INTERNATIONAL JOURNAL OF BUSINESS, 7(3), 2002 ISSN:1083-4346

Non-performing Loan Resolutions in China and Taiwan: A Policy Evaluation

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ABSTRACT

The soaring non-performing loans have been hampering the recovery of Asian countries from the 1997 crisis. Even after taking drastic policy actions in reducing bad debts, countries in Asia still find it difficult to resolve the problems and restore the safety and soundness to the banking systems. This essay looks into the severity of the non-performing loan problems in China and Taiwan and comments on the policy resolutions that have been undertaken. The essay singles out the nationalization of bad debt as the common cause that led to the bad-debt problems in these two economic markets and comments on why the establishment of asset management companies would not be able to resolve the problems.

JEL: *G28*

Keywords: *Non-performing loans resolutions; Nationalization of bad debts; Asset management companies; Financial reforms*

I. INTRODUCTION

The soaring non-performing loans have been hampering the recovery of Asian countries from the 1997 crisis. Even after taking drastic policy actions, countries in Asia still find it difficult to resolve the non-performing loan problems and restore safety and soundness back to the banking systems. This short essay looks into the severity of the non-performing loan problem in China and Taiwan and comments on policy resolutions that have been undertaken in resolving the problem.

II. BANKS' BAD DEBT PROBLEMS

A. The Chinese Banking Industry

The official estimate by the People's Bank of China has shown that about a quarter (25%) of total bank loans were not performing by the end of 1997 for the four largest state-owned commercial banks. For other specialized banks and local cooperatives, the non-performing loans (NPLs) could be much worse. The percentage of NPLs could be understated, because Chinese banks only record the portion of the loans that is overdue. If the total amount of loans is included, the percentage of NPL could be as high as 60 percent of total loans in China. Even with the official data, the percentage of NPLs had been steadily rising over the last few years, increasing from 20 percent in 1994, to 22 percent in 1995, and to 25 percent in 1997. Table 1 shows the NPLs for those joint-equity banks, which had better NPL records than the overall depository financial institutions. Even for these banks, the average NPLs ratio increased from 11.8 to 17.3 percent between 1997 and 1999.

Table 1
Non-performing loan ratios at year end of shareholding commercial banks

Bank	1997	1998	1999
China Merchants Bank	9.1	10.5	13.3
Bank of Communication	13.9	19.3	20.0
China Everbright Bank	7.7	13.7	39.0
CITIC Industrial Bank	11.2	15.0	13.2
China Minsheng Bank	2.0	6.0	8.7
Hua Xia Bank	4.3	5.7	6.64*
Shanghai Pudong Development Bank	6.7	8.9	9.1
Guangdong Development Bank	15.0	21.5	23.28*
Shenzhen Development Bank	15.4	20.4	24.6
Fujing Industrial Bank	12.3	14.0	14.20
Average	8.36	13.5	17.20

Note: * indicates percentage in June 1999.
Sources: PBC Quarterly Statistical Bulletin; Annual reports, various issues.

The NPL problems had impacted commercial banks. Profitability had been dropping significantly, from 13.7% in 1993 to 0.2 percent in 1997. Table 2 provides more details about the profitability for specialized banks over the years and for individual specialized banks in 1999 and 2000. If the practice of recording interest income on NPLs as income during the year is disallowed, the whole banking industry's returns might have been negative. For city and rural cooperatives, the profitability is even worse.

Table 2
Capital and profits of China's specialized banks

All Banks	Capital as % of total assets	Specialized Bank	ROA in 1999	ROE in 1999	ROA in 2000	ROE in 2000
1985	12.10%	Industrial and Commercial Bank of China	0.12%	2.2%	0.1%	2.7%
1986	11.80%	Bank of China	0.11	2.0	0.1	2.8
1987	9.70%	Agricultural Bank of China	-0.02	-0.3	0.0	0.2
1988	9.60%	China Construction Bank	0.25	4.6	0.3	6.6
1989	8.90%	Bank of Communication	0.35	6.9	0.3	6.6
1990	7.90%	China Everbright Bank	0.41	7.4	0.3	4.8
1991	7.50%	China Merchants Bank	0.59	8.2	0.5	10.7
1992	7.80%	CITIC Industrial Bank	0.84	16.0	0.4	10.8
1993	5.00%	China Mingshen Bank	0.85	17.4	0.6	8.1
1994	2.80%	Hua Xia Bank	0.59	8.1		
1995	2.70%	Shanghai Pudong Development Bank	0.99	16.8	0.7	12.9
1996	2.50%	Shenzhen Development Bank	1.31	17.8		
1997	2.40%	Guandong Development Bank	0.15	4.2	0.1	4.4
		Fujing Industrial Bank	0.63	8.7		

Data Sources: Capital as a % of total assets is taken from Lardy (1998).
Annual reports, various issues.

The NPL loans had also caused the deterioration of bank capital. On the one hand, the loan loss reserve ratio was dragged down to a very low percentage, less than 10% of the total NPLs in 1999. Even for the healthier 10 shareholding banks, the loan loss reserves/NPL ratios in 1999 for Bank of Communications was 9.0%, 6.5% for Everbright, 6.8% for Shenzhen Development Bank, 2.1% for Merchants Bank, and 1.0% for Fujing Industrial Bank. Only Minshen Bank and Shanghai Pudong Development Bank had a ratio greater than 10% (15.3% and 20.6%, respectively).

On the other hand, the capital to total assets ratio of Chinese banks has been decreasing, from 12.1% in 1988 to 2.4% in 1998. As shown in Table 3, even for the stronger specialized banks, none of them had a Tier 1 capital adequacy ratio above the 8% international standard. Many banks technically were bankrupted.

Table 3
Capital to total assets ratio at the end of 1999

Bank	Capital/Total Assets Ratio
Industrial and Commercial Bank of China	5.1%
Bank of China	5.6
Agricultural Bank of China	5.9
China Construction Bank	4.8
Bank of Communications	5.0
China Everbright Bank	5.5
CITIC Industrial Bank	5.1
Hua Xia Bank	5.2
China Minsheng Bank	4.9
China Merchant Bank	7.2
Shanghai Pudong Development Bank	7.5
Shenzhen Development Bank	6.3
Guandong Development Bank	3.5
Fujing Industrial Bank	7.2

B. The Taiwanese Banking Industry

In terms of absolute percentage of NPLs, Taiwanese banks fare a little better, with 6.20% of total loans overdue in 2000, as shown in Table 4. Follow the same trend as in China; this overdue loan percentage has been rising rapidly each year, from 0.8 percent in 1992 to 6.2% in 2000. Small cooperatives were the ones that had seen the fast deterioration of loan quality, with overdue loans increased by more than four times from 1995 (3.49%) to 2000 (15.68%).

The overdue loans led to declining profits and capital adequacy. The return of assets had been drifting down from 0.9% to 0.50% by 1999, while the return on equity was even worse. Capital positions for banks, on average, were below the 8 percentages level as required by the international standard.

Table 5 and 6 report the deterioration of profitability and capital adequacy of different classes of Taiwanese banks after 1997, especially for domestic and other financial institutions. The capital to total assets ratio was the highest at 6.82% in 1998, still below the eight percent international standard (not adjusted for risks). For other financial institutions, capital to total assets ratio was at 3.78%, inadequate for loss payments. Problems for other financial institutions also show up in the ROA and ROE figures. Table 6 shows that branches of foreign banks achieved much greater efficiency in terms of profitability. Domestic banks still had 6.05% of ROE in 2000, as compared to 3.89% for all banks. The low profitability for all banks was mainly due to the losses incurred by other financial institutions.

Table 4
Overdue loans of financial institutions in Taiwan (December figures)

	Overall	Domestic Banks	Foreign Banks	Other Financial Institutions
1992	0.80			
1993	1.10			
1994	1.80			
1995	3.00	2.88	0.82	3.49
1996	4.15	3.74	1.00	7.10
1997	4.18	3.74	1.07	8.53
1998	4.93	4.41	1.64	10.57
1999	5.67	4.96	3.20	13.70
2000	6.20	5.47	3.22	15.68
2001*	7.44	6.63	2.97	18.50

Source: Ministry of Finance, Taipei, Taiwan.
Note: 1992-94, the figures are the NPL as a percentage of total loans.
2001 figures are at the end of June.

Table 5
Profitability of Taiwanese banks

	All Banks		Domestic Banks		Branches of Foreign Banks	
	ROA	ROE	ROA	ROE	ROA	ROE
1994	0.71%	13.34%	0.84%	13.86%	0.88%	20.67%
1995	0.60	11.17	0.71	11.87	1.24	26.74
1996	0.62	10.85	0.73	11.36	1.24	25.69
1997	0.72	11.45	0.88	12.23	1.34	30.52
1998	0.58	8.56	0.71	9.29	1.07	21.97
1999	0.47	6.98	0.54	6.91	0.76	17.51
2000	0.19	3.89	0.47	6.05	1.09	30.19

Data Source: Financial Statistics Abstract, Bureau of Monetary Affairs, Ministry of Finance, R.O.C.

Table 6
Capital to total assets ratios of Taiwanese banks

	All Banks	Domestic Banks	Foreign Banks in Taiwan	Other Financial Institutions	ROA, All Banks	ROE, All Banks
1991	4.25%	4.34%	4.36%	4.09%		
1992	51.3	5.99	4.29	3.71		
1993	4.88	5.84	4.16	3.44		
1994	5.35	6.05	4.65	4.14	0.71%	13.34%
1995	5.38	6.00	4.65	4.27	0.60	11.17
1996	5.72	6.42	4.82	4.49	0.62	10.85
1997	6.33	6.99	4.37	5.23	0.72	11.45
1998	6.82	7.63	4.89	5.23	0.58	8.56
1999	6.73	7.82	4.33	4.30	0.47	6.98
2000	6.50	7.70	3.60	3.78	0.19	3.89

Data Source: Financial Statistics Abstract, Bureau of Monetary Affairs, Ministry of Finance, R.O.C.

III. CAUSES OF THE NPL PROBLEMS – NATIONALIZATION OF BAD DEBTS

It is very obvious that bad debt problems in both China and Taiwan were caused by the deficiency in the lending process, especially due to policy distortion or crony capitalism. Nationalization of bad debts is the ultimate cause among all of the reasons. Nationalization takes different forms in China and Taiwan. In China, it is due to the state ownership of commercial banks, while in Taiwan, it is the crony capitalism that forces the government to pay for banks' losses. Overall the sound and safe lending policies and procedures that are generally followed by western banks are all violated:

A. Inadequate Lending Policy, Procedures, and Monitoring

Under the state ownership of banks in China in the past, bank lending was basically strictly a part of the nation's economic planning. Loans were made directly by the state government to specific sectors and/or companies. No specific lending policy that was based on the economic principal was established. Bankers did not have to do any credit valuation of customers, nor did they have to exercise proper review and monitoring after a loan was extended. Under this system, a bank was not really a bank; it was simply part of the state's resource allocation in its economic planning.

For both state-owned and privately owned banks in Taiwan, western-style lending policies and procedures were followed, with specific criteria for loan evaluations and reviews. These policies and procedures were only followed when it came to evaluating un-related general public borrowers. The problem for private banks is that when it comes to evaluating closely related customers who are connected to the bankers financially, these sets of policies and procedures were ignored. In a lot of cases involved with fraud and mismanagement, insiders lending to bankers themselves was the norm.

Even worse, many banks, owned by financial conglomerates or family business groups, would create fictitious subsidiaries to rob resources from the banking firms. Insiders' lending often was a single most critical factor that led to bank failures in Taiwan. Under such circumstances, even a rigorous lending policy would have no function at all in controlling lending.

B. Ineffective Supervision and Government Forbearance: The Consequences of Nationalization of NPLs

In China, nationalization of bad debts is mainly the result of the state-ownership of enterprises. First of all, most of the long-term investment and short-term liquidity needs of state-owned enterprises were planned and funded by the central government. Commercial banks were instructed to provide a given amount of loans to each of the enterprises as long as they had the quotas. Further, the state government requires its state-owned enterprises to repatriate most of their profits to the central government in Beijing. From 1980 to 1993, enterprises had handed in about 80% of their earnings each year, including the amount of depreciation taken which is supposed to be for capital accumulation. The repatriation of corporate earnings leaves not much funding for state-owned enterprises for liquidity payments and/or for fixed asset investment. Coupled with the fact that a capital market is incomplete, this leaves bank loans to be the only source of external funding.

The consequence of the state-ownership of enterprises entangled the three sectors, the government, commercial banks, and state-owned enterprises, together. This system legitimizes the right for state-owned enterprises to obtain funding from commercial banks, as well as the right not to repay the bank loans by state-owned enterprises. Thus bad debts were mounting. By some western standards, bad debts in the banking section amounted to 70 percent of total assets, a percentage high enough to foster an internal financial crisis.

The state-ownership of enterprises also leads to capital forbearance on technically bankrupt enterprises. Since the debts incurred by the state-owned enterprises would have to be assumed by the government, state-owned enterprises tended to recourse the debt obligations back to the government, asking creditors to seek repayment from the government. The state or local government has very rarely declared insolvency of the SOEs and even commercial banks for social stability reasons.

In Taiwan, it's a matter of crony capitalism that banks' insiders and politically connected interest groups exercised their political power to obtain loans from banks. Most of the problem loans were involved with lending that violates the loan procedures established by the banks themselves and by the bank supervisory authority. The two most common practices include insiders' lending to subsidiaries or relatives/associates of the parent company controlling the bank and lending to politicians in exchange for political favors or financial benefits.

Problem loans typically started with shaky loans with inflated collaterals. The borrowed loans were then misappropriated for other uses, including speculating on the stock and real estate markets and sometimes used to rescue other subsidies that had been falling due to stock speculations. This speculation had caused many firms to go bankrupt and become unable to pay back to the banks.

Bankers, who were also corporate owners who had loaned to themselves, would then exercise their political power to wrangle with the government for either rescuing individual banks or providing subsidies to the banking industry, especially when the whole industry was in trouble or the economy had fallen into recession. Out of concern for the stability of the financial system, the government in many cases would yield to the demand of these bankers-business owners. The most recent reduction of the gross business receipts tax (GBTR) rate for banks by the Ministry of Finance in July 1999 is a typical rescue example of the above process. Again, the relief or rescue by the government leads to a de facto nationalization of bad debts.

C. Out-of-Date Banking Knowledge and Technology

In both China and Taiwan, the technology for credit evaluation is not fully developed. This is particularly so in China with no databases on borrowers' credit history and information. Taiwan does have some credit information, but it has not been used to the best extent.

The system for asset value appraisal is also inadequate. It has just started in China and has yet to be standardized in Taiwan. This leaves opportunities for bank fraud. Many bad loans in Taiwan start from inflated collaterals. In quite a few cases, the banking firms even collide with appraising firms for the inflated values on assets and properties so that more money can be shifted out.

Collecting credit information for a loan evaluation is not the only problem, periodic credit reviews after loans are extended are also irregular and problematic. Many banks didn't even check on how the borrowers used the funds extended properly and whether loan covenants were followed.

Even though all of these loan procedures can be administered manually, technology can be applied to help the lending process be more efficient and effective, and more importantly reduce the chances for fraud and mismanagement in lending. The technology, of course, is lacking in these two market areas.

IV. POLICIES FOR REDUCING NON-PERFORMANCE LOANS IN CHINA AND TAIWAN

Even a financial crisis is not imminent as a result of huge bad debts, it is still threatening the stability of the financial system and the economy. Both China and Taiwan have taken action to deal with the NPL problems. The two common actions taken include the establishment of Asset Management Companies (AMCs), to specifically deal with the bad debt problems, and capital injections to financial institutions with government subsidies.

A. Establishing Asset Management Companies to Deal with Bad Debt Problems

1. China's Government-Funded AMCs:

In October 1998, Primer Zhu Rongji decided to set up an asset management company for the China Construction Bank (called Cinda after it's formation in April 1999). The other big four banks all have followed suit with the establishment of their own asset management companies. These asset management companies are a separate entity from their parent banking firms, but are funded by the Minister of Finance.

With the authorization by the Ministry of Finance (MOF), non-performing loans made before 1996 are being transferred to the AMCs at their face value. Therefore, there are no write-offs on the part of the banks on the loans that are transferred to the AMCs. To finance the transfer of NPLs, the AMC would issue bonds back to the four state-owned banks with interests and principals guaranteed by the MOF.

Table 7
NPLs purchased by the four AMCs by the end of 1999

AMC	Bank	NPLs Purchased at Book Costs ($b RMB)
Cinda AMC	Construction Bank	350
Hua-Rong AMC	ICBC Bank	408
Great Wall AMC	Agriculture Bank	346
Orient AMC	Bank of China	296

The AMCs intend to manage and dispose of these loans through debt/equity swaps, debt collection, debt exchange, debt transfer and sale, debt restructuring, stock listing and the underwriting of bonds, direct investment, and bond issues. RMB 395 billion of them have already been disposed of with a debt/equity program for 596 SOEs.

The establishment of AMCs might help the big four banks in two ways. First, bad loans now are taken over and managed by the AMCs, which allow more banks opportunities to re-capitalize themselves. Second, profits for the big four banks would be boosted as the banks receive interest on the bonds issued by the AMCs. This interest revenue should help the banks absorb additional losses.

Indeed, the risk control efforts through AMCs have paid off. By the end of June 2002, the four AMCs had taken in about $1,300 billion RMBs worth of NPLs, reducing the ratio of NPLs to loans to within 20 percent for the four state-owned banks.

But establishing AMCs alone would not resolve the NPL problems. They were created to serve no purpose other than to release the liabilities of banks. After taking over more than RMB $1.3 trillion of NPLs, the total amount of problem loans of the big four banks still exceeds RMB $1 trillion. If the asset management company program does not address the quality issues of banks for future lending, another round of NPLs will be accumulating, and the same asset quality problems will be repeated in the future.

2. Taiwan's Privately Funded AMCs

Taiwan's AMCs could provide some additional functions in becoming a legitimate part of the financial system. AMCs are to be set up by private corporations with approval from the government. AMCs are to be funded by the private sector and managed by professionals. In addition to buying NPLs from financial institutions, they are allowed to manage other assets. Banks are allowed to set up their own AMCs to move their bad loans off the balance sheet as long as it does not affect their capital adequacy ratio. In the government's mind, the capital injected into AMCs by a bank could be used to buy its bad loans off.

The problem with AMCs being set up to resolve NPL problems is that these AMCs would only have total assets of NT$20 billion (U.S. $615.38 million), far from being enough to solve the problem of having NT$1.186 trillion in overdue loans in the financial system. AMCs can take over overdue loans once, but AMCs would not guarantee the long-term loan quality. A long-term solution is to follow the practices by the Resolution Trust Corporation in the U.S. in closing down insolvent banks and making shareholders pay. Any form of government subsidy should be avoided.

B. Capital Injections by the Governments

The bad debt problems at the end would still have to be resolved by the government in various forms of subsidies. Both China and Taiwan have resorted to either director capital injection or tax reduction as ways of solving the bad debt problems, which essentially amounts to subsidizing poorly managed banks. Unfortunately, this case of government subsidies happens again and again.

In 1998, the Ministry of Finance in China issued 270 billion dollars of special government bonds to the four state-owned banks and immediately injected all this money into these banks. The capital injection was intended to be used to resolve the non-performing loans and to increase their capital to asset ratios. In addition, the required reserves on deposit accounts were reduced to free additional liquidity for banks. These policy actions had increased these banks' capital from $208 billion to $478 billion, and the capital to asset ratio increased to about 8 percent.

In Taiwan, similar government actions took place. In February 1999, the Central Bank cut required reserve ratios to free up reserve liquidity that could be used for further lending. Later in July 1999, the Ministry of Finance also lowered the gross business receipts tax (GBTR) rate for banks from 5% to 2%. The extra bank profits derived from these two measures, estimated to be NT$35 billion per year, were required exclusively to be used to write off bad loans.

The Ministry of Finance also revised bank regulations to enable banks to speed up the process of writing off bad loans and to issue preferred stocks to improve their ability to bear losses.

Some analysts point out that this policy will widen the operation performance between banks with higher loan quality and banks with poor loan quality, simply because the latter will use the savings from tax cuts to supplement their substantial losses from their lending activities. Some even contest that the policy is nothing more than using taxpayers' money to subsidize poorly run financial institutions.

C. Additional Financial Reforms

1. Ban Mergers and Acquisitions and Bank Holding Companies

In addition to NPL problems, the over-crowded financial institutions lead to reduced efficiency and excess competition to hamper the Taiwanese banking system. The sheer size of Taiwanese banks is also too small to compete internationally. During the years of 2000 and 2001, the Ministry of Finance has been pushing for banks' mergers and acquisitions. The laws for M&As have been passed into legislation and a few cases of M&As have occurred. The M&A legislation gives the government a tool for resolving bankrupt or near-bankrupt financial institutions.

A new undergoing development is the authorization of the formation of bank holding companies by capital-adequate commercial banks. The question for all of these new developments in Taiwan is that, except for bringing in additional capital through M&As and/or establishing holding companies that help to make banks more capital-sound and more diversified, they don't correct the problems that led to the accumulation of NPLs and bank failures.

2. Foreign Ownership

A better approach for resolving the NPL problem might be to follow what a few Chinese banks have been doing by selling ownership to foreign banks to form a partnership. The foreign ownership could bring in rigorous lending policies and procedures that would be strictly enforced. By following the basic market economic principal and making managers responsible for the profits and losses of a banking firm, they can then resist the pressure from political distortion, including those from the government agencies and politically influential entities.

V. WHAT WOULD BE THE APPROPRIATE FINANCIAL REFORMS

The measures of capital injection and the establishment of asset management companies failed to correct the NPL problems in both China and Taiwan. They are aiming at resolving the current bad debt problems, rather than implementing a sound lending principal and practice, and an effective regulatory structure to ensure the quality of assets. More appropriate reforms would have to focus on:

A. Requiring Immediate Re-capitalization by Shareholders without Government Subsidies

Banks with inadequate capital amounts would have to be required to inject capital by the current shareholders to the level that is considered to be sound and safe without any government subsidies. For the state-owned banks in China, if the Chinese government would keep their current ownership structure intact, the Chinese government would be the one who would have to inject the needed capital. After the recapitalization, it would be better for the Chinese government to subcontract off these state-owned banks to outside professionals for management of loan decisions. The board of directors could set general guidance on loan policy, while professional managers would make the actual lending decisions. A final resolution is to privatize all those state-owned commercial banks.

For Taiwanese banks with insufficient capital, due to their private ownership nature, the banking supervisory authority should require a capital injection plan to bring capital up to standard. The capital plan could be implemented over a specific time period, say 3-5 years. Before the capital being adequate, certain lending and investment activities, as well as dividend distribution, should be restricted. In enforcing this capital re-capitalization, the banking authority should be delegated with total authority in requiring capital injection and all of those prompt corrective actions that are implemented on banks in the U.S.

B. A lending policy and procedure that is strictly based on commercial considerations.

The lending policy would have to be based strictly on returns and risk considerations and kept away from intoxication by crony capitalism or political influences. This implies that there will be no policy loans as dictated by the central government in China, even for those specialized banks that were created to provide funding to specific sectors. A mechanism protecting banks from local government influence would also have to be in place. In Taiwan, this implies that law enforcement would be required to prevent any influence of interest groups or politicians.

C. Enforcing Loan Loss Reserves as Required by Banking Laws

In both China and Taiwan, policy on loan loss reserves has been implemented. These policies, however, are not really enforced, especially for China. To ensure the soundness and safety in the banking industry in the future, a much stronger enforcement of loan loss reserve requirements would be needed.

D. Introducing the Concept and Techniques of Risk Management into Bank Management and Bank Supervision

Asian banks have been far behind as compared to more advanced markets in bank risk management. The concepts like assets/liabilities management, credit risk management, market risk management, Value at Risk, and Credit Metric, may not have not been heard of by Chinese bankers and by government officers.

Risk management, however, has revolved into becoming an effective and critical tool for banks to gauge the level of either interest rate risk, credit (default) risk, market risk, or others. With these tools available, risk management can be done on a daily basis. Supervisory authority could also require commercial banks to integrate measures of various risks into risk-based capital requirements and/or deposit insurance premiums.

E. Implementing Risk-Based Capital Requirements and/or Deposit Insurance Premiums

For risk control and for ensuring adequate capital for any level of risk-taking, risk-based regulations would have to be implemented. Taiwan has implemented a mechanism for risk-based deposit insurance premiums. However, the problem is that the difference in premiums for well managed and poorly managed banks is miniscule and is not enough to control risk taking by banks. China has a long way to go, first with a mass educational introduction of risk concepts and techniques for risk management. With these two risk-based regulations, owners of banks would have to either ensure safe and sound bank management or be ready to pay for excess risk taking. This would be a better mechanism as compared to other administrative actions taken by regulators for either preventing or resolving risk taking activities by banks.

VI. CONCLUSION

In summary, comparing the banking systems from these two sides of the Taiwan Straight, Taiwan has a better regulatory structure ensuring a safe and sound banking system. Its problems arise from an ineffective enforcement of the laws and policies, which tend to be tempered by political interest groups. To prevent any tempering by interest groups, any reforms should be geared toward establishing a safety net that could provide a bulletproof safety net that could keep away intervention by politicians and interest groups.

China requires a total structural and regulatory reform, from ownership structure, lending polices, loan loss reserves, capital adequacy, risk management, to banking regulations. Product innovations are also far behind other developed financial systems. The most urgent reform needed would be for the government to set a hands-off policy, not only to stop requiring policy lending from banks, but also to stop the recourse of SOE liabilities back to commercial banks. In one word, the fiscalization of corporate debts and bank non-performing loans by the central government would have to stop. Effectively establishing each bank as a profit center will be a key in reaching the above two urgent resolutions needed.

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