

7. Banking Sector

The government has launched extensive financial reforms to modernize the financial system. The Financial Institution Merger Law, which took effect in November 2000, was enacted to encourage mergers between financial institutions, lays a legal framework for asset management companies, and speeds up the disposal of non-performing loans of financial institutions. Consequently, two local asset management companies were set up during the year 2001. The *Statute for Establishment and Management of Financial Restructuring Fund* was promulgated in July 2001. The Fund, totaling NT\$140 billion, aims to make up for the losses of problem financial institutions before turning their ownership and management over to designated banks. As a consequence, 36 community financial institutions were restructured by the Fund. The *Financial Holding Company Law* also took effect in 2001. The *Law* offers tax incentives to encourage financial institutions to set up financial holding companies in order to achieve synergy and provide the public with better services. Upon the enactment of the *Law*, four financial holding companies were set up by the end of 2001.

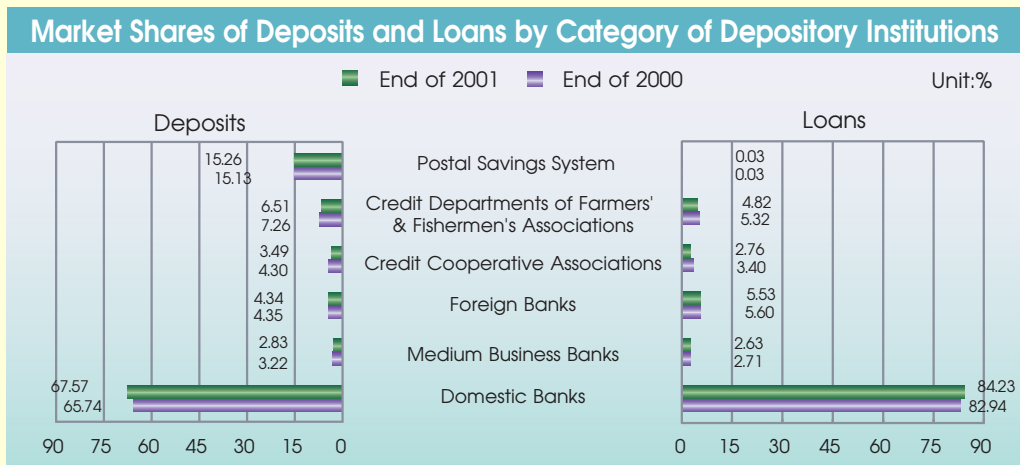
There were 416 depository institutions (including deposit money banks and the Postal Savings System) in Taiwan at the end of 2001, a decrease of 39 institutions compared with the previous year-end. Of the 39 institutions, 36 community financial institutions, including 7 credit cooperative associations and 29 credit departments of farmers' and fishermen's associations, were taken over by 10 domestic banks in September of the year. In addition, 2 credit cooperative associations were merged with 2 domestic banks. The number of foreign banks

Number of Depository Institutions by Category

	Annual Change	End of 2001	End of 2000
Combined Number of Main Offices	-39	416	455
Domestic Banks	0	48	48
Medium Business Banks	0	5	5
Foreign Banks	-1	38	39
Credit Cooperative Associations	-9	39	48
Credit Departments of Farmers' and Fishermen's Associations	-29	285	314
Postal Savings System	0	1	1
Combined Number of Branches			
Local Branches	206	5,690	5,484
Overseas Branches	2	76	74
Offshore Banking Units	0	68	68

Sources: 1. *Financial Statistics Monthly, Taiwan District, the Republic of China, Central Bank of China.*

2. *Bank Examination Department, Central Bank of China.*



decreased by one because a merger of two foreign banks reduced one branch in Taiwan, one closed its branch in Taiwan, and one set up a new branch in Taiwan during the year.

With respect to the market shares of deposits and loans by category of depository institutions at the end of 2001, domestic banks accounted for 67.57 percent of deposits and 84.23 percent of loans. Both were higher than the respective shares of 65.74 percent and 82.94 percent in the previous year, mainly resulting from the 36 problem community financial institutions being merged into banks. As for the local branches of foreign banks, on account of their conservative lending policies, their market share of loans fell at the end of the year. The share of deposits also decreased due to the marked drop in foreign currency deposits. As for the Postal Savings System, even though its market share of deposits increased slightly to 15.26 percent, its share of loans remained at only 0.03 percent, as in the previous year. The substantial difference between the shares of deposits and loans reflected the fact that the Postal Savings System, even though serving as a deposit-taking institution, is prohibited by the government from making loans directly to the general public.

With respect to sources of funds in depository institutions, due to the shrinking interest rate spread between demand and time deposits during the year and a sharp increase in local stock transactions in the last two months of the year, the ratio of demand deposits to total deposits increased significantly, at the expense of that of time deposits.

With regard to the uses of funds in depository institutions, bank lending, after adjusting for the valuation changes of the NT dollar exchange rate in foreign currency loans, exhibited a decline in its annual growth rate in 2001. The main reasons were weak fund demand from enterprises and the conservative attitudes of banks toward lending mainly because of high

non-performing loan ratios. Nevertheless, portfolio investments registered positive growth.

The non-performing loan ratio of depository institutions (including investment and trust companies) rose from 6.20 percent at the end of 2000 to 8.35 percent in September 2001. The ratio fell to 8.16 percent at the end of the year due to banks actively writing off bad loans with funds from their own annual earnings and the compensation received from the Financial Restructuring Fund. The combined pre-tax profit of depository institutions went up due to the revaluation gains from equities investments of the Postal Savings System. The risk-weighted capital adequacy ratio of domestic banks declined to 10.52 percent at the end of 2001 from 10.75 percent a year earlier. This decline was attributable to banks' increased provisions for bad loans and the reduction of their net worth by persistent buyback of their own shares.

Sources and Uses of Funds in Depository Institutions

Unit: NT\$ Billion

	Annual Change		End of 2001		End of 2000	
	Amount	Share (%)	Amount	Share (%)	Amount	Share (%)
Sources:						
Demand Deposits	535.9	1.86	4,500.2	21.95	3,964.3	20.09
Time Deposits	221.4	-1.67	14,698.7	71.70	14,477.3	73.37
NT Dollar Deposits	351.0	-0.80	13,579.8	66.24	13,228.8	67.04
Foreign Currency Deposits *	-129.6	-0.87	1,118.9	5.46	1,248.5	6.33
Government Deposits	50.7	0.10	848.2	4.14	797.5	4.04
Borrowings from CBC	2.8	-0.04	285.1	1.39	282.3	1.43
Other Items (Net)	-43.1	-0.25	168.3	0.82	211.4	1.07
Total	767.7		20,500.5	100.00	19,732.8	100.00
Uses:						
Net Foreign Assets *	236.0	1.00	1,032.1	5.03	796.1	4.03
Loans	-456.7	-4.98	4,042.7	68.50	14,499.4	73.48
NT Dollar Loans	-265.3	-3.94	13,649.8	66.58	13,915.1	70.52
Foreign Currency Loans *	-191.4	-1.04	392.9	1.92	584.3	2.96
Portfolio Investments	279.2	1.01	2,100.1	10.24	1,820.9	9.23
Purchases of CDs Issued by CBC	371.3	1.71	907.9	4.43	536.6	2.72
Deposits with CBC	337.9	1.26	2,417.7	11.80	2,079.8	10.54

Note: * excluding valuation changes in the exchange rate of the NT dollar against foreign currencies when calculating their annual changes.

Source: *Financial Statistics Monthly, Taiwan District, the Republic of China, Central Bank of China.*

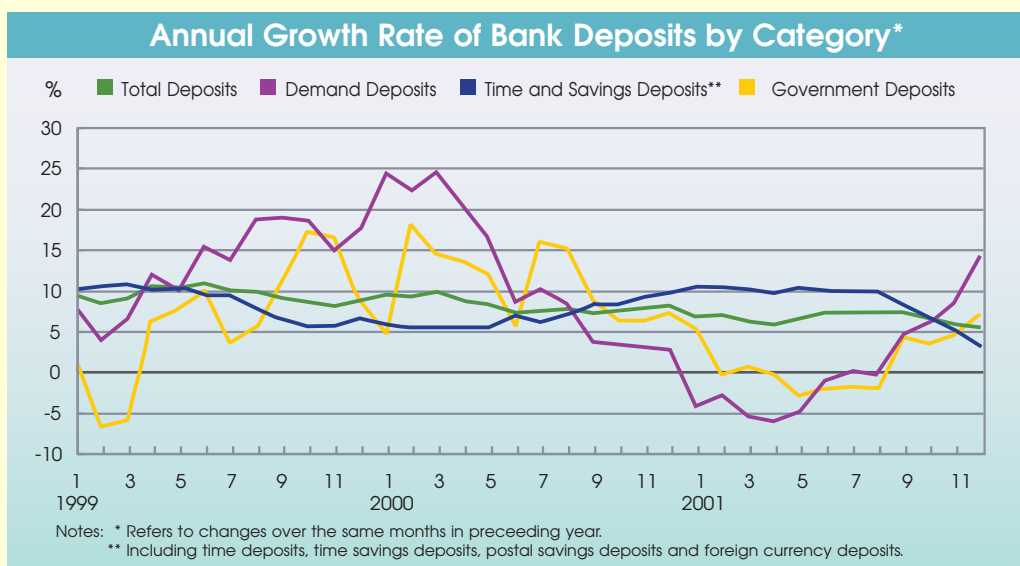
Slower Growth in Bank Deposits

Total deposits of depository institutions registered an annual growth rate of 4.59 percent at the end of 2001, considerably lower than 7.18 percent recorded in the previous year. The much slower growth rate was mainly a result of the sluggishness in banks' lending activities in

line with the marked slowdown in both the global and domestic economies, and a marked shift of funds from bank deposits to bond funds by local investors in pursuit of higher tax-free interest income.

In terms of the different types of deposits, demand deposits increased by 13.52 percent at the end of 2001, up from 1.75 percent recorded a year earlier. Its share in total deposits increased to 22.45 percent from the preceding year's 20.68 percent. The annual growth rate of demand deposits was negative in the first eight months of the year. However, it turned to positive and accelerated from September onwards. This change was due to the narrowing interest rate spread between demand and time deposits and a robust rebound of the local stock market in the last two months of the year.

As mainly affected by shifts of funds to demand deposits and bond funds by the general public, time deposits grew at a slow pace of 2.03 percent in 2001 from 8.82 percent a year earlier. Of the different kinds of time and savings deposits, NT dollar time deposits experienced a negative annual growth rate in each month of the year, and concluded with an annual growth rate of -9.60 percent at the end of the year. NT dollar time savings deposits grew steadily during the year, with growth rates gradually rising from the preceding year's 4.69 percent to 7.45 percent. Postal savings deposits showed an annual growth rate of more than 10 percent throughout the year, except for dropping to 7.48 percent in December. The growth rate of foreign currency deposits tumbled to -4.94 percent from the previous year's 79.99 percent, partly due to the lower interest rates of US dollar deposits at home when

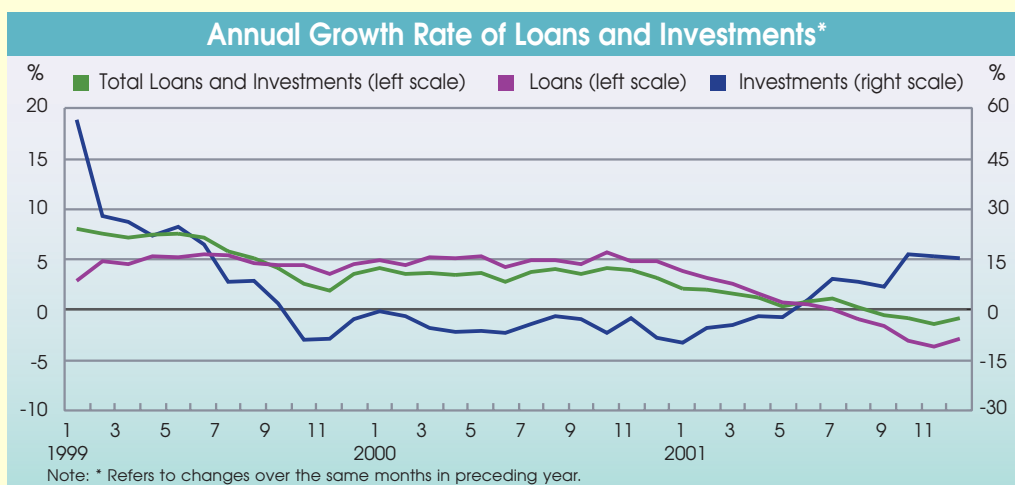


compared with those of NT dollar deposits and the comparison base effect. Government deposits in depository institutions grew by 6.36 percent during the year, slightly lower than that of the preceding year.

Shrinkage in Loans and Investments

The annual growth rate of loans and investments of depository institutions followed a downward trend during the year and recorded -0.88 of a percentage point at the end of 2001. The annual growth rates of loans fell from 4.76 percent at the end of 2000 to -2.93 percent at the end of 2001. The reasons for the fall included: (1) the new investment projects of enterprises were trimmed due to dim economic prospects; (2) some enterprises raised funds directly from financial markets, replacing part of their borrowings from banks; (3) banks adopted conservative attitudes toward lending due to concerns over rising non-performing loan ratios; (4) life insurance companies used their ample funds to promote lending so that bank loans were partly crowded out; and (5) banks actively wrote off bad loans. The annual growth rate of banks' portfolio investments, on the other hand, increased from -8.37 percent at the end of 2000 to 15.33 percent at the end of 2001. The rise was mainly due to banks using their excess funds to increase their holdings of risk-free government securities in order to lower their overall lending risks and earn fixed income.

As for the use of loans by industry, an additional NT\$300 billion in preferential loans to traditional industries (the total amount reached NT\$750 billion) was provided by the Executive Yuan to revitalize traditional industries during the year 2001. The share of loans extended to the manufacturing industry rose slightly to 45.65 percent at the end of the year



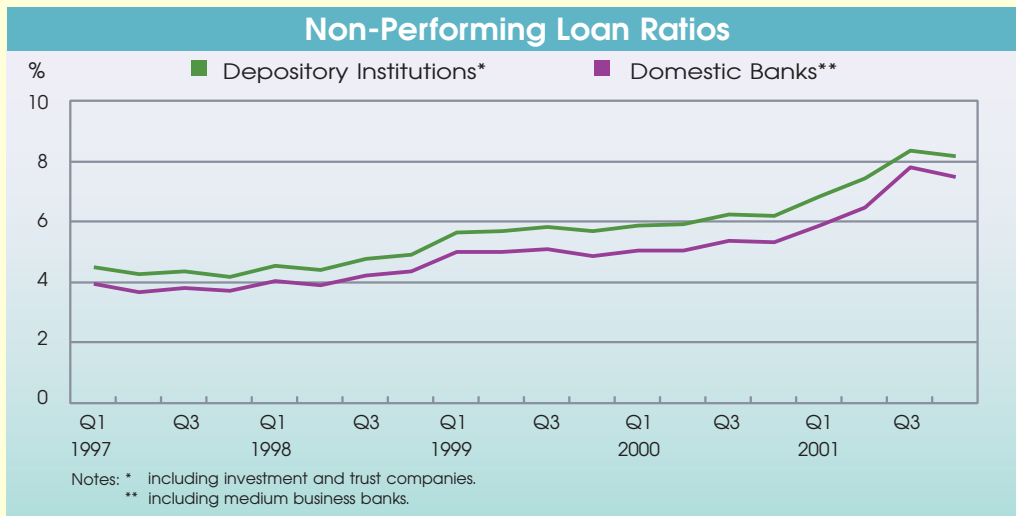
from 45.27 percent recorded a year earlier, while that to the real estate sector (including the construction industry) rose from 15.21 percent to 15.60 percent. The increase in the latter was partly attributable to the promotion of preferential housing loan policy by the government. As for the NT dollar loan-to-deposit ratio, it went down to 72.12 percent at year-end, representing a decrease of 5.23 percentage points over the previous year.

Portfolio investments of depository institutions exhibited an upward trend in annual growth rates, recording an increase of 15.33 percent at the end of 2001. Taking domestic banks as an example, commercial paper still accounted for the largest share of their total investments, or 38.50 percent at the end of 2001, which was considerably lower than the corresponding ratio of 41.96 percent recorded in the previous year. The drop was mainly because enterprises reduced their issues of commercial paper owing to the weak demand for funds. In contrast, the share of government securities held by domestic banks rose to 32.19 percent at the year-end from 29.30 percent a year earlier. The increase reflected large amounts of newly-issued bonds and bills by the government to raise funds from the public to cover its budget deficit, which was mainly the result of a marked decrease in transaction tax revenue collected from the lackluster local real estate and stock trading. Meanwhile, banks purchased government-issued bills in order to earn risk-free yields on their excess funds.

Rising Non-performing Loan Ratios

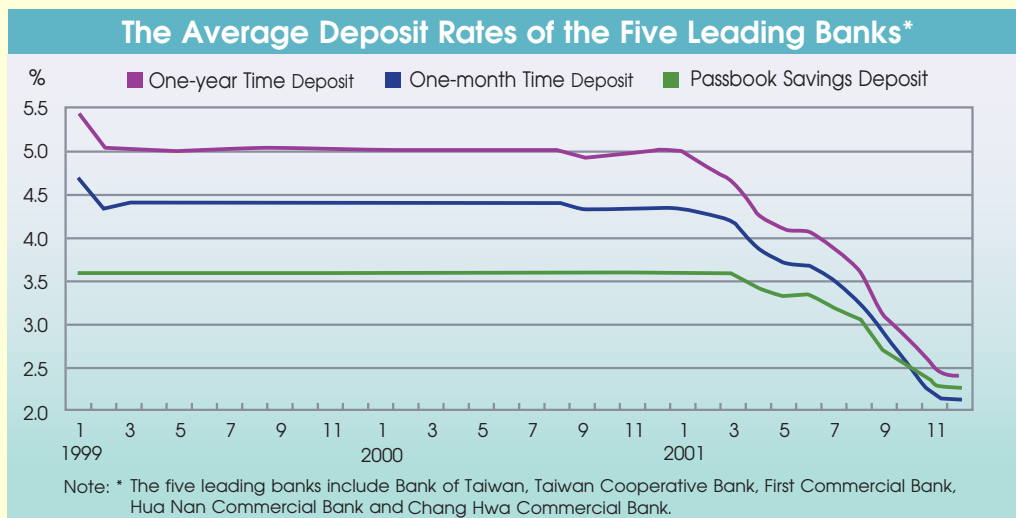
The non-performing loan (NPL) ratio of depository institutions and investment and trust companies went up from 6.20 percent at the end of 2000 to 8.16 percent at the end of 2001, while that of domestic banks and medium business banks rose from 5.34 percent to 7.48 percent.

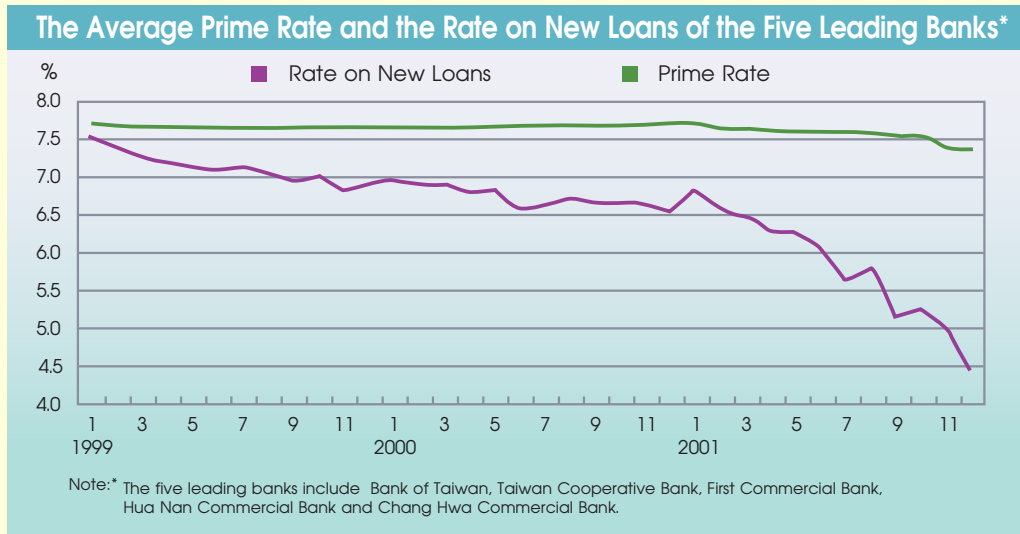
With regard to the NPL ratio for domestic banks (including medium business banks) during the first half of the year, the slowdown in economic growth adversely affected the financial conditions of enterprises while the steadily rising unemployment rate weakened individuals' ability to service their debt. As a result, NPL ratios rose continually. In the third quarter, the NPL ratio peaked at 7.79 percent, mainly owing to an accelerating drop in the local economy resulting from the impact of the September 11 terrorist attacks in the US and the serious damage to the country caused by Typhoon Nari, in addition to the inclusion of a vast amount of bad loans associated with the take-over of 36 problem community financial institutions by 10 domestic banks. There were some improvements in the NPL ratio in the fourth quarter, however, as banks actively writing off bad loans with funds from their own earnings and the compensation received from the Financial Restructuring Fund.



Steadily Declining Bank Interest Rates

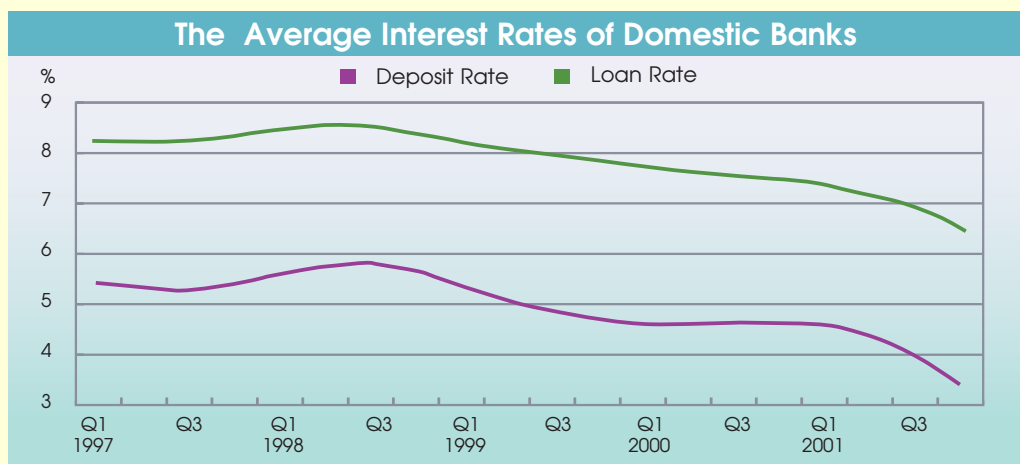
In 2001, with a view to stimulating the economy, the Bank adopted a consistently easy monetary policy and cut its discount rate twelve times from December 2000. Funding conditions in the banking system were loose, and interest rates posted by banks showed a downward trend. Taking the interest rates of the five leading domestic banks as an example, the average interest rate on one-month time deposits and one-year time deposits sharply dropped to 2.13 percent and 2.41 percent at the end of the year, respectively, or 2.21 and 2.59





percentage points lower than the corresponding figures a year earlier. However, banks hesitated to lower their prime lending rates because they were eager to improve profitability so as to strengthen their ability to write off the large amount of bad loans accumulated over the past few years. In addition, their funding costs were kept high relative to market interest rates since they relied heavily on fixed-rate deposits. The average prime rate of the five leading domestic banks was 7.377 percent at the end of 2001, merely 0.334 of a percentage point lower compared with that of the previous year.

The average interest rates on new loans trended downward in response to the steadily



loosening monetary policy during the year. Banks, in order to improve the quality of their assets, were inclined to extend new loans at money market rates to government agencies and enterprises with good financial records. Meanwhile, the government introduced several preferential loan packages to stimulate the economy. As a result, the weighted average rate on new loans hit an all-year low of 4.462 percent in December, or 2.086 percentage points lower than its corresponding figure in 2000.

The yearly weighted average deposit rate in domestic banks dropped to 4.09 percent from 4.62 percent a year earlier, while that of the lending rate shrank to 6.99 percent from 7.61 percent. As a result, the annual average interest spread between bank loans and deposits slightly narrowed from the year 2000's 2.99 percentage points to 2.90 percentage points in the year 2001.

Increased Profitability

In 2001, the combined pre-tax profit of all depository institutions increased by NT\$1.8 billion compared with that of the previous year. Of this amount, the pre-tax profits of domestic banks decreased by NT\$38.2 billion due to the large provisions for bad loans. As for foreign banks, their pre-tax profits increased by NT\$0.3 billion mainly due to increased income from the transactions of financial derivatives and from the purchase and sale of short-term bills. Owing to the revaluation gains from equities investments as well as the increased income from the purchase and sale of short-term bills and bonds, the pre-tax profit of the Postal Savings System increased significantly by NT\$38.7 billion when compared with that of the previous year.

The average return on assets (ROA) for all depository institutions remained the same as

Profitability of Depository Institutions by Category

Unit: NT\$ Billion

	Profit before Tax			Return on Assets (%)*			Return on Equity (%)**		
	2001	2000	Annual Change	2001	2000	Annual Change	2001	2000	Annual Change
Domestic Banks***	58.6	96.8	-38.2	0.27	0.47	-0.20	3.66	6.05	-2.39
Foreign Banks	10.8	10.5	0.3	1.13	1.08	0.05	25.79	25.58	0.21
Credit Co-operative Associations	2.4	0.7	1.7	0.32	0.08	0.24	4.58	1.20	3.38
Credit Departments of Farmers' and Fishermen's Associations	0.2	0.9	-0.7	0.01	0.06	-0.05	0.19	1.23	-1.04
Postal Savings System	11.5	-27.2	38.7	0.36	-0.90	1.26	58.70	-335.81	394.51
Total	83.5	81.7	1.8	0.30	0.30	0.00	4.65	4.59	0.06

Notes: * Return on Assets = Profit before Tax / Total Assets

** Return on Equity = Profit before Tax / Net Worth

*** Including medium business banks.

Source: Bank Examination Department, Central Bank of China.

that of the previous year, at 0.30 percent, while their average return on equity (ROE) went up to 4.65 percent from 4.59 percent recorded in the previous year. Among depository institutions, foreign banks achieved the highest ROA, 1.13 percent, and the Postal Savings System registered the highest ROE, 58.70 percent. Except for domestic banks and credit departments of farmers' and fishermen's associations, all other depository institutions' ROAs and ROEs were higher than those of the previous year.

