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**TRENDS AND DEVELOPMENTS IN INSOLVENCY SYSTEMS AND RISK  
MANAGEMENT – THE EXPERIENCE OF CHINESE TAIPEI**

**By**

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# **Trends and Developments in Insolvency Systems and Risk Management – The Experience of Chinese Taipei**

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## **Introduction**

This report has two parts: the first will update on the recent developments of Chinese Taipei's RTC and the rather speedy resolution of the NPL problem; the second part of this report describes the Procomp fraud case and the government's answers to it in the form of partial amendments to the Securities Transaction Law and the Commercial Accounting Law. Some controversies surrounding these amendments will also be briefly discussed.

## **Part 1: Dealing With the Non-Performing Loan Problems : Chinese Taipei's Experience**

How did Chinese Taipei bring down the NPL ratio in half (from over 8% to less than 4%) in less than 3 years? Chinese Taipei did it through a three-pronged approach, namely, infusion of RTC fund into the most troubled institutions, active and aggressive participation of AMC in bad loan auctions, and the bold apportionment of large non-performing loan losses taken by troubled financial institutions.

However, this does not mean that Chinese Taipei is completely home free from the threat of a potential financial crisis while Chinese Taipei managed to escape from financial meltdown. Some of the measures used to tame the NPL beast are of the quick-fix or makeshift patching nature that posed potential problems and raise latent apprehension on the health and long-term sustainability of Chinese Taipei's financial system. This section pinpoints and elaborates some of these problems that we think should be brought to the attention of policy makers.

## **RTC**

First, regarding the usage of public funds to help lower the NPL ratio, the most contentious issues in Chinese Taipei are the efficiency, adequacy and fairness stemming from past operation of RTC. For instance, the bulk of RTC approval and dispensing decisions were made in less than 2 months as part of the political mandate to salvage some 40 failing local credit unions. In a short 2 month period and without a well designed operating mechanism and procedure in place, it is virtually impossible to conduct a comprehensive evaluation of the assets and collaterals associated with non-performing loans in question, rendering the pricing of the packaged loans (and dispensing of RTC) to be grossly inaccurate and at best questionable. Furthermore, the decision makers (the appointed RTC supervisory committee members) are part-timers and it is impossible to expect them to devote full attention to the information and appraisals given to them to ensure the most efficient and fair outcome of their decisions. As a result, controversies, suspicions and disputes were bound to arise (and indeed surfaced) from their decisions.

## **AMC**

Besides RTC, another option of non-performing loan management is to sell bad loans to asset management corporations (AMC). In practice, this approach has met with fair amount of success in Chinese Taipei: 400 billion, amounting to 40% of the one trillion bad assets being disposed of up to now, are resolved through this channel.

However, this approach is not free from problems and potential distortions. For one thing, the Ministry of Finance allowed financial institutions to take a five-year amortization over the loss incurred from selling their bad assets to AMC. As a result, the aforementioned 400 billion bad assets were disposed of by AMC paying for example, 160 billion to acquire those assets. Assuming the recovery rate to be 40% and the banks were able to digest the remaining 240 billion transaction loss by amortizing them over 5 years and showing them in the banks' balance sheets under the guise of 48 billion "deferred assets" each year.

This "clever" accounting maneuver, which was allowed perhaps with good intention to facilitate disposal of non-performing loans, distorts the reading of banks' balance sheets and can conceivably lead to serious understatement (and hence misjudgment) of the extent of problem plaguing a troubled financial institution. Moreover, each financial institutions may take advantage of this accounting trick in varying degrees, (some uses up the entire annual allowed amount listing the loss as deferred assets but some uses the allowance partially),

rendering comparisons of financial conditions across banks difficult and unreliable. The problems associated with this accounting trick, which is in violation of international accounting protocol, will linger around for more years to come even after the termination of this provision effective July 1 of 2005.

Another concern related to the AMC approach to NPL reduction is the high leverages implied in AMC's purchase of bad assets. To be sure, leverage buyout is to be expected in this type of business and does not pose a concern by itself. The concern arises from the extremely high leverages in many AMC purchases. More seriously, except TAMCO and a few foreign AMCs, many of these AMCs are joint ventures between domestic financial institutions and foreign entities, even with some suspected to have been set up exclusively by a domestic institution (which itself also has NPL problem) and functioning virtually as its affiliate or subsidiary. While the latter case cannot be ascertained given that the current legal framework on AMC regulation does not provide adequate disclosure of the funding source of an AMC, there is no telling if bad assets purchased by an AMC are truly disposed of or are simply shifted from one hand to another in the same sector. If the last scenario prevails, it would just make the numbers look good, creating illusionary improvement of the situation.

### **Banks Acknowledging and Absorbing Losses**

Third, we turn to considering the direct approach that banks take initiative writing off unrecoverable portion of bad loans themselves. This approach typically entails banks tapping into past surplus reserves to absorb the loss.

Again, despite the above appealing reasons for promoting this approach to taming high NPL ratios, it is not without limitations and reservations either. The first and foremost concern is about the depletion of surplus reserve and the long-term viability of this approach. This approach has forced banks to draw from a pooled reserve built up over surplus accumulated through last 20 or 30 years, and now with the expensing of several billion and more to be expected the reserve stands to be exhausted in the not far future. This raises the inevitable question: what to do if similar explosions of bad loans recur? How can the banking system in Chinese Taipei fight the unthinkable without any more self-owned ammunition?

To conclude, even though Chinese Taipei was able to avoid the banking crisis that normally would have occurred as predicted by outsiders, and seems to succeed in lowering NPL ratios with a three-pronged approach of RTC infusion, AMC purchase and recovery, and banking system's self restructuring, it is not completely out of the woods yet. This section of the report enumerates several hidden problems and concerns that challenge policy makers to take heed and act on them to ensure a sustainable and healthier financial system in Chinese Taipei.

### **Part 2: The Procomp Fraud Case**

On June 14, Procomp Informatics Ltd, Chinese Taipei's first gallium arsenide epitaxial (GaAs) wafer foundry and once touted as "the King of Stocks", filed a restructuring proposal in a local district court, saying it was unable to maintain solvency. GaAs chips are used in communications devices including mobile phones, satellite communications systems and car navigation systems due to their speedier transmission compared with other chips. On June 16, the company failed to pay a bond worth NT\$2.98 while financial reports showed it had NT\$6.3 billion in cash. The default led to a suspension of trading of Procomp shares on June 23 and the detention of its chairwoman Sophie Yeh on June 27.

On October 25, the district prosecutors, after 4 months' investigation, indicted Yeh and suggested a 20-year sentence and a NT\$500 million fine on charges of breach of trust and violating the Securities Transaction Law and the Commercial Accounting Law. In addition to Yeh, prosecutors also indicted another 30 employees of the company who were allegedly Yeh's accomplices. The initial investigation showed that Yeh had stolen approximately NT\$6.3 billion (US\$187 million) from the company, but the prosecutors think she may have actually stolen more than NT\$7 billion. The Securities Investor Protection Center, a pseudo government agency, has already received more than 8,000 claims amounting to NT\$4 billion against Yeh and Procomp within just a month, setting records for Chinese Taipei.

Summarizing from the indictment and financial press reports, Yeh used 4 primary schemes to steal from the company or to profit from the stock market:

**1. Fabricating export/import transactions to window-dress financials** Yeh started fabricating transactions as early as 1994, five years before the IPO. It is estimated that as much as NT\$11 billion worth of revenues and associated accounts receivables per year were created through as many as 40 domestic and foreign shell upstream/downstream companies. As a result, Procomp first got listed in December 1999 at NT\$98 and within four months, reached NT\$368, and claimed the “King of Stocks” title.

**2. “Arranged ECB” issue** During 2002 and 2003, Yeh issued US\$50 million worth of ECBs and had her shell companies buy them all, using Procomp funds. After converting all the bonds into Procomp stocks, the shell companies simply sold them and presumably funneled the proceeds to Yeh’s phony agent accounts. The funds that the shell companies used to buy ECBs were borrowed from two foreign banks. The banks okayed the loans based on Procomp’s deposits. At the end of the day, it was the investors who bought Procomp stocks who were badly conned.

**3. “Arranged CLN” issue** Also during 2002 and 2003, Yeh asked several foreign shell companies to buy another foreign shell’s corporate bonds using borrowed funds with either Procomp funds or shell associates’ own fictitious accounts receivable as collateral. The bond issuer then took out loans totaling US\$85 million by issuing CLNs (credit linked notes) through a foreign bank. The proceeds again disappeared presumably into Yeh hands.

**4. Manipulating Procomp stock price and insider trading** At various points, particularly right before IPO, recapitalization, and the pricing of ECB, she purposefully released favorable company information to boost up its stock price. She also used company funds to buy company stocks at the same time, but kept any profits as personal gain. The transactions have all been done on false domestic and foreign accounts.

### **The Government’s Answer to the Confidence Crisis Prompted by Procomp Scandal**

The case of Procomp and the several “landmine” cases following it happened at a highly opportune time. The brand new integrated financial sector regulatory body FSC (Financial Supervisory Commission) just opened its door on July 1. Before that, many proposals and initiatives were sitting on various agencies’ desks waiting for the new agency to review and finalize. Most of them had corporate governance or risk management improvements in mind. The FSC selected two from these as a quick answer to the Procomp crisis: the “Securities Transaction Law Amendments” (STLA) and the “Commercial Accounting Law Amendments” (CALA).

The STLA initiative came from the “Financial Reform Taskforce” of the Executive Yuan started in May, 2002. It includes four major areas:

- **Corporate governance** To require the inclusion of at least 1/4 board seats for independent directors; to set up audit committee comprised of independent directors to replace board supervisors for large corporations; to improve on board supervisors’ independence for those corporations who do not elect to set up audit committees.
- **Securities Companies’ Business** To relax restrictions for securities houses not to hold shares of other houses; to allow securities companies to engage in related business lines such as investment trust and investment advisory; to allow securities companies to transact in more financial products, such as more exotic synthetic derivatives; to streamline securities underwriting procedures.
- **Foreign Cooperation in Regulatory Actions** With prior consent from the Executive Yuan, to allow various functional regulatory bodies to sign cooperative memorandum with foreign counterparts, mainly to enhance the sharing of information and technology, to join force in fighting economic crimes, etc.
- **Fine tune market manipulation and insider trading-related clauses**

Similar to the STLA initiative, the CALA initiative has been around for a couple of years since Enron. US Sarbanes-Oxley Act of 2002 also had its influence. It is not until the Procomp scandal that the government finally decided to quickly pass it through the Executive Yuan and deliver it to the Legislative Yuan for formal legislation. The amendments include the following major areas:

- **Towards a Better environment for CPAs** To clarify on the status of the so-called “united CPA firm” as a partnership; to introduce the US-style limited liability partnership (LLP) to be the standard organizational form

for the large CPA firms, where the felon partner has unlimited liability while the other partners are liable only up to his(her) stake in the firm.

- **To strengthen the CPA Associations' Roles** To promote an individual member-based national association to handle the US AICPA and PCAOB-like functions such as CPA registering, quality assurance/monitoring, continuing education, sanctions, etc.
- **Tougher punishments for wrongdoing** For minor violations such as soliciting for business without a CPA license, the fine is to be increased from under NT\$3,000 to between NT\$300,000 and NT\$1.5 million; for LLP-type CPA firms' violations such as causing the investors serious financial losses, the fine can go as high as NT\$30 million.
- **To improve quality of CPA work** To bar CPAs doing consulting or other non-audit work which may compromise his(her) independence from also doing the client's audit; to toughen the requirements for CPA registration and post-registration continuing education requirements; to authorize FSC regulators to examine a CPA firm's business and financial operations and documentations if circumstances warrant such examinations
- **Other rationalization measures for CPAs** Such as easier registration procedures, allowing firms to open more than one branch office in each metro area, more lenient rules on advertisement.

### **Some Controversies Surrounding the FSC's Actions and the Proposed Amendments**

- Observers from many different sectors believe FSC's actions were heavy on punishing CPAs and light, too light, on regulators themselves. Within weeks after FSC was set up and only a little more than a month since Procomp case broke out, the FSC decided to sanction both Procomp's former and then current CPAs by suspending their licenses for two years. FSC faulted the four CPAs for not being able to uncover the fact that Procomp's huge cash balances during the past three years were nonexistent or at best restricted by the banks supposedly holding its deposit. Both firms are big-4, and both have indicated strong objections to this allegation and are preparing to appeal for the four CPAs. In the meantime, neither the Chinese Taipei Stock Exchange (TSE) or FSC's Securities and Futures Bureau have expressed any apology or intentions to review their own personnel or procedures.
- Unlike US' Sarbanes-Oxley Act after the Enron and WorldCom fiascos which was passed swiftly and the time for SEC to start implementing its statutes was within a mere 100 days after it was signed into law by President Bush, many implementation deadlines in the original proposed amendments were relaxed and significantly postponed. Most notably were the implementation deadlines set for independent board directors, audit committees and board supervisors' independence enhancement measures, which were postponed from the original immediately taking effect to the beginning of 2006. The official explanation is "to allow corporations a reasonably long enough period to adjust to the new requirements." Many observers, however, believe the real reason was pressure from a few business tycoons visiting the new FSC commissioner shortly after it announced the proposals. Similarly, the monetary fines included in the STLA initiative were originally set at much larger amounts than the original STL's, but then were adjusted back to the original amounts, way too low relative to Sarbanes-Oxley or financial losses of investors caused by Procomp.
- Although independent directors were included in the STLA, the way they will be nominated was left to the corporate charter to stipulate the details. Unlike Sarbanes-Oxley and the since formulated SEC and NYSE regulations which clearly specify director nomination process and minority shareholder protection arrangements, this lack of specifics will no doubt give the many family and conglomerate business owners leeway to engagement related and fully controlled individuals to act as independent board directors and supervisors.