Disposition of Failed Financial Institutions Under Commission by the Financial Restructuring Fund

1.Background of Establishment and Operations of Financial Restructuring Fund

Since the 1990's, Taiwan had been suffering from the burst of the economic bubbles with the real estate market mired in recession. The situations were exacerbated by the Asian financial crisis of 1997 and the September 21 earthquake in 1999. Many businesses started to experience financial crises. As a result, business operations of Taiwan's financial institutions were fast deteriorating with bad loans continuing to soar. During this period of time, the *British Economist* and the US *Business Week* started to anticipate a financial turmoil in Taiwan sometime before the Chinese Lunar New Year in 2001. Moreover, Standard & Poor's downgraded Taiwan's sovereignty rating. The market was awash with negative news and impacted the financial industry to detrimental effect. Rumors were rampant that systemic financial risk would be triggered. To facilitate the withdrawals of ailing financial institutions from the market smoothly and as soon as possible, and to preempt the occurrence of financial turmoil, the government had borrowed experiences from the US, Japan and Korea that utilized public funds to quickly resolve financial crises of the business sector and safeguard depositors' benefits. *The Statute for the Establishment and Management of the Executive Yuan's Financial Restructuring Fund* (hereinafter simply referred to as the *Financial Restructuring Fund Statute*) was promulgated and the Financial Restructuring Fund was set up and operative for a period of three years. However, it was extended for one further year after the approval of the Parliament. In 2004 the Parliament furthered its validity by one year to July 10, 2005. Within this period of time, the Financial Restructuring Fund shall provide a transitional blank guarantee to all depositors and other creditors of the problem financial institutions to avert chain risk of financial crises.

Originally, the Financial Restructuring Fund amounted to NT$140 billion. In June 2005 the Parliament increased its resources of funds by NT$110 billion. Therefore, the total resources of the Financial Restructuring Fund are now about NT$250 billion. The Financial Restructuring Fund Management Committee (hereinafter simply referred to as the Management Commission) is responsible for deliberating the uses and operations of the Fund, approving the Fund's receipts and expenditures custodianship plans, reviewing the Fund's financial reports and cash flow arrangements, and the appraisal of other issues related to the Fund. The Management Committee consists of 9 to 13 members, including one chairman and one vice-chairmen, who serves concurrently as the head and deputy head of the competent authority (it was Ministry of Finance from July 2001 to June 2004, and has been changed to Financial Supervisory Commission since July 2004), respectively. In addition, four committee members are the concurrently serving deputy governor of the Central Bank , deputy chairman of Council of Agriculture, deputy director of Directorate General of Budget, Accounting and Statistics, and chairman of CDIC; the appointment of these members is based on their official posts. The other committee members shall be chosen according to their professional expertise or experience in law, economics, finance, and other relevant fields. The number of committee members belong to any single political party may not exceed half of the total membership, in order to assure the independence of the Management Committee's decision-making process. Therefore, the Management Committee is very well fairly represented. The Financial Restructuring Fund is not a legal person and without official organization or staff. Its Chairman is served by the head of the financial competent authority. As far as policy making is concerned, the structure of the Financial Restructuring Fund has the benefit of combining the monitoring function of the Management Committee and the supervision function of the competent authority. The Financial Restructuring Fund has been operative since July 16, 2001 after the establishment of the Management Committee. The execution of the Management Committee's resolutions has been carried out by CDIC pursuant to the *Financial Restructuring Fund Statute* in consideration of handling costs and availability of expertise.

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2. Handling Failed Financial Institutions

(1) Handling failed financial institutions by assuming

A. Year 2001

In view of the limited legal resources of the Financial Restructuring Fund, and to maximize the resolution number of problem financial institutions and hence safeguard as many depositors as possible, the Committee had chosen total 36 community financial institutions with negative adjusted net worth based on the assessment reports on the financial examination conducted in end July 2001 as the objectives of handling in order to swiftly and effectively resolve the financial quagmire. In August of the same year, Ministry of Finance entrusted CDIC with 118 staff with the support of another 78 staff from 4 state-owned banks to station on site and assist the aforesaid 36 community financial institutions. In the meantime, ten banks after being inquired of their intention agreed to assume these problem institutions and complete the legal assignment procedure in September of the same year.

Despite that the handling of the 36 failed community financial institutions had been resisted by some of their responsible persons, staff and members, it was completed smoothly with careful planning and resolution of the competent authority and CDIC. A withdrawal mechanism whereby problem financial institutions can exit from the market has been successfully established. In addition, it has been the forerunner of Taiwan's financial reforms, which evidently demonstrated the government's resolve in implementing financial reforms.

B. Year 2002

In the beginning of 2002, the financial status of a handful of community financial institutions was still deteriorating. The adjusted net worth of the credit departments of seven farmers' associations was negative as indicated in the assessment reports of their financial examination. These institutions were reported to the Management Committee and resolutions were passed to include them in the second stage of handling. Ministry of Finance entrusted CDIC in July of the same year to station on site and perform the rights of their credit departments. When it was verified by the accounting firm hired by the Management Committee that the adjusted net worth of the credit departments of these seven farmers' associations, Taiwan Cooperative Bank and Land Bank of Taiwan took over the credit departments of these seven associations after completing the legal assignment procedure in July 2002.

With the experiences of handling the 36 problem community financial institutions, the resolution of the seven problem community financial institutions had been smooth and successful in the whole operation and timing. Within less than one month, the said financial institutions had withdrawn from the market.

(2) Deal with Fifth Credit Cooperative Association of Tainan City by public price competition and negotiation

The non-performing loan ratio of Fifth Credit Cooperative Association of Tainan City continued to climb as a result of miscalculated management strategy and hence deteriorating loan quality. In 2002 its adjusted net worth was negative as indicated in the assessment report of the general financial examination. The Management Committee included the institution as the objective for handling. It followed that Ministry of Finance entrusted CDIC to station on site for conservatorship. In accordance with the resolution of the Management Committee, CDIC conducted the public price competition and negotiation of the said association in June and July 2002. Institutions that participated in the competition included Sunny Bank and Cosmos Bank. After the second price competition and negotiation, Sunny Bank won the right of merger and acquisition. It assumed all businesses, assets and liabilities of the said association in August 2002 and continued to operate. This was the first case of dealing with problem institutions via the competition mechanism of price competition and negotiation, which provided the incentive of free relocation of a given percentage of places of business to the assuming institution. It served a good reference for CDIC when formulating strategy of disposition later on.

(3) Deal with Kaohsiung Business Bank by auctioning off

The non-performing loan ratio of Kaohsiung Business Bank grew year by year as battered by the declining economy, faction strife and wrong management strategy. Eventually, the adjusted net worth became negative. In January 2002 Ministry of Finance entrusted CDIC to take over the bank. After the passing of resolution by the Management Committee to include the bank as objective of handling, CDIC conducted the auction of the bank in March 2002. However, the auction was aborted because no potential investor was interested due to the requirement of bidding the whole bank. A financial adviser was brought in by CDIC afterwards. The bid was divided into non-performing loans and businesses, assets and liabilities excluding non-performing loans. With the approval of the Management Committee, the non-performing loans of the bank were successfully auctioned off in June 2003. The first auction of the businesses, assets and liabilities was held in December 2003. However, during the process the labor union resisted and decided to go on strike indefinitely. The strike was called off after CDIC's mediation and communication with the union and the staff. Nevertheless, some investors had lost their interest in participating in the bid as a result of the incident. The valuation of the investors had also turned conservative. Eventually, the bid was not awarded as bidders' quotes had exceeded the maximum price set by the Management Committee. After the incident, CDIC had tried to negotiate with the staff to fulfill their requirements of compensation packages giving consideration to maintain the bank's capability of basic operations. Eventually, the second auction was held in May 2004 drawing acute competition among eight financial institutions.The bid was awarded to E.Sun Commercial Bank with the prescribed repayment amount of NT$13.37 billion by the Financial Restructuring Fund, or equivalent to net saving of NT$3.7 billion as compared to the negative net worth of NT$17.07 billion ending at the end of February 2004, or the valuation standard date. E.Sun Bank officially took over the businesses, assets and liabilities of the bank on September 4, 2004 and continued to operate.

Kaohsiung Business Bank was the first successful case that the Financial Restructuring Fund handled the problem financial institutions by dividing the business items. The strategy of auction is justified as it meets different requirements of professional investors of the market and has the advantage of enhancing competition and hence reduces handling costs. The non-performing loan of bad quality (the so-called Bad Bank) was first auctioned off followed by the selling off of the Good Bank, namely the remaining normal assets, liabilities and businesses. The reasons why the auction result of the Good Bank ended with the amount smaller than the net worth on book value (being negative) include the administrative incentive of free relocation of places of business, the competitive mechanism of open auction, transparency and the transaction mode that met market requirements. As a result, the auction had successfully attracted many investment institutions and hence retrenched the repayment by the Financial Restructuring Fund.

(4) Deal with Fongshan Credit Cooperative Association of Kaohsiung County by auctioning off

The Management Committee passed the resolution to include the Fongshan Credit Cooperative Association of Kaohsiung County as the objective of handling when its adjusted net worth became negative. Ministry of Finance entrusted CDIC to station on site for conservatorship in April 2004. In July 2004 CDIC followed the resolution passed by the Management Committee and conducted the auction of the whole businesses and assets and liabilities of the said association in July 2004. Chinatrust Commercial Bank won the bid after acute competition of seven bidders with the prescribed repayment amount of NT$1.1 billion by the Financial Restructuring Fund, or equivalent to net saving of NT$0.77 billion as compared to the negative net worth of NT$1.87 billion ending at the end of May 2004, or the valuation standard date. Chinatrust Commercial Bank has assumed the whole businesses and assets and liabilities of the institution since October 1, 2004 and continued to operate.

The reasons why the auction result of this case ended with the amount smaller than the net worth on book value (being negative) include mainly the administrative incentive of free relocation of places of business, the competition and transparency of the open auction mechanism. The competition of bids had fully reflected the value of the intangible assets and hence retrenched the repayment by the Financial Restructuring Fund.

(5) Deal with the Chung Hsing Bank by auctioning off

During the period of supervision, Chung Hsing Bank was required to supplement significant amounts of valuation reserves after the assessment by the accounting firm resulting partly from the undue credit granting policy of the original management. Chung Hsing Bank's accumulated losses continued to magnify and capital was in serious shortfall. Although the bank came up with a self salvation plan of capital decrease/increase in June 2001, it failed to meet the deadline of capital increase, namely October of the same year. The plan did not materialize. The Management Committee included Chung Hsing Bank as the objective of handling and CDIC was entrusted by Ministry of Finance in October 2001 and supervision was changed to conservatorship.

To handle the bank smoothly and establish a transparent mechanism of the disposition of failed financial institution, CDIC proposed the method of open auction and was accepted by the Management Committee. Total three times of public price competition and negotiation were held in February, May and July 2002. All three were aborted as a result of either no bidder or bidders' quotes being higher than the maximum price set by the Management Committee. In October 2002 Ministry of Finance re-entrusted Land Bank of Taiwan as the conservator.

Afterwards the Management Committee passed the resolution that CDIC was allowed to follow the mode of Kaohsiung Business Bank and hire a financial adviser for planning the auction. Ministry of Finance changed the entrustment to CDIC again charging with handling the auction of the bank's non-performing loans, assets and liabilities and businesses. As for business operations, it was entrusted by CDIC to Land Bank of Taiwan.

The auction strategy proposed by the financial adviser was reported to the Management Committee, which passed the resolution to adopt auctioning off of divided businesses. The non-performing loans were auctioned off in two batches in December 2003 and March 2004 after public auction. As for the assets and liabilities and businesses outside the non-performing loans, it was decided to resolve in two stages considering the expansion of the Financial Restructuring Fund had not passed the Parliament. That is, the deposits by the financial industry of NT$64 billion was not included in the auction for the time being, while the assets and liabilities and businesses outside deposits of financial industry were auctioned off to Union Bank of Taiwan in December 2004 at the price of NT$7.11 billion with the transaction completed in March 2005. The proceeds from the auction had repaid part of the deposits of the financial industry. The remaining balance of the deposits of the financial industry, about NT$57 billion, will be repaid after when the fund resources of the Financial Restructuring Fund are in place.

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3. Legal Prosecution

The government established the Financial Restructuring Fund to dispose of problem financial institutions, hold personnel whose illegal actions create losses at a financial institution accountable for their civil and criminal responsibility, and thereby safeguard the rights and interests of the Fund and uphold justice. CDIC therefore actively pursues civil and criminal action against illegal acts by the responsible parties and employees of financial institutions in accordance with the *Financial Restructuring Fund Statute* and resolutions of the Fund Management Committee. As up to end of August 2005, CDIC had submitted 179 cases of malfeasance to prosecution agencies for handling, and recovery of losses has already been sought in about 96 civil cases.

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4. Enforcement Results

Since the establishment of the Financial Restructuring Fund in July 2001, total 44 community financial institutions have been restructured in 2001 and 2002, marking the precedents of peaceful withdrawal of Taiwan's problem financial institutions from the market. In 2003 and 2004 non-performing loans of Kaohsiung Business Bank and Chung Hsing Bank were auctioned off first. In the second half of 2004 the two problem banks and one problem credit association were successfully auctioned off, setting the record of forcing the withdrawal of problem financial institutions by auction in Taiwan. These achievements have revamped Taiwan's financial system and environment, boosted Taiwan's financial competitiveness and promoted steady economic growth.