns, which indicates higher conversion cost.

Based on the consideration of non-participating banks' reactions, there may be different results. Berger et al. (1998) evaluated the impact of bank consolidation on other banks' loans in the market. They found the decrease in loans of participating banks may be offset by the increase in loans from other banks to SMEs. A number of papers show that the proportion of loans from the new bank to SMEs is higher than that from other small banks of the same scale, and the high proportion will last for a couple of years, indicating positive external effects of bank mergers on loans to SMEs (Goldberg and White, 1998;DeYoung, 1998, DeYoung et al., 1999).

According to traditional theories, it is generally believed that the credit limit for SMEs is related to the bank size, and bank consolidation is therefore unfavorable to SMEs. Takats (2004) proposed a perspective different from traditional theories; he examined the attitude of banks toward loans to SMEs from the perspective of bank corporate governance. Takats argued that bank loans are correlated with the bank's structure; a decentralized structure will be advantageous to transmission of implicit information, e.g. the transmission of debtors' credit and risk ratings, while a centralized business is advantageous to transmission of explicit information (Stein, 2002). An acquisition of a small or medium-sized bank by a decentralized bank is favorable to financing for SMEs; on the contrary, an acquisition by a centralized bank will reduce the efficiency of loans to SMEs. Thus consolidation between banks is not necessarily detrimental to SMEs.

4. The Impact of Second Financial Reform on the Development of Financial Industry in Taiwan

4.1. The Impact of Released Shares of State-Owned Banks

Among the controversies over the second financial reform, one of the major arguments is that, according to the public perception, the reform may cause reallocation of the nation's financial resources while the government is urging financial institution consolidation. In the future, Taiwan is likely about to enter an era of "the poor get poorer while the rich get richer"; the gap between the average earnings per capita will grow much wider. Thus, in this subsection, we will discuss the concerns about whether the released shares of state-owned banks would result in financial conglomeration and transfer of the public property at a big discount.

Whenever we are trying to review whether the family conglomeration impairs the public interest, it is essential to define the meaning of a "family firm" in advance. We can divide the definition into two perspectives. First, the company's major shares are held by the manager and his consanguinity or relatives by affinity, so that the managers can control the company. And second, although the managers (including their kinsmen of the third degree of consanguinity) do not hold a high ratio of shares, they still can control the company indirectly through reinvestment or cross shareholding from a specific company with a high share ratio of the company. La Porta, Lopez-de-Silanes and Shleifer (1999) found that in East Asian countries, a single shareholder holding 20% shares is sufficient to be regarded as a major shareholder; and many large companies are prone to be control by the government or family stakeholders; this is especially obvious in countries lacking protection mechanism for minor shareholders. Classens et al. (1999) found that, particularly in Asia, shareholders always obtain votes of the company or other companies by indirect shareholding such as cross shareholding or intercorporate shareholding. The fact that a shareholder obtains additional votes, larger than those demonstrated in the financial statement, with little capital will lead to an agency problem between stakeholders and minor shareholders and trigger moral hazards of benefiting the stakeholders (Shen , Chen, and Wu, 2005).

In view of the second aspect described in the preceding paragraph, we can find that the operator in an alleged family business does not hold a high shareholding ratio while substantially taking control over the board of directors. Thus we do not define a family conglomerate by the book shareholding ratio but substantial control rights instead. La Porta et al. (1999) propose the principle of "one share-one vote", i.e. each share is given a vote. "Share" refers to the share actually held by shareholders. As it is calculated based on the practical paid-in capital, it is called "cash claim", representing the ownership of the company. The perception of "vote" should be based on actual votes, including the votes due to direct or indirect shareholding, representing the control over the company. In a word, a shareholder having few control rights but acquiring the right through indirect shareholding breaches the principle of "one share-one vote". Thus the difference between one share and one vote can be an indicator for measuring moral hazard (Shen et al.; 2005).

Shen et al. (2005) found that the larger the moral hazard, the higher the non-performing ratio and the fluctuation of return on assets, and the lower the return on assets. If, during consolidation between a state-owned bank and a private one, the private bank shareholder acquires control rights over the state-owned bank without investing in much capital or any investment, there might be moral hazards, namely, concerns about conglomeration.

Morck and Yeung (2004) identified, in their World Bank's report, that among the countries in the world, corporate assets and corporate governance are usually concentrated on few rich families. Their findings prove that a family business, in most countries, often controls other companies by pyramid shareholding. Morck and Yeung (2004) argued that concentrated shareholding would not eliminate the agency problems; pyramid shareholding might cause damage to the nation's economics on the contrary. Johnson, La Porta, Lopez-de-Silanes and Shleifer (2000) also proposed a similar theory, which is referred to as "tunneling". Tunneling means the conversion of corporate assets and profits into the controlling shareholder's wealth. Perez-Gonzalez (2002) studied the correlation between the family's inheriting manager and the company's operating performance and found that return on assets, price-book ratio of a company controlled by a family's manager are lower relative to those of a company controlled by a non-family manager.

Thus, most experts believe family conglomerates often have inefficient corporate governance. The family's wealth is increased and, comparatively, the influence on other companies is expanded while the government is conducting financial reform. The government is liable to prevent such a situation. The possibility of wealth transfer could be increased or decreased due to the government regulations. Studies found that the opportunity of tunneling in common-law countries is lower that that in civil-law countries, as equities are well protected, accounting surveillance is acceptable and contracts are executed well in the former countries shareholder (Morck and Yeung, 2004). That is to say, a nation with strict accounting regulations and reinforced banking control experiences little wealth transfer, so the government should focus on making financial regulations and the function of the surveillance authority. Developing international markets, reducing the entry barrier to the banking sector and increasing business competition pressure are acceptable methods for eliminating wealth transfer.

4.2. Concerns about State-Owned Properties Sold at a Big Discount

Recently there have been prevailing queries about the government's promotion of the second financial reform, which has made wealth concentrated in several family conglomerates. The major argumentation is to review the growth rate of the asset scale of these family conglomerates before and after mergers. According to *Common Wealth Magazine*, Cathay Financial holdings had a prompt asset growth rate of 84% after consolidating UWCCB in 2002 and recorded a profit growth rate of 57% in the following year; Fubon Financial Holdings experience a stiff asset growth rate of 150% after merging Taipei Bank in 2002 and a profit growth rate of 47% in the following year. This is what scholars had queried that state-owned properties were sold at a big discount. As we are studying whether it is true that the government sold the state-owned shares at considerably low price, we have to clarify the fact that the banking sector is an industry with tremendous assets and liabilities; from a perspective of asset growth, we cannot judge that the government is suspected of profiting conglomerates. Some scholars also query that, if state-owned banks were sold at low price, the stock price of acquiring companies should have been raised, because foreign shareholding emphasizes return.

From Table 2, we find that the acquiring price and price-book ratio of consolidation between a state-owned bank and a private one are higher than those of consolidation between two state-owned banks or between private ones. This proves that state-owned shares are not released at lower price.

Table 3 shows the stock returns of Tai Shin Financial Holdings and the foreign shareholding ratio three days after purchase of NTD 1.4 billion of CHB preferred stock. From table 3 we may understand that Tai Shin Financial Holdings purchased CHB at NTD 26.12 per share, which is 40% higher than the stock price of CHB. This a simple a two-stage purchase approach. After eliminating bad debts, CHB did not preserve much net value. If the stock value is lower than NTD 10, Tai Shin will have preferential subscription rights. And, from the foreign shareholding ratio, we can see that even CHB held a prospectus conference to explain its strategies, foreign shareholding, instead of being redeemed, kept selling out their shares, causing Tai Shin experiences falling market value.

Of course, each bank is different from another in operating status and structure. The verification may not reflect the genuine situation but provide the public another perspective to review whether the government sold state-owned shares at low price.

4.3 Relationships between Family Banks and Operating Performance

Typically a family business is defined as "the founder or his family members of the family business still serves as the company's director, management or stakeholder holding most of the company’s shares". Due to Taiwan's business tradition, most of the enterprises are run by family members. Today, the economic structure has been transformed into a professional division of work, but family businesses still play a key role in Taiwan's economic development. Based on the survey conducted by *Common Wealth Magazine,* among Taiwan's Top 50 companies, there are more than 20 conglomerates of which the core corporate shares are held by families or individuals. According to Fortunate 500, one-third of which are family businesses. In this section a summary of the board and business operating performance for companies in foreign countries is prepared, and then the relation between domestic financial holdings and the bank's operating performance is analyzed.

With exacerbating agency problems between of shareholders and managers, the composition of the board in a company has significant effects on its operating performance (Barnhart, Marr and Rosenstein; 1994). It is essential to have insight into the composition of the board and surveillance. The composition also affects the role of the board and its efficiency (Hermalin and Weisbach, 1988). The insight helps evaluate the reform of director election. With 21 retailers as samples, Chaganti, Mahajan and Sharma (1985) found that insolvency has no correlation with the board structure. Millstein and MacAvoy (1998) found that a board with active and independent operation has better operating performance in comparison with those passive boards lacking independence.

From an overview of existing studies, most of them involve the discussion about the connection between the structure of the board, the scale of the board, CEO-chairman duality, the inside/outside proportion of the board, and the financial performance (Kesner & Dalton, 1987; Morck , Shleifer & Vishny, 1988; Rechner & Dalton, 1991; Furst & Kang, 1998). Empirical studies show inconsistent results, and most of which exclude samples in the financial, insurance sector, because the financial, insurance sector is different from normal sectors in operation type. For this reason, the study is to discuss if there is any significance in overall financial performance between family shareholding and non-family shareholding in the banking industry.

Hwang, Liu, Liu and Wu (2005) have analyzed financial performance[5] of Taiwan's state-owned or private listed banks (or OTC banks). Again, in this paper that whether these banks are held by a family firm or has impact on the performance of

[5] The financial performance includes financial structure, solvency, operation, profitability, scale, and growth.

these listed or OTC banks is analyzed[6]. From Table 4, many of the private banks of excellent financial performance are held by family firms, while state-owned banks with excellent financial performance are not held by family firms, because they are controlled by the Ministry of Finance. In addition, most of the banks with poor financial performance are held by family firms. So, whether it is a family control bank is irrelevant, it is the level of moral hazard index that matters.

With respect to Taiwan's listed or OTC banks, about a half of which are held by family firms. The family firm may be an initial founder of a bank and then expand their business to other sectors. Also, some families were not engaged in the banking sector initially, but they expanded to the banking sector gradually with their business growth. As same as other affiliates of the family business, such a bank is a "tool" used to fulfill the family's interest. Therefore, the bank is required to serve the affiliates in accordance with the family's overall interest, and has no control power fundamentally over companies affiliated to the family.

4.4 The Effects of Second Financial Reform on the Competitiveness of Financial Institutions in Taiwan

One of the objects of the second financial reform is to facilitate overseas competitive edge for at least one financial institution. Today, the profits of the financial industry in Taiwan come from the booming development of consumer financing and SMEs since the mid-1990s. The surging growth of consumer financing and SMEs has driven the economic success. As an island country, Taiwan should have her industries develop international competitiveness by launching globalization, engaging in manufacturing and sales in countries with lower production cost, for long-term operation. With other industries moving toward globalization, inevitably Taiwan's banks have to be faced with worldwide competition. Taiwan's government is looking forward to urging its banking sector, following the high-tech electronics, to become a globalized industry, making Taiwan's banking sector an indispensable economic power and substantiating the identity of Taiwan in the world. As Taiwan is encountered with intensive competition from other countries, e.g. H.K., Singapore and Korea, etc., in the banking marketplace, the government needs to promote the

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[6] The rankings come from Hwang et al. (2005), and the data used to determine whether shares are held by family firms is obtained from shareholdings of directors or supervisors and the major shareholders data provided in each bank's annual report. The main determination criteria are distinguished by the followings: 1. whether the family firm is a stakeholder of the bank, and whether the bank's ownership belongs to the family firm or family conglomerate; and 2. whether the bank's operation is manipulated by the family firm, either directly or indirectly, and whether the administration policy is directly or indirectly developed by the family.

consolidation of domestic financial institutions with unqualified bank scale, competitiveness, capital and structure for international market. According to Table 5, Taiwan's banks are inferior to those of other Asian nations in return on assets or return on equities, proving operating inefficiency of Taiwan's financial institutions.

According to Table 6, among the Top 9 banks in Taiwan, most of which are state-owned banks (except Chinatrust and Cathay United), but the operation efficiency of state-owned banks is often inferior to that of private banks. Thus, in the second financial reform, the priority will be enhancement of banks' operation efficiency in Taiwan, namely focusing on privatization of top-ranked state-owned banks. Large financial holding companies can only gain international competitive advantages by solid development in Taiwan and improvement of international financial practices and outlets. Wang (2004) employed the development experience of HSBC and Hang Seng Bank in Hong Kong to explain Taiwan cannot be upgraded as a regional center unless access to the international market. HSBC Holdings recorded net profits of USD 8.8billion in 2003, and saw a significant growth (55%) of net profits in the first half of 2004, totaling to USD 6.4billion. Hang Seng Bank, the second largest financial institution in Hong Kong merely garnered profit rates of 15% and 13% respectively. The considerable profitability gap between HSBC and Hang Seng Bank testifies to Taiwan's unexpanded market subject to small market scales and reiterates the importance of launching the international market.

As China's banking industry emerges and many Taiwanese firms rush to Mainland China for a big share in market, Mainland China had become the biggest trade partner for Taiwan. With indigenous linguistic and cultural advantages, Taiwan needs to expand its geographical reach to Mainland while accessing to Asian market. Up to now, however, the ban on cross-strait banking sectors is not yet lifted, and Taiwan's banks are prohibited from setting up branches in Mainland, which results in Taiwan's banks failure to maximize their overseas financing business. Concerns about domestic financial institution mergers are raised. Does a Taiwan's financial institution that cannot extend its business in the Mainland enter the international market as expected after bank M&As, or do the M&As simply lead to monopoly of financial resources? For this reason, the second financial reform should involve the liberalization of cross-strait banking, allowing consolidated financial institutions to develop business opportunities in Mainland China and solicit foreign investment.

5. Conclusions and Suggestions

To effectively resolve these bottlenecks of the financial reform, we have to improve the original design of the financial supervisory commission from the financial professional thoughts. Hence, we should establish the Financial Affairs Foundation (FAF) to operate the functions of financial supervision and examination. The relationship between the FSA and the FAF is similar to that between the Mainland Affairs Council and the Straits Exchange Foundation. The FAF shall have the Department of Financial Supervision, Department of Research and Development, the Department of Administrative Management, the Department of Secretariat, etc. The Board of Directors at least consists of the members of the Financial Policy Commission of the Financial Services Authority and the Chairman, the Governors or the Directors of the Bureau of Finance, the Securities and Futures Commission, the Department of Insurance, the Department of Bank Examination of the Central Bank, and the CDIC. Therefore, we can reposition the structure of the FSA plus the FAF as the best choice. After reconstructing the financial supervisory system, there are some remaining issues we have to deal with. The issues are (1) the function and the position of the Central Deposit Insurance Corporation, and (2) the adjustment of examination power of the Central Bank. For these issues, we have pointed out the critical steps the government should take next. That would be helpful for financial reform in Taiwan.

From the banking industry analysis in Section 4, the competitiveness of each bank is not much changed before and after the reform. Top-ranked performance banks still retain their advantages after the "258 financial reform". This does not suggest that there's no structural alteration, but that these banks have changed in consistent with the "258 financial reform" and kept themselves at a certain level of competition power. The ongoing second financial reform is targeted at the promotion of the regional financial service center, thus these financial institutions should be strengthened. Compared to other major countries, Taiwan faces more challenges such as small bank size, inefficiency of state-owned banks, over-banking, and low market shares held by large banks, etc., and bank consolidation is the solution. By referencing experience of some developing countries (South Korea, Malaysia, etc.), we may expect successful financial institution consolidation driven by the government.

The policy of the second financial reform, setting deadline and cutting the bank size by half, has raised public concerns. It is suspected that the government profits financial conglomerates, because only family banks are able, and willing, to launch the consolidation. However, from this study, it's not generally considered that state-owned bank privatization makes profits promptly, and there's no evidence showing that the state-owned properties are sold to any family banks at a big discount currently. As a robust banking system is closely correlated with the nation's economic growth, the banking sector requires the government surveillance. But, according to the experience in the US, tight regulations on the banking sector will urge banks to avoid government surveillance by financial innovations.

Because the financial liberalization is inevitable, financial surveillance should be properly released to accelerate bank consolidation and facilitate the efficiency brought by the economies of scale. Unfortunately, enhancing the bank efficiency (e.g. adaptation of different business cultures or deduction of bad debts) takes time; the market response to the consolidation after announcements is not necessarily positive. Based on the six cases in Taiwan, the acquiring bank's shareholders may experience negative abnormal returns while the target bank's shareholders have positive returns 4 days within the consolidation announcement. Consistent with foreign cases, the profits will be attributed to the target bank's shareholders, even though it's believed that the consolidation would generates synergies in the market. The acquisition of state-owned banks by private banks also produces the same effect.

Merging state-owned banks with private ones is more feasible, in case that a bank attempts to enhance competitiveness by means of consolidation. With respect to operating performance, generally private banks are superior to state-owned banks. Thus the priority of share release for the government should be private banks. Despite outstanding performance in some state-owned banks, still more state-owned banks which require improvements should have their shares released to private banks for overall balance. Share release has been initiated by the government for the second financial reform, but becomes a ripe target of public criticism. According to our conclusion, the government should select financial institutions with excellent operating performance for share release. While most of the financial institutions of good performance are known as family holdings companies, controversies over whether the second financial reform profits financial conglomerates are stirred. Nevertheless, to enhance operating efficiency of state-owned banks, state-owned shares released to family banks is not the one and only one but a "mandatory" solution.

Therefore, it is recommended that first, the competent authorities should measure the moral hazard index when reviewing the merger application; if the merger may cause excessive difference between control rights and ownerships, the authorities should reject the merger case. There should be restrictions on reinvestment of financial holdings companies in non-banking industries, so as to prevent these companies from affecting the other industries with their significant market influence. There is no need to make special regulations separately for family banks.

In a liberalized market, as open competitions will inhibit consolidated banks from exercising their market power, plus adequate regulations and proper surveillance, adverse effects will be eliminated. Hence, it is recommended to preserve one or a number of state-owned banks for carrying out government policies, without the need for competing with other private banks. If a state-owned is not to be merged by a private bank, the government may remain to be the biggest shareholder after state-owned share release; in this case, the second biggest shareholder (private shares) is responsible for operation of the bank, and the government is entitled to change the operators in case of private-share directors' poor operating performance.

Table 1
Stock Price Return and Financial Index Return (%) within Four Days after Merger Announcement

Bidder: Fubon Financial Holdings				Bidder: Cathay Holdings				Bidder: TaiShin Holdings			
Target: Taipei Bank (TB)				Target: UWCCB				Target: Chang Hwa Bank (CHB)			
Date of Announcement: 02/08/08				Date of Announcement: 02/08/12				Date of Announcement: 05/07/22			
Date	Fubon	TB	Index	Date	Cathay	UWCCB	Index	Date	TaiShin	CHB	Index
02/08/08	-0.3	4.33	0.22	02/08/12	2.67	6.78	2.81	05/07/22	-0.3	4.33	0.22
02/08/09	-2.44	6.92	4.33	02/08/13	-6.81	0	-2.87	05/07/25	-2.44	6.92	4.33
02/08/12	0.31	1.29	2.81	02/08/14	-5.16	4.37	-0.19	05/07/26	0.31	1.29	2.81
02/08/13	-2.18	-2.88	-2.87	02/08/15	-1.13	-1.52	-0.03	05/07/27	-2.18	-2.88	-2.87
Bidder: Chinatrust Holdings				Bidder: SinoPac Holdings				Bidder: Shin Kong Holding (SKFHC)			
Target: Grand Commercial Bank				Target: International Bank of Taiwan				Target: Macoto Bank			
Date of Announcement: 03/07/02				Date of Announcement: 04/08/26				Date of Announcement: 05/04/19			
Date	Chinatrust	GCB	Index	Date	SinoPac	IBT	Index	Date	SKFHC	Macoto	Index
03/07/02	0	3	1.22	04/08/26	2.37	4.13	3.79	05/04/19	3.3	-	0.99
03/07/03	-3.52	6.8	1.51	04/08/27	-1.16	0.88	-0.26	05/04/20	-3.53	-	0.06
03/07/04	-0.73	6.82	-0.92	04/08/30	0	0.44	0.5	05/04/21	3.14	-	1.29
03/07/07	2.57	2.13	4.23	04/08/31	0	-2.17	-1.01	05/04/22	0.51	-	0.6

Note: Index means Financial Index Return

Table 2
Large Financial Institution Mergers in Taiwan in Recent Years

Announcement Date	Bidder	Target	Stock-Exchange Ratio 1: Bidder	Purchase Price Per Share	Net Value Per Share	Purchase Price/ Net Value
2/7/2003	Chinatrust Holdings	Grand Commercial Bank	Common Stock: 0.25; Preferred Stock: 0.63	13.9	10.85	1.28
26/8/2004	Sinopac Holdings	Int'l Bank of Taipei	1.36	21.6	16.03	1.35
4/2/2002	Mega Holdings	ICBC	0.75	22.5	16.43	1.37
12/8/2002	Cathay Holdings[a]	UWCCB	0.59	20.5	13.92	1.47
19/4/2005	Shin Kong Holding	Macoto Bank	0.93	25.9	17.09	1.52
22/7/2005	Tai Shin Holdings[a]	Chang Hwa Bank		26.1	16.34	1.60
8/8/2002	Fubon Holdings[a]	Taipei Bank	0.87	33.8	20.91	1.62

Note: The purchase price is Stock Price of the acquiring bank * Exchange Ratio on consolidation date.

a indicates consolidation between a state-owned financial institution and a private one.

Tai Shin purchased CHB at NTD26.12 per share (NTD1.4billion of mandatory convertible preferred stock in three years (22%))

Table 3

Stock Returns of Tai Shin Financial Holdings Three Days after Purchase of NTD1.4 Billion of Preferred Stocks

Tai Shin Holdings	FY 2005	Stock Price	Change of Stock Price	Foreign Shareholding Ratio	Change of Foreign Shareholding Ratio	Change of Financial Industry Index
	7/21 (Thu)	28.00	-	23.35%	-	-
Bidding Announcement Date	7/22 (Fri)	27.65	-0.35	23.31%	-0.04	5.54
Prospectus meeting	7/24 (Sun)	-	-	-	-	-
	7/25 (Mon)	26.55	-1.1	21.33%	-1.98	17.45
	7/26 (Tue)	26.60	0.05	20.96%	-0.37	-11.75
	7/27 (Wed)	26.70	0.1	20.92%	-0.04	-0.09

Table 4
Family Holdings and Ranking of Financial Performance

	Family Bank	FY 2001 Ranking	FY 2002 Ranking	FY 2003 Ranking	FY 2004 Ranking
Chang Hwa Commercial Bank		19	20	18	22
First Commercial Bank		11	13	15	7
Hua Nan Commercial Bank		10	15	7	8
China Development Industrial Bank		1	2	16	18
ICBC		5	3	4	5
Hsinchu International Bank	v	23	23	17	15
Int'l Bank of Taipei	v	14	9	12	12
Tainan Business Bank	v	30	30	29	29
Taitung Commercial Bank	v	32	32	26	23
Taichung Business Bank	v	28	29	28	28
Chinatrust Commercial Bank	v	2	1	1	4
Farmers Bank of China		25	27	27	24
Chiao Tung Bank		3	5	8	9
Cathay United Bank	v	4	11	2	3
Grand Commercial Bank		27	16	—	—
Taipei Fubon Commercial Bank	v	9	6	10	10
The Chinese Bank	Conglomerate	24	22	24	27
Taiwan Business Bank		26	17	23	25
Bank of Kaohsiung		13	12	25	26
Cosmos Bank, Taiwan	v	18	14	14	16
Union Bank of Taiwan	v	20	25	13	13
Bank SinoPac		6	4	9	6
E.Sun Bank		7	8	5	2
Fuhwa Commercial Bank		21	21	20	19
Taishin International Bank	v	8	7	3	1
Fat Eastern International Bank	v	15	24	6	11
Ta Chong Bank	v	17	26	11	20
En tie Commercial Bank	v	22	19	21	14
Bowa Bank	Conglomerate	29	31	31	31
Jih Sun International Bank	v	16	18	22	21
Bank of Overseas Chinese		31	28	30	30

Taiwan Cooperative Bank	**12**	**10**	**19**	**17**

Table 5

Average Return of the First Three Banks In Millions of USD

Country	Asset	Net Profit	Shareholder Equity	ROA	ROE
Taiwan	62,537	107	2995	0.17%	3.57%
Singapore	80,919	470	8059	0.58%	5.83%
South Korea	123,721	247	5738	0.20%	4.30%
Hong Kong	37,647	372	3420	0.99%	10.88%

Data Source: The Asset 2004/11

Table 6

Market Shares of Top 9 Banks in Taiwan as of the end of June 2005

Financial Institution	Market Shares
Bank of Taiwan	9.80%
Taiwan Cooperative Bank	7.63%
Land Bank	6.91%
First Bank	6.09%
Hua Nan Bank	5.89%
Chinatrust Commercial Bank	5.39%
Chang Hwa Bank	4.95%
Taiwan Business Bank	4.04%
Cathay United Bank	4.09%

Note: Calculated by asset scale; Data Source: Central Bank of Taiwan

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