

BANKING

The members of the Committee commend the government for engaging in deregulation in a timely and concrete manner to improve the business environment for Taiwan's banking industry. The Financial Supervisory Commission (FSC), for example, deserves credit for its "Financial Import Substitution Policy" aimed at upgrading the competitiveness of Taiwan's financial market to an international level. The Committee also highly appreciates the FSC's newly created business models, the "Bond Agency Platform" and "Financial Derivative Information and Advisory Service," which are expected to create numerous opportunities for the banking industry. As responsible members of the financial community in Taiwan, we aim to contribute to the sustainable development of the banking industry and to help make Taiwan one of Asia's financial hubs.

In this year's paper, we have focused our attention on

four main issues, all of which we believe could be resolved in the coming year. In view of the FSC's desire to expand Taiwan's financial market and increase job opportunities, the first step in that effort should be to allow more products to be provided to different types of customers in Taiwan, so as to retain business opportunities within Taiwan and make Taiwan as competitive a financial market as Hong Kong and Singapore.

Suggestion 1: Further broaden opportunities for offshore product development and distribution.

In recent years, the relevant government agencies in Taiwan have taken positive steps with regard to broadening financial product offerings, in line with the theme of promoting the Taiwan market internationally. However, industry perceives that more could be done to help foster market growth by permitting an even greater variety of financial instruments so as to satisfy differentiated risk-return demands.

The Committee presents the following recommendations for liberalizing the scope of product offerings:

1.1 Lower the rating requirement for issuers selling OSP to retail investors. Since 2011, due to regulatory restrictions on the credit rating of the issuer, the number of issuers who can issue offshore structured products (OSPs) to retail investors in Taiwan has significantly decreased. The situation has almost brought the OSP market in Taiwan to a standstill. Although the FSC lowered the OSP issuer rating in 2014 to S&P A+ (or Fitch A+ and Moody's A1), the change did not markedly improve the market situation. Taiwan investors still need to pursue investment opportunities from offshore markets, especially from neighboring countries such as Hong Kong where the entry barrier for issuance is lower than in Taiwan. A crucial factor in making Taiwan a more attractive market for these investors will be the variety of products that can be offered through more active participation by the market players. To attract more market participants, the first step is to lower the issuer rating to at least A- as in Hong Kong.

Moreover, using the issuer rating as the only reference for the financial status of the issuer is not the current international practice. It is also noteworthy that the OSP issuers in Taiwan are the leading global banks, which are subject to stringent capital requirements and supervision in their home markets. When lowering the issuer rating, the regulator at the same time may implement rules based on other financial criteria that may truly reflect the financial status of the issuers. The committee believes this approach could best meet the goal of protecting investors' interests.

1.2 Include PRC-linked bonds in the bond-agency product scope. Despite the generally positive response from

the regulators to industry's longstanding appeal for a relaxation of restrictions on financial products, some operational obstacles continue to constrain the business.

To be in compliance with the Basel rules, the global banking industry has had to be very prudent in its risk-taking activities to ensure efficient capital usage and adequacy. Given this market trend, the preferred business model is to run bond trading under an intermediary/agency instead of acting as the principal. Although the FSC has permitted securities firms and banks to trade RMB-denominated bonds in the capacity of principal trading, trade in RMB-linked bonds in the agency booking model has not been allowed – contrary to market expectations. The restriction on the origination/issuing country also still applies with regard to trades of PRC government and corporate bonds by Professional Institutional Investors (PII).

The current restrictions on bond-agency trading create unnecessary obstacles for professional investors' portfolio management. As China has undoubtedly emerged as one of the world's most important economies, PRC-linked fixed income instruments and currency exposure have become essential parts of a well-diversified international portfolio, as can be seen from the composition of key international benchmark indexes.

Furthermore, "PRC-linked bonds" as defined in the existing regulations include bonds listed on the Hong Kong and Macao exchanges with the issuing enterprises directly or indirectly owned by PRC government or corporates. These securities are excluded from legitimate investment scope. The defined criteria increase the compliance and supervisory cost involved, given the difficulty of verifying the identity of the major shareholders for each issuer. To meet professional investors' needs and enable Taiwan to keep up with global financial-market development, the Committee suggests elimination of the current regulatory restrictions on bond agencies regarding tradeable markets and the country of origination of issuers.

1.3 Allow repo/reverse repo to be covered under offshore bond agency licenses. Since January 2014, the FSC has opened the offshore-bond agency business to banks that concurrently operate securities businesses. Several banks have received approval to conduct such business.

However, it was later understood from the FSC that repurchase and reverse repurchase (repo/reverse repo) transactions are not covered in the offshore-bond agency license. This interpretation has deprived PIIs of the ability to obtain short-term liquidity using repo/reverse repo of the offshore bonds that the banks sell to or buy from the PII. Repo/reverse repo is a common funding vehicle used by bond markets worldwide to enable banks to provide secured funding or lend bonds to the PII.

According to the FSC's previous comments, repo/reverse repo is categorized as securities proprietary trading business and should follow the "Rules Governing the Proprietary Trading of Foreign Bonds by Securities Firms" (the Rules) issued by the Taipei Exchange (TPEX). However, the transactional flows and booking processes of such proprietary trading business are different from those of transactions conducted under brokerage – the offshore bonds agency business. Moreover, according to the Rules, the underlying bonds are required to be registered with the TPEX, but in practice this is not feasible for offshore bonds under the offshore bond agency license.

Repo/reverse repo should be considered an integral part of the offshore-bond agency business. Without repo/reverse repo, banks are unable to provide complete services to a PII when it needs funds or bonds on a short-term basis. The relaxation of this business would help foster a thriving and robust bond market.

1.4 Expand investor eligibility to include SPIs for "offshore bond agency" and "derivatives information and advisory" businesses.

In order to achieve the objective of the Financial Import Substitution Policy to retain financial businesses within Taiwan, the FSC in 2014 relaxed regulations dealing with banks' provision of information and advisory services on offshore derivatives, and with the engagement by securities firms in the offshore-bond agency business. However, the eligible investors for both types of business are limited to banks, insurance companies, and securities firms, defined as PIIs.

In contrast, in 2015 the FSC amended the "Rules Governing Offshore Structured Products (OSP) and the "Regulation Governing Internal Operating Systems and Procedures for Banks Conducting Financial Derivatives Business" to add one more investor category – Senior Professional Investors (SPIs) – to cover corporates that meet four regulatory qualifications and apply to be an SPI. For entities deemed to be an SPI, most regulatory requirements are relaxed for engaging in derivatives transactions and OSPs. Essentially the SPI is treated the same as a PII in these cases.

By the same token, it would also be appropriate to include SPIs as eligible investors for the offshore-bond agency business and the derivatives information and advisory business. Large SPI corporates conduct business globally and actively look for investment opportunities in other countries such as India, Russia, Japan, etc. Due to the constraints of time-zone and language differences, they prefer to contact the main relationship manager in Taiwan, who can assist to communicate with the branches in other countries. This service helps local corporates to achieve better efficiency, while also increasing the

banks' competitiveness. Treating SPIs the same as PIIs would better serve the needs of large local corporates and enhance financial control.

In addition, under the current definition of SPI investors, one of the conditions is that the entity's net assets exceed NT\$20 billion. The Committee suggests allowing this requirement to be met by applying the assets of the corporate's parent company. Due to strategic considerations, many large local companies use their offshore subsidiaries as invoicing or manufacturing centers. Although the associated foreign-exchange risk is borne by the subsidiary, the risk is generally managed by the parent-level finance center on behalf of the subsidiaries. Broadening the definition of the entity's size to include the entire group would better capture the corporate client's business model and allow banks to provide suitable product services.

Suggestion 2: Allow banks to provide financing to customers by using their financial assets under trust from the lending bank as collateral

The Committee highly welcomes the regulatory change that now enables clients to use their mutual fund assets under trust as collateral to obtain financing from a third-party bank. However, treating the third-party bank instead of the trust bank as the financing counterparty creates operational hurdles for the various parties involved.

In international practice, investment product financing is a very common wealth-management service that banks in Hong Kong and Singapore have for years offered to high net-worth and mass-affluent client segments. We suggest that customers be able to pledge the entrusted beneficiary financial assets held with the trust bank as collateral for a loan, as credit by the same bank rather than a third party is far more operationally efficient.

The key benefits of this service include enhanced returns, diversification, and most importantly, liquidity. Currently the investment products are mostly offered through the trust platform, where restrictions have made them unavailable to be pledged for lending. If trust assets could be unleashed from that constraint, it would greatly benefit clients' financial flexibility and efficiency, while also benefiting the overall banking market.

In comparison, both insurance companies and securities firms are allowed to offer financing services to their direct clients through assets under the firm's control. Permitting banks to provide a comparable service would significantly facilitate development of the wealth-management business.

The Committee suggests revising existing regulations to enable the banking industry to provide credit to clients who pledge their entrusted financial assets as collateral with the same lending bank.

Suggestion 3: Further relax client qualification for foreign bank branches.

In 2014, the FSC agreed that the five foreign-bank Taiwanese subsidiaries could retain their foreign-bank Taiwanese branch licenses to conduct lending, foreign exchange, and derivatives businesses and to participate in the money market. However, the FSC also imposed a restriction that these retained branches can only serve domestic or foreign corporate clients whose single legal-entity annual turnover is above NT\$35 billion. Later, on October 1, 2015, the FSC issued circular no. 10400218620, relaxing the restriction by saying that the NT\$35 billion annual turnover requirement would not apply to a newly established company or a company that has not yet started operations, though they would have to meet the NT\$35 billion annual turnover level within two years of being granted a bank loan. If the entity is a holding company that has not yet started operations, the annual turnover of its wholly owned subsidiaries can be included in the NT\$35 billion requirement calculation.

In the interest of fair and consistent treatment, the Banking Committee recommends that ability to include the annual turnover of wholly owned subsidiaries also be extended to existing holding companies. That change would reflect current accounting principles requiring the parent company and its wholly owned subsidiaries to issue a consolidated financial report, which includes an annual turnover calculation covering both the parent company and wholly owned subsidiaries.

Further, for reasons of internal structure and business diversification, a holding company (or any parent company) will often set up different subsidiaries for different business sectors, and the parent company will draw up financial plans and use appropriate financial services or products, including bank loans, according to the different business needs. These clients should not be restricted to choose financial services based only on the overall business and financial planning needs of the group. The Committee therefore recommends that the FSC lower the annual turnover threshold from the NT\$35 billion level. We suggest that the customer qualification criteria be revised to permit branches of foreign banks that also have a subsidiary (as well as permitting the branch's OBU) to serve clients in the following circumstances:

1. If the borrower's annual sales are below NT\$35 billion, but a parent guarantee is in place and the parent's annual sales are above NT\$35 billion.
2. If the borrower's annual sales are below NT\$35 billion, but there is 100% cash collateral or a stand-by L/C from one of the top 1,000 banks in the world.

Suggestion 4: Allow banking staff to take charge of "bond agency" and "derivative information and advisory" functions concurrently.

The recently initiated "Bond Agency Platform" and

"Financial Derivative Information and Advisory Service" business models will significantly increase business opportunities in Taiwan. In order to attract transactions from Taiwanese institutional investors and ensure the competitiveness of Taiwan's financial industry versus regional financial centers such as Hong Kong and Singapore, we recommend that the FSC allow banking personnel more flexibility in concurrently taking charge of the bond agency and derivative advisory service businesses, sharing the use of offices.

The banking business should not be treated according to the regulatory scheme for the securities business. The operation of banking businesses is subject to the Banking Act, and the regulation governing banks' provision of financial derivative advisory and information services and the regulation governing banks' conducting financial derivative business are derived from Article 3, Item 22 of that Act. Recently, the FSC has been promoting its "Financial Import Substitution" proposal, which would allow banks to engage in the derivative business with the aim of expanding the banking industry's business scope. These business activities are not governed by the Securities and Exchange Act, which covers the securities underwriting, dealing, commission agency, and brokerage and agency businesses, and whose Article 15 prohibits staff from concurrently taking charge of both dealing and brokerage activities.

Conflicts of interests commonly arise in securities agencies, given that staff in the securities dealing section can take advantage of knowledge of what their clients are trading. For that reason, a segregation requirement is applied to securities houses. However, information and advisory services on financial derivatives is a service provided by a bank to meet the client's demands in accessing financial derivatives products. This practice is unrelated to securities dealing pursuant to the Securities and Exchange Act. As a result, there should be no restriction on the offshore banking industry concurrently using staff to conduct both derivative and bond product businesses.

Concurrently handling derivative and bond products would help staff to increase their expertise, as they would be required to meet certain qualifications and undergo training. They would also be able to provide better service to clients, who are onshore PIIs, as a result of the enhanced service efficiency. The procedures involved in providing these two types of services are identical.