7.Banking Sector

To strengthen the soundness of Taiwan's banking sector, the Bank and the Ministry of Finance continued to push forward financial reforms in 2002. The major goal for banks is to lower their non-performing loan (NPL) ratios to less than five percent by the end of 2003. In addition, banks were encouraged to raise their capital adequacy ratios to prepare for the implementation of the New Basel Capital Accord. At the end of 2002, the average non-performing loan ratio of financial institutions was reduced to 6.84 percent and the average capital adequacy ratio was strengthened to 10.63 percent.

Decrease in the Number of Depository Institutions

Depository institutions continued to adjust and consolidate in the face of growing competition. There were 404 depository institutions (including deposit money banks and the Postal Savings System) at the end of 2002, a decrease of twelve financial institutions compared with one year earlier. The decrease was due in part to merger activities of one domestic bank, two foreign banks and one credit cooperative association. The other eight poorly performing community financial institutions, including seven credit departments of farmers' associations and one credit cooperative association were taken over by three domestic banks under the government's financial restructuring policy. In spite of the consolidation, market shares of deposits or loans remained little changed for each type of depository institutions compared with the previous year.

Number of Depository Institutions by Category

	2002	2001	Change
Combined Number of Main Offices	404	416	-12
Domestic Banks	47	48	-1
Medium Business Banks	5	5	0
Foreign Banks	36	38	-2
Credit Cooperative Associations	37	39	-2
Credit Departments of Farmers' and Fishermen's Associations	278	285	-7
Postal Savings System	1	1	0
Combined Number of Branches	5,874	5,834	40
Local Branches	5,724	5,690	34
Overseas Branches	78	76	2
Offshore Banking Units	72	68	4

Sources: Financial Statistics Monthly, Taiwan District, The Republic of China, Central Bank of China.
Bank Examination Department, Central Bank of China.

Market Shares of Deposits and Loans by Category of Depository Institutions

As of the end of 2002, thirteen financial holding companies had been set up since the Financial Holding Company Act took effect in July 2001, an increase of nine companies as compared to the previous year-end.

Sources and Uses of Funds

With regard to sources of funds in depository institutions, time deposits remained as the

Sources and Uses of Funds in Depository Institutions

Unit: NT$ Billion

	End of 2002		End of 2001		Change	
	Amount	Share (%)	Amount	Share (%)	Amount	Share (%)
Sources:						
Foreign Liabilities *	704.8	3.25	536.3	2.57	168.5	0.68
Demand Deposits	4,964.3	22.88	4,500.2	21.53	464.1	1.35
Time Deposits	14,755.4	67.99	14,703.2	70.33	52.2	-2.34
Government Deposits	750.0	3.46	835.8	4.00	-85.8	-0.54
Borrowings from CBC	282.4	1.30	285.1	1.36	-2.7	-0.06
Other Items (Net)	244.1	1.12	43.7	0.21	200.4	0.91
Total	21,701.0	100.00	20,904.3	100.0	796.7	0.00
Uses:						
Foreign Assets *	1,544.7	7.12	1,561.1	7.47	-16.4	-0.35
Loans	13,559.6	62.49	13,910.2	66.55	-350.6	-4.06
Portfolio Investments	1,932.0	8.90	2,107.4	10.08	-175.4	-1.18
Purchases of CDs issued by CBC	1,925.7	8.87	907.9	4.34	1,017.8	4.53
Deposits with CBC	2,739.0	12.62	2,417.7	11.56	321.3	1.06

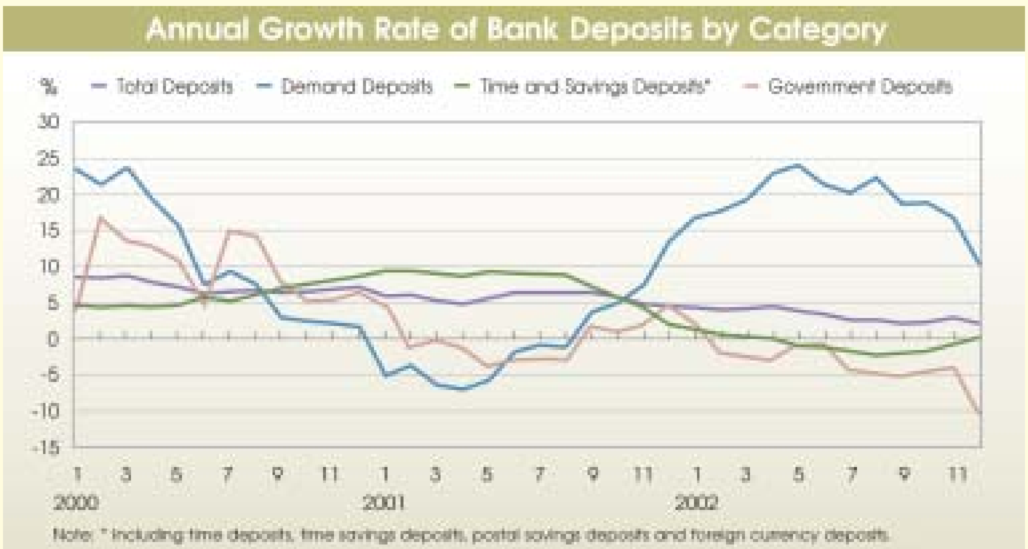
Note: * Excluding valuation changes in the exchange rate of the NT dollar against foreign currencies when caculating their annual change.
Source: Financial Statistics Monthly, Taiwan District, The Republic of China, Central Bank of China.

main source of funds in 2002, followed by demand deposits. However, mainly resulting from the narrowing interest rate spread between demand and time deposits during the year, the share of demand deposits in total sources of funds kept increasing, whereas that of time deposits declined. With respect to the uses of funds in depository institutions, loans still constituted the primary use of funds in 2002, while bank loans continued to show negative growth and portfolio investments also turned to decrease during the year. However, both the share of holdings of CDs issued by the Bank and the share of deposits with the Bank both increased, as depository institutions deposited their excess liquidity with the Bank.

Mild Increase in Deposits

The total deposit balance of depository institutions as of the end of 2002 increased by an annual rate of 2.11 percent, a slower rate as compared to 4.59 percent in 2001. In the beginning of the year, with active stock market transactions and net foreign capital inflows, deposit accretion steadily continued and its annual growth rate reached its yearly high of 4.46 percent in April. Thereafter, as those favorable factors disappeared, along with banks' slower lending activities, the deposit growth rate began to reverse its upward trend and further slid to 2.11 percent in December.

In terms of the different types of deposits, with lower transaction demand for cash balances in line with the sluggish stock market, the demand deposit growth rate decreased from 13.52 percent at the end of 2001 to 10.31 percent at the end of 2002. However, the share of demand



deposits increased from 22.45 percent to 24.25 percent during the same period.

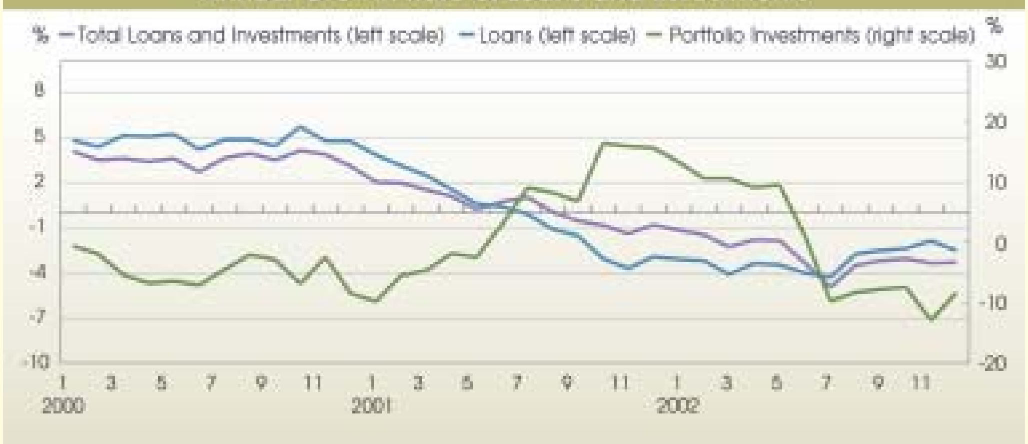
The growth rate of time and savings deposits also dropped from 2.12 percent to 0.30 percent, mainly owing to the shifts of funds to demand deposits and bond funds. The ratio of time and savings deposits to total deposits decreased to 72.04 percent at year-end 2002, compared with 73.39 percent a year earlier. Of the different kinds of time and savings deposits, NT dollar time deposits posted a negative annual growth rate throughout the year and reached negative 3.18 percent at the end of 2002. The main factor behind this was the narrowing interest rate spread between demand deposits and time deposits. NT dollar time savings deposits kept growing steadily, while due to a higher comparison base in the previous year, its growth rate lowered to 2.07 percent from 7.60 percent a year earlier. The annual growth rates of postal savings deposits generally declined throughout 2002, and slipped to 0.67 percent at year-end from 7.48 percent at the previous year-end. Mainly reflecting the lower interest rates on US dollar deposits at home than those on NT dollar deposits, the annual growth rate of foreign currency deposits dropped from negative 4.94 percent to negative 6.81 percent during the same period.

Government deposits in depository institutions declined by 10.26 percent over the year, as compared to 4.8 percent growth in 2001. During the same period, the ratio of government deposits to total deposits also decreased from 4.17 percent to 3.66 percent.

Slowdown in Loans and Investments

The annual growth rate of loans and investments of depository institutions continued to

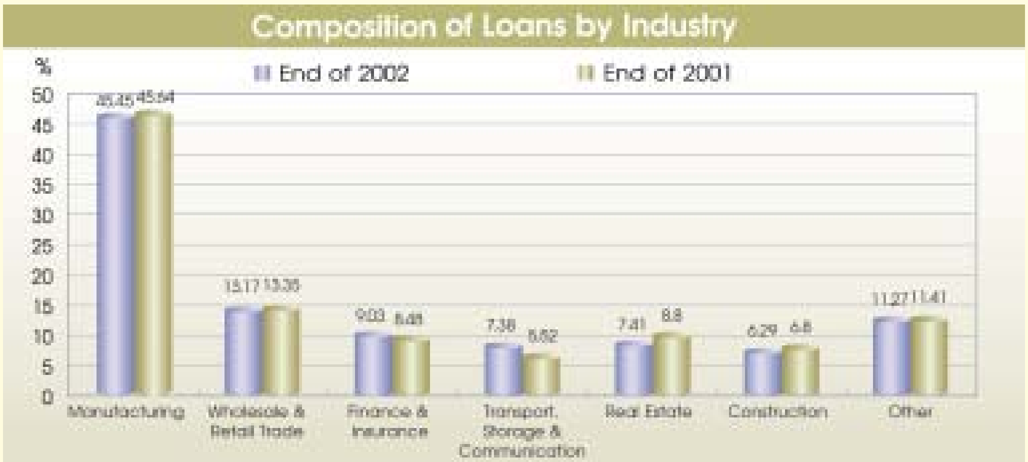
Annual Growth Rate of Loans and Investments



slide during the year and reached negative 3.30 percent at year-end. Among them, the annual growth rate of loans was negative 2.54 percent, after a contraction of 2.92 percent at the previous year-end. The major reasons why the balance of loans made by depository institutions decreased were listed as follows: (1) banks continued actively dealing with non-performing loans and writing off bad loans; (2) more firms resorted to issue corporate bonds for raising funds, partly replacing borrowings from banks; (3) amid the soft pace of the economic rebound, firms were still hesitant about increasing investment, leading to weak credit demand; (4) banks' cautious lending attitudes due to their high NPL ratios; (5) the falling value of collateral against loans prompted banks to curtail lending.

Despite weakening in lending activity for most loan categories, domestic banks aggressively got involved in the consumer banking market, which contributed to 3.56 percent growth in consumer loans at year-end 2002 as compared to a year ago.

As for the composition of loans by industry, manufacturing and wholesale & retail trade remained as major borrowers. However, the combined share of loans to the real estate industry and the construction industry fell from 15.6 percent to 13.7 percent, partly reflecting banks' cautious lending attitudes toward real estate related industries.



As regards loans by currency, the share of foreign currency loans to total loans rose to 3.26 percent at year-end from 2.82 percent the previous year. This increase mainly resulted from the revival of international trade and market expectations of an appreciation of the NT dollar from the second quarter onwards. The share of NT dollar loans to total loans still reached a predominant 96.74 percent at year-end. As for the NT dollar loan-to-deposit ratio, it dropped to 67.52 percent at year-end from 71.43 percent a year earlier.

With respect to portfolio investments of depository institutions, its annual growth rate significantly dropped to negative 8.32 percent at year-end from 15.73 percent at the previous year-end. Of the components of portfolio investments, government bonds accounted for the largest share, followed by commercial paper. In the case of domestic banks, government bonds and Treasury bills accounted for 40.31 percent of their total investments, up from 32.19 percent. This was mainly owing to the increased issuance of government securities aiming to finance the fiscal shortage, along with financial institutions' buying more government securities to seek default risk-free yields on their surplus funds. The ratio of investment on commercial paper to their total investments tumbled to 24.94 percent from 38.50 percent, primarily reflecting the decline in commercial paper issuance by local firms.

Decreased Intermediate Financing vs. Increased Market Financing

In the last few years, non-bank financial institutions such as life insurance companies, aggressively extended loans partly at the expense of bank loans. Therefore, taking into account the loans provided by life insurance companies and investment and trust companies, financial institutions' reclassifying non-accrual loans and written-off bad loans, as well as market financing, the total demand for funds from the government, enterprises and individuals still showed an increase in 2002.

In terms of cash flows, the ratio of funds borrowed from financial institutions (intermediate financing) fell substantially to 40.18 percent in 2002 from 89.52 percent a year earlier. Conversely, the ratio of funds raised from non-financial sectors (market financing) increased from 10.48

Intermediate Financing vs. Market Financing

Unit: NT$ Billion

	(1) Intermediate Financing*				(2)Market Financing**	Total (1)+(2)	(2)/(1)+(2) (%)
	(1)subtotal	(1)/(1)+(2) (%)	Loans	Portfolio Investments			
2000	1,107.9	81.84	1,029.8	78.1	245.8	1,353.7	18.16
2001	572.5	89.52	175.0	397.5	67.0	639.5	10.48
2002	309.4	40.18	23.6	285.8	460.6	770.0	59.82

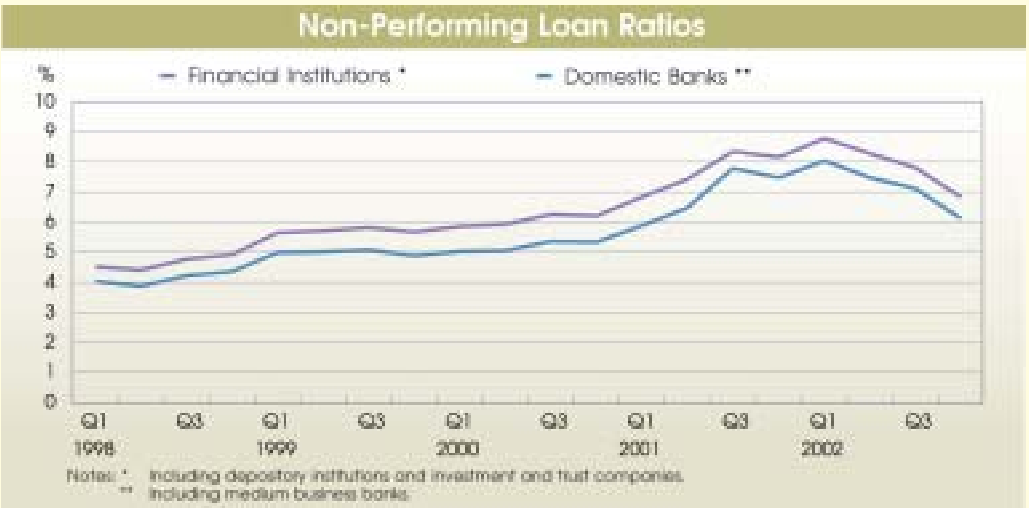
Notes: * Refers to loans and portfolio investments made by financial institutions, which include depository institutions, investment and trust companies, and life insurance companies.
** Securities issues subtract those held by financial institutions.
Source: Economic Research Department, Central Bank of China.

percent to 59.82 percent. This was mainly due to greater issuance of government securities and the decline in loans and investments of financial institutions, despite the reduction in issuance of short-term bills.

Lower Non-performing Loan Ratios

With the efforts made by local asset management companies and financial institutions, the accumulated amount of non-performing loans sold reached NT$146.8 billion by the end of 2002. In addition, banks continued to write off bad loans with funds from their own earnings and the compensation received from the Financial Restructuring Fund for losses resulting from banks' take-overs of problem community financial institutions. These actions greatly improved the NPL ratio. Furthermore, the Legislative Yuan passed the Financial Asset Securitization Law on June 21, which will help banks deal with non-performing assets, raise the liquidity of financial assets and lower the NPL ratio.

As an uncertain economic climate took its toll on some companies and as the slack job market worsened individuals' debt-servicing ability, the NPL ratio of overall financial institutions rose from 8.16 percent at year-end 2001 to 8.78 percent at the end of March 2002. Thereafter, as economic conditions steadily improved and banks actively dealt with non-performing loans and wrote off bad loans, the NPL ratios gradually declined to 6.84 percent at year-end 2002. Following a similar pattern, the corresponding NPL ratios for domestic banks and medium business banks (including offshore banking units and overseas branches) were 7.48 percent, 8.04 percent and 6.12 percent over the same period.



Declining Bank Interest Rates

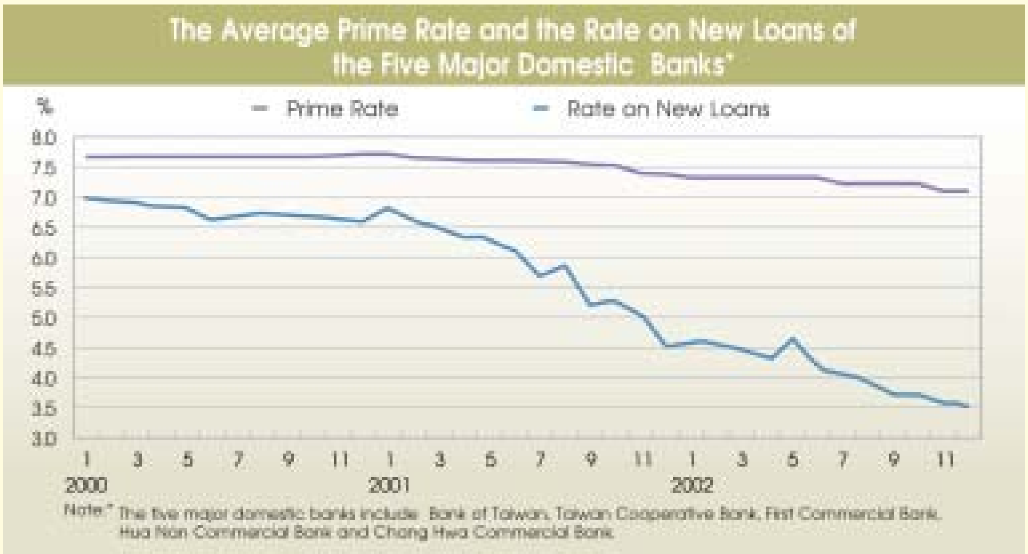
Given ample liquidity in the banking system, interest rates posted by banks showed a downward trend throughout 2002. In the case of the interest rates of the five major domestic banks, the respective average fixed rates on one-month and one-year time deposits dropped to 1.48 percent and 1.86 percent in December 2002 from 2.13 percent and 2.41 percent a year before. However, the five major banks' prime rates fell only slightly from 7.38 percent to 7.1 percent over the same period. This was because banks were eager to perk up profits to write off massive bad loans accumulated over the years. Further, their costs of funds were kept high relative to market interest rates due to their relying predominantly on fixed-rate deposits.

The Average Deposit Rates of the Five Major Domestic Banks *

Note: * The five major domestic banks include Bank of Taiwan, Taiwan Cooperative Bank, First Commercial Bank, Hua Nan Commercial Bank and Chang Hwa Commercial Bank.

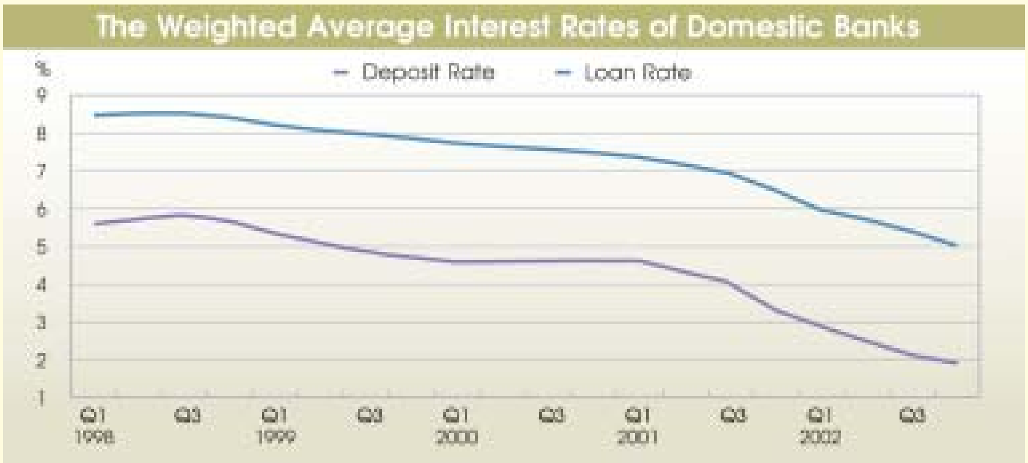
Even so, customers with good credit usually were able to get better deals from banks, despite the downward rigidity of the prime rate. As the rigid prime lending rates did not reflect the falling trend of market rates, several banks instead launched adjustable rate mortgages. The Bank also urged commercial banks to adopt the new flexible prime rate benchmark scheme to align their rates more closely with market rates, which helped cut borrowing costs. As of the end of 2002, there were 37 domestic banks offering adjustable rate mortgages and 7 adopting the new prime rate benchmark scheme.

Similarly, under the effects of the loose funding conditions, banks' increasing lending to government agencies and firms with good credit at money market rates, and the government's



several preferential loans aiming to revitalize the economy, the average rates on new loans of the five leading domestic banks trended downward throughout the year and hit a record low of 3.49 percent in December 2002. In particular, banks' mortgage rates were brought down by the ongoing mortgage price competition, which stemmed from the introduction of adjustable rate mortgages, bargain-hunting borrowers switching their mortgages from one bank to another, coupled with competition from life insurance companies. Under these circumstances, the spread between the rates on new loans and prime rates kept widening, following the sliding trend in new loan rates.

The weighted average rates for all deposits and loans of domestic banks also continued to drift downward throughout 2002. For the year as a whole, the weighted average deposit rate went down to 2.38 percent from 4.09 percent a year earlier, while the weighted average lending rate fell to 5.53 percent from 6.99 percent. The easy funding conditions and banks' being able to raise funds by issuing bank debentures contributed to banks' weak demand for funds from the general public, which led deposit rates to decrease more rapidly than lending rates. In addition, banks hesitated to reduce their lending rates as banks' earnings were undermined by actively writing off bad loans, combined with the rising share of consumer loans in total loans. As a result, the spread between deposit and lending rates widened in the second and third quarters. After that, as more banks reduced lending rates to expand their market share and launched adjustable rate mortgages, the spread shrank to 3.07 percentage



points in the fourth quarter, lower than the 3.14 percentage points recorded in the corresponding quarter of 2001.

Decreased Profitability

The profitability of banks declined significantly during 2002. The combined pre-tax earnings of all depository institutions plunged by NT$189 billion and posted a loss of NT$105.5 billion in 2002. Of this amount, the pre-tax earnings of domestic banks declined by NT167.5 billion, primarily attributable to banks' large provisions for bad loans and losses from dealing with non-performing loans, coupled with decreased income from the purchase and sale of short-term bills and bonds, despite an increase in commission revenue. The pre-tax profit of foreign banks

Profitability of Depository Institutions by Category

Unit: NT$ Billion

	Profit before Tax			Return on Assets (%)*			Return on Equity (%)**		
	2002	2001	Annual Change	2002	2001	Annual Change	2002	2001	Annual Change
Domestic Banks***	-108.9	58.6	-167.5	-0.50	0.27	-0.77	-7.61	3.66	-11.27
Foreign Banks	12.1	10.8	1.3	1.09	1.13	-0.04	27.85	25.79	2.06
Credit Cooperative Associations	-1.3	2.4	-3.7	-0.18	0.32	-0.50	-2.81	4.58	-7.39
Credit Departments of Farmers' and Fishermen's Associations	-1.7	0.2	-1.9	-0.13	0.01	-0.14	-2.25	0.19	-2.44
Postal Savings System	-5.7	11.5	-17.2	-0.18	0.36	-0.54	-35.29	58.70	-93.99
Total	-105.5	83.5	-189.0	-0.37	0.30	-0.67	-6.54	4.65	-11.19

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.

increased by NT$1.3 billion due to gains from foreign exchange business and rising income from the purchase and sale of short-term bills and bonds. As credit cooperative associations increased provisions for bad loans and credit departments of farmers' and fishermen's associations continued to make fewer loans, they posted losses as well. The Postal Savings System's loss largely came from the hefty provisions for their stock holdings as the stock market turned bearish in the second half of the year.

The average return on assets (ROA) for all depository institutions dropped to negative 0.37 percent in 2002 from 0.30 percent recorded a year earlier, while the average return on equity (ROE) plunged to negative 6.54 percent from 4.65 percent. Within depository institutions, except for foreign banks, all other depository institutions' ROAs and ROEs fell into negative territory during the year.

Despite lackluster profitability, banks issued more subordinated debentures to strengthen their capital bases. The average capital adequacy ratio for all depository institutions thus rose to 10.63 percent at the end of 2002, compared with the previous year's 10.40 percent.