mortgage crisis. According to statistics from the Financial Supervisory Commission, at the end of 2007, 21 domestic banks reported an aggregate balance of NT$72.6 billion in outstanding investments associated with subprime mortgage-related products and structured investment vehicles (SIVs). The preliminary estimation of losses stood at NT$19.1 billion, part of which have been recognized and thus eroded profitability for the year. The estimated losses further rose to NT$25.9 billion by the end of February 2008. With a widened spillover effect from the US subprime mortgage crisis, whether such losses to domestic banks will be aggravated further and impact profitability should be closely monitored.

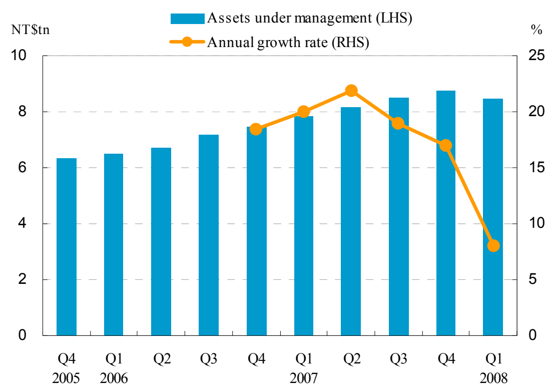
Box 1
Risks to banks engaging in wealth management business

Rapidly rising national income and a high savings rate are fueling continued accumulation of wealth in Taiwan and spurring increased demand for wealth management services. In addition, the credit card and cash card debt crisis of the past two years, which had a major impact on bank profitability, prompted many banks to expand their wealth management business in a bid to establish alternative stable sources of revenues. As a result, Taiwan's wealth management market is growing quickly, but fierce market competition has given rise to a spate of frauds and customer disputes. Banks thus face sharply increased risks.

1. Rapid growth in assets under management

The wealth management business in Taiwan's banking industry has been growing rapidly in recent years. The 36 banks that have received approval to offer wealth management services[1] had NT$8.75 trillion in assets under management at the end of 2007, equal to 70% of 2007 GDP. The annualized growth rate of assets under management peaked at 21.85% in June 2007 before falling back to 16.97% by the end of the year as turbulence in international financial markets decreased the investment willingness of investors. By 31 March 2008, assets under management had further fallen to NT$8.45

Chart B1.1 Assets under management at wealth management services



Source: FSC.

trillion, down 3.37% from the end of 2007 (Chart B1.1).

2. Risks related to the wealth management business

Banks earn service fees in the wealth management business by providing consulting and brokering services and do not take the credit and market risks associated with the investments. Hence, wealth management business has often been mistakenly thought to be low risk. In actuality, banks do face operational, legal, and reputational risks and the losses stemming there from are not easily quantified. If not properly managed, fraud and customer disputes could occur frequently, and potential losses could be enormous. For example, the use of predatory selling practices by wealth managers in the United States against high-net-worth individuals has caused a continuing string of lawsuits. There have already been two cases in which state governments have stepped in to work out settlements of class action suits that resulted in payouts of over a billion dollars by financial institutions.[2]

To develop wealth management services, banks in Taiwan have recruited large numbers of wealth managers. However, they have not all been well trained, and the turnover rate among them has been fairly high. Moreover, most banks have adopted remuneration programs heavily oriented toward performance, while failing to strengthen internal controls. The result has been a string of fraud and customer disputes. Since 2005, for example, there have been numerous instances of wealth managers embezzling customer funds or using customer accounts to make investments without authorization. Some of the cases have involved tens of millions of NT dollars. Also, many customer disputes have involved wealth managers improperly recommending investments in high-risk structured derivatives. The Consumers' Foundation received 51 complaints from 2005 to mid-2007 related to mutual funds, insurance, foreign exchange deposits, and trading in foreign stocks. Among cases arising in 2006, there were seven complaints in which wealth managers allegedly misled customers. After the US subprime mortgage crisis erupted, many holders of structured notes[3] suffered big losses after the underlying assets fell far enough in value to invalidate principal protection guarantees. A rash of disputes followed in which customers charged that wealth managers had failed to clearly inform them of the risks associated with their investments.

The Banking Bureau of the Financial Supervisory Commission (FSC) reports that most of the complaints it receives fall into one of four basic categories, all of which generally relate to inadequate internal controls at banks: (1) the wealth manager did not fully understand the product; (2) the wealth manager intentionally downplayed risks; (3) the wealth manager did not recommend a suitable product to the customer; or (4) the wealth manager embezzled customer's funds.

3. Banks need to strengthen risk management and regulatory compliance

To strengthen risk management in the wealth management business, the FSC issued the Directions for Banks Engaging in Wealth Management Business in February 2005, which require banks to establish and implement appropriate internal control and risk management systems. The Bankers Association in September of that same year adopted the Operational Rules for Banks Engaging in Wealth Management Business to ensure that wealth managers possess certain minimum qualifications. Despite these measures, however, customer disputes have continued to occur, so there is clearly still room for improvement.

To further safeguard customer interests and comply with regulations issued by the competent authorities, the Bankers Association issued the Self-regulatory Rules for the Conduct of Wealth Management Business and Sale of Financial Products by Banks, which call on banks to strengthen internal controls in order to prevent improper selling, avoid moral hazard, and improve disclosure in publicity and advertising. More recently, in light of the fact that structured derivatives investments account for many disputes that have occurred in recent years in the wealth management business, the Banking Bureau of the FSC recommended that the Bankers Association draft control measures based on the self-regulatory rules on the sale of structured products issued by the US National Association of Securities Dealer. In response, the Bankers Association amended the aforementioned Self-regulatory Rules in April 2008 by adding a Chapter 5, "Strengthened control over the sale of structured products," aimed at improving internal control over the processes employed in selling structured notes. Measures set out therein include evaluation of the reasonableness of products prior to their launch, review of customer suitability, control of marketing processes, and qualifications and training of employees. In the future, banks will have to implement all applicable laws, regulations, and self-regulatory rules, and do a thorough job of improving risk management in order to safeguard customer interests and reduce the risks associated with wealth management services.

Additionally, the Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities[4] issued by the US government in January 2007 is a good reference for Taiwan's banks as well. The document calls upon banks to properly implement the following risk management processes in order to reduce legal and reputational of risks:

- Establishing and implementing processes to identify elevated risk complex structured finance transactions (CSFTs);
- Adopting and implementing policies and processes for review, approval, and documentation of elevated risk CSFTs so as to ensure that the legal and reputational risks arising from elevated risk CSFT activities have been thoroughly reviewed by bank personnel at the proper level of authority;
- Establishing a "tone at the top" through both actions and formalized policies that sends a strong message throughout the financial institution about the importance of compliance with the law and overall good business ethics; and
- Other measures, such as: establishment of a risk monitoring and reporting system; periodic independent reviews to verify that policies and controls are being implemented effectively; strengthened internal audits of CSFT activities; and better training of personnel involved in marketing and monitoring of CSFT activities.

Notes: 1. Of the 36 banks, 30 are domestic and 6 are the local branches of foreign banks.
2. Economic Daily News, 20 June 2007.
3. Statistics released by the Trust Association of R.O.C. indicate that domestic investors in 2007 used non-discretionary money trusts to invest a total of NT$908.9 billion in foreign structured notes and NT$900 million in structured products offered by domestic securities firms.
4. "Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities," the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Securities and Exchange Commission, January 2007.

Asset quality continued to improve

At the end of 2007, the outstanding non-performing assets[27] of domestic banks as a whole stood at NT$656.6 billion and the average non-performing asset ratio was 2.32%, down year on year by 15.54% and 0.75 percentage points, respectively. Potential losses on non-performing assets were estimated at NT$112.7 billion, also off from the previous year by 4.21%. The overall asset quality of domestic banks continued to improve. Expected losses of non-performing assets were equal to 44.71% of loan loss provisions and other reserves,

[27] The Regulations Governing the Procedures for Banking Institutions to Evaluate Assets and Deal with Non-performing/Non-accrual Loans break down credit assets into five different categories, as follows: Category One – normal credit assets; Category Two – credit assets requiring special mention; Category Three – substandard credit assets; Category Four – doubtful credit assets; Category Five – loss assets. Other assets break down to four different categories, as follows: Category one for normal assets, while Category Two, Category Four, and Category Five are for special mentioned, doubtful and loss assets, respectively. The term "non-performing assets" includes all classified assets other than those in Category One.