

Choosing Entry Mode to Mainland China

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Abstract

The Economic Cooperation Framework Agreements (ECFA) is an agreement between the Republic of China (Taiwan) and People's Republic of China (Mainland China), which was signed on June 29, 2010. The ECFA can have a far reaching impact on bilateral businesses relationship of the two parties, further strengthening the financial infrastructure and enhancing financial stability. Currently, thirteen Taiwanese banks meet the capital adequacy or stake acquisition requirements in the mainland China; on the contrary, five mainland Chinese banks meet the capital adequacy and operation experience requirements for opening a representative office in Taiwan. Consequently, a merger of banks and related options between the two regions are under discussion. In a review of the ECFA and other reports, Taiwanese banks will be able to progress further on the banking business in the mainland market within 2 years. However, there are still many uncertainties and questions concerning bank characteristics after ECFA; such as competitive position, market efficiency, long term returns and dimensional stability. This paper investigates theoretical and empirical studies and application of PESTEL analysis on the major factors in the macro environment of China. Specific attention is made in regards to the securities, banking and insurance aspects. The vital finding of this study is investigation of the entry mode strategy for the Chinese market with a long-term vision to foster into global competition. Finally, in order to intensify the competitive advantage, this paper explores a viable model for Taiwanese Banks to structure their products and services upon. The result of this study has important implications.

Keywords: Taiwan, Mainland China, model, banks and financial institution, ECFA
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** PhD Student, Business Administration Department, Asia University, 500 Lioufeng Rd. Wufeng, Taichung, Taiwan R.O.C. 41354 E-mail : amrita_mn@yahoo.com for the Taiwanese bank management in guiding a successful market entry into Mainland territory.

1. RESEARCH OBJECTIVES

This research attempt endeavors to identify the opportunities and challenges faced by Taiwanese banks in light of the ECFA in order to create a competitive business advantage in Mainland China. Under the conditions of the ECFA, both sides agree to gradually reduce mutual barriers for trade and investment as well as foster a fair business environment. The government of Taiwan plans to spend NT 95 billion (USD 2.97 billion) over the next ten years period to help domestic industries and businesses upgrade their operations to compete more efficiently in globalized market economy (Gao, 2010).

The official definition of a bank is as a financial institution licensed by the government or Central Bank to provide financial services to customers, such as accept deposits and lend money, currency exchange, insurance and other financial services (Chandler, 1953 and Gouge, 1996). Despite retaining the traditional bank services, it has become necessary for banks to continuously develop innovative products and services in order to remain competitive in an increasingly globalized financial world (Chen-Yu, 2004 and Cheng-Chang, 2006). The main argument for this research is the idea that Taiwanese banks shall gradually shift their banking strategy, “from localization to internationalization” and banking structure “from traditional to modern” that an attractive strategy and an innovative structural model provides a competitive advantage to differentiate their products and services (Rogers, 1993; Rosen, Case & Staubus, 2005 and Tumpel- Gugerell, 2009).

The essential background questions for this research ask: (1) How to be

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efficient and competitive in the mainland market compared to domestic banks? (2) How to ensure the stability of banks while changing their strategic efforts? However, there are only a limited number of studies and research studies about the success of investments in the mainland market (Mohan; Nitsure & Joseph, 2005). Thus, while answering above questions, this paper guides Taiwan banks to make a prominent instructional mode on its banking strategy and model.

2. CONCEPTUAL BACKGROUND

Practitioners and researchers constantly work to understand the nature of business interaction between the two countries despite the ECFA (Warner, 2003). Similarities between language and religion between China and Taiwan help create a positive atmosphere for interaction, however significant differences occur over basic business dynamics; leadership styles, work customs and labor forces (Tang & Ward, 2003 and Liao & Jeng, 2005). A highlight of the social and business differences between the two is revealed in the tendency of Taiwanese business people to shy away from politics, whereas mainland Chinese business people have a propensity to intertwine business with politics (Chen, 2010). There are large amounts of capital investment which flow from Taiwan to Mainland China, officially reaching USD 75.9

billion, while unofficial estimates places capital investment flow from USD 200 billion to USD 400 billion as of January' 2009. Unfortunately, there is little or none of direct investment from mainland China to Taiwan, because, it is not allowed by the Taiwanese legal environment (Zhao & Tong, 2009). In 2008, Taiwan's trade with China exceeded USD 132 billion, despite the global financial crisis (The China Post, 2009).

2.1 ECONOMIC AND BANKING BRIEFING OF P. R. O. CHINA

In 1978, Mainland China started "Open Door" reform that leads to current economic development (Warner, 2003). And, by 2010, Mainland China classifies as an emerging and developing economy country (IMF, 2010). In 2000, the GDP per capita was USD 800, but by 2010 it had sharply increased up to USD 4,282.89, with the inflation rate at 3.5 percent and unemployment at 4.1 percent (IMF, 2010). After the ECFA approval, the Bank of China and the Bank of Communications established representative offices in Taiwan. China Construction Bank, China Merchants Bank and Industrial and Commercial Bank meet the capital adequacy and operation experience requirements for opening representative office in Taiwan (Lin, 2010).

Mainland China's banking market is the third largest in the world after USA and Japan (Heijes, 2008). However, the banking system of Mainland is complicated and holds large number of non performing loans. The banking sector lacks proper transparency; as a result banks can disclose their information only to government but not to the public. During 1980s, the Chinese banking system was based on a mono-bank model, in the 1990s the two tiered banking system replaced it (Lin & Zhang, 2009), and from early 2000, the Mainland government agreed to set up private banks to prepare the entry of China into the World Trade Organization (WTO). Consequently a number of private commercial banks began operations throughout Mainland

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with higher interest rates for both deposits and lending (Liu, 2002). Four state owned banks were still able to maintain their place as key players in financial market: Bank of China (BOC), the China Construction Bank (CCB), the Agricultural Bank of China (ABC), and the Industrial and Commercial Bank of China (ICBC) (Costa, Curtis & Field, 2006). But, those state owned banks were found to be less efficient and less profitable compared to the commercial private banks within market, indeed foreign banks are comparatively competitive than both state owned and private domestic banks (Lin and Zhang, 2009).

In 2003, the Chinese Banking Regulatory Commission was launched to coordinate banking related activities and spur the banking system reform (Liw, 2007). The highest priority was to overcome the weaknesses of the four state owned banks, and foster competitiveness with the more than 500 international financial institutions operating across the China (Boos.E, Boos.Ch & Sieren,

2003). The Banking Act of the P.R. of China passed in 1931 and has been amended several times, in 1989, in 1993 and in 2007, in order to meet global competitiveness (Banking Bureau, Financial Supervisory Commission, P. R.C, 2009). In 2005, three of the four banks announced plans for partial privatization therefore they enforced to enhance their loan allocation by the Chinese Banking Regulatory Commission.

According to the Ministry of Commerce of P.R.C. (2009), China formed a Closer Economic Partnership Agreement (CEPA) with Hong Kong (Kai, 2003 and Fong, 2007) and Macao, respectively, which was initially signed on March' 2003 (Trade and Industry Department of Hong Kong, 2004), followed Choosing Entry Mode to Mainland China 77

by five supplemental contracts signed between 2004 to 2009. They work cooperatively in 11 sectors, including banking (Tsang, 2005; Hong Kong Trade Development Council, 2009 and Leung, 2009). By 2009, 58 Hong Kong based banks, containing 55 branches, one financial company and two joint ventures opened their branches in Mainland. Currently, 38 of them serve with RMB (Chinese currency) covering deposits, remittances and currency exchanges to individuals and businesses (Harrison, 2004 and Yeo, 2009).

2.2 ECONOMIC AND BANKING BRIEFING OF TAIWAN R. O. C.

Taiwan known as "Formosa" is located east of the Taiwan Strait, off the southeastern coast of mainland China. Taiwan went through rapid economic growth since 1970s to become one of the Four Asian Dragons. It is categorized as an advanced economy country by the IMF (2010) and as a high income economy country by the World Bank (2009). The basis of the economy is a technology industrial park, which manufactures a major portion of electronics in the global market, the computer and semi-conductor industry generating almost 60 percent of the GDP (CIA World Fact Book, 2009 & Wang, 2010).

The main exports are agricultural products, such as rice, fisheries, banana, tea, wax apple and guava. GDP per capita is USD 34,743.31 (IMF, 2010).

Taiwanese economic development is divided into four periods: (1) import replacement period from 1949 to 1960; (2) export oriented period from 1961 to 1973; (3) export led period from 1974 to 1986; and (4) internationalization period from 1987 to present (Warner, 2003 and Leemen, 2004). Taiwan's foreign reserves are USD 281.13 billion. However, due to the global financial

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crisis, the economy sharply declined from 5.5 percent in 2008 down to 3.3 percent in 2009. Unemployment rate has been constant as 5 percent since December' 2008 until now (Zhao & Tong, 2009 and IMF, 2010).

Currently, 422 financial institutions operate under 28 regulatory laws across the Taiwan (Chen & Kao, 2010). Eight Taiwan banks disbursed a total amount of USD 495.94 million loans to firms in the Mainland, which constitutes only 0.11 percent of their total assets (Cheng & Hsu, 2009). In contrary, only about 30 percent of loans credited from Mainland banks to

Taiwanese investors. During the global financial crisis, the government of Taiwan adopted a relaxed monetary policy to help promote the financial markets and cut interest rates to influence bank liquidity (Wang, 2010), but the problem of over liquidity still remains an issue in Taiwan (Yu, 2010). After ECFA, Directorate General of Budget Accounting and Statistics (DGBAS) (2010) forecast the Taiwanese GDP to grow 8.24% in 2010 and 4.64% in 2011. Same time, the estimation of loan amount increases from 5% in 2010 to 10% in 2011. Corporate income tax was lowered to 17 percent. After ECFA approval, 27 international corporations signed investment Memorandum of Understandings (MOU) with Taiwanese companies with a total amount of NT 108 billion or USD 3 billion (Yu, 2010). Furthermore, economic impact of rising inbound tourism from Mainland China and the rising number of corporate investment are likely to influence job creation and domestic consumption. The Chinese Banking Regulation Commission approved four Taiwanese banks to set up their branches in the mainland: Land Bank of Taiwan and First Commercial Bank in Shanghai city, Taiwan Cooperative Bank in Suzhou City of Jiangsu province and Chang Hwa Bank in Kunshan City of Jiangsu province (Chen & Chang, 2009; Zhao & Tong, 2009 and China Banking Regulation Commission, 2010).

3. LITERATURE REVIEW

Bank internalization relies on two contrast theories; first, a bank's cross border expansion depends on clients' needs of a home country; and second, a bank's operation management factor is closely related to the diversification of banking products and services (Focarelli & Pozzolo, 2008). A number of comprehensive studies emphasize that a bank's success is due to economies of scale achieved in a host country, while implementing a long-term efficiency strategy allowing for quick responses to changes in the market environment (David, 1993; Lau, Law, Tse & Wong, 2000 and Howson, 2003). In particular, foreign banks shall reach a dominant position within short period, adopting structural changes to achieve an optimal balance of performance, cost and reliability without uncertainty and vagueness (Johnson & Walzer, 2000 and Ding, 2010).

3.1 PESTEL analysis provides a crucial set of inputs for further strategy development, in order to find a new area for Taiwan banks.

Early empirical studies found that it is essential to know the host country's market entry mode, such as country risk, the country openness, social and economic distance, cultural differences and asset sizes of banks (Bessis, 1998 and Johnson & Jellis, 2008). In order to achieve long-term sustainability in a new place, banks need to measure not only economic capital, but also need to assess the political, social, cultural, technological, environmental and legal

environment (Anderson & Raton, 2005). Such information has led to more favorable expectations, to balance the investment of new capital, and to reduce the asymmetric information problem to be fully – integrated financial conglomerate (Walter & Hiraki, 1993; Amable, Chatelain & De Bandt, 2002 and Mishkin, 2003). Although research stresses the PESTEL analysis (Carpenter & Sanders, 2009) is good starting point for entering into new country or region with high profitable growth and to avoid failure and negative effects in the future.

In addition, numerous studies demonstrate that PESTEL analysis provides a clear orientation ensuring business stability for new market entry. Empirical researches found different findings on operational performance between foreign banks and local banks. Majority studies concluded that foreign banks have better performance than local banks. But a few of studies stated that foreign banks frequently confronted with difficulties compared to the domestic banks (Claessens & Horen, 2009). According to the previous researches, banks need to circulate a regulatory pyramid on the basis of internal and external environment (Johnson & Gustafsson, 2003; Spath & Fahrnich, 2007 and Howson, 2008), which help to expose its strategy and expand operational function.

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3.2 Banks of Taiwan need to differentiate their operational strategy from existing banks in mainland China by introducing innovative financial products and services to the market.

Miller (1992) emphasizes that business world is constantly changing due to globalization and as a result banks need to be flexible to be able to adjust to new competition. A proper strategy is an essential tool in any business to expand to new market (Robinson & Robinson, 2004), to excel in the marketplace, and maximize the market value of their banks (Rogers, 1992). It is clear that a traditional banking strategy will not work efficiently unless bank deposits keep increasing without any barrier or credit losses. Unfortunately it does not happen, which confirmed by recent global financial crisis and most bankers force to maintain their financial positions while has been revising and updating their current strategy (Sharma, 2008 and Crotty, 2009).

According to the Lee (1999)'s research, Taiwan's inchoate financial regulation, conservative financial policy and low level of financial internationalization made Taiwan's banking sector weak blocking economic progress (Wang, 2010). Kung (2009) mentioned in his interview to Forbes magazine that Taiwan's domestic market consolidation is slow because 50% of the market share relies on government owned banks. If government owned banks don't privatize, than Taiwan will not able to consolidate the banking market and strengthen its financial service industry. During recent financial crisis, the Taiwanese government reduced the interest rate of banking industry, heavily impact on earnings of banks (Wang, 2010).

What would be the most contested strategy for Taiwanese banks? This

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paper proposes the universal bank strategy for engaging in banking, securities and insurance in order to respond to the demands of globalization. It is clear that Taiwan's advantage is high tech orientation, therefore creating new financial products and services using the latest technological trends will give advantage to Taiwan banks in Mainland market (Porter, 1998; Lee; Roehl & Choe, 2000 and Cho & Moon, 2001). However, there is no cross-country empirical evidence on universal bank strategy (Beck; Demirguc-Kunt & Levine, 2005), therefore, researchers are increasingly interested in studying the relationship between banks, security and insurance firms (Lin, Zhang & Zhu, 2009). Considering Allen and Jagtiani (2000)'s suggestion, this paper proposes a synthetic universal bank, consisting of one bank, one securities firm and one insurance company. This structure has two benefits: synergic gains and risk diversification, which will reduce cost and risk exposure. If seen from a negative point of view, a universal banks establishes its own client' foundation through their lending power, and creates conflict of interest on data transparency. But, banks' monitoring is better in emerging market such as that of Mainland China's, than in developed markets.

According to the research definition, a universal bank is combination of a commercial bank and an investment bank. The Glass-Steagall Act enacted during Great depression, which was passed in 1932 (Glass-Steagall Act, 1932) stated a separation between commercial banks and investment banking restricting its joint operation to protect bank depositors from additional risks associated with security transactions. But the act was dismantled in 1999 and replaced by The Gramm-Leach-Bliley Act (GLB) or Financial Services

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Modernization Act (1999), which opened the market among bank, security and insurance companies (The Gramm - Leach - Billey Act, 1999). The optimal universal banking service includes investment and insurance services in addition to services related to savings and loans (Walter & Hiraki, 1993; Yihong, 1998 and Terry, Hutchenson & Hun, 2000).

3.3 Creating a model for banks to verify the strategy, protect from minimal distortion of operating efficiency and ensure the long - term stability.

Designing a new structural model helps to reduce risk, creates value and validates adopted strategy (Edvardsson, 1997 and Watson, 2005). The model creates under assumptions and predictions for the future in order to earn a stable profit and maintain high return (Burton, 2003; Voelpel, Leibold, Tekie, & Krogh, 2005; and Fettke & Loos, 2007). Twelve (12) definitions of a model identified from literature review that the most common definition is a plan implemented by company to generate revenue and profit detailing long-term strategy (Smith & Hoboken, 2007). Almost 129 models are deployed in the

world, 65 of them are most successful, operating with a competitive advantage (Watson, 2005) in the global business environment. However, during model validation associated to universal bank strategy, the majority of the models are rejected because they do not fit to the term of a banking sector. The foundation of the model is derived from comparative analysis of different appropriate models in order to meet a bank's customer requirements (Klugman, Panjer, & Willmot, 2004 and Johnson; Christensen & Kagermann, 2008) and interrelates

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to the strategy presented in this paper. Moreover, Chinese banks are going to modify their banking model by 2010 reflecting changes in the legal and economic environment, product offerings, customer demand and market competition (Liaw, 2007).

How to design a new model for Taiwanese banks integrating universal banking strategy? The equal distribution of financial activity designated according to the full service -universal bank, composes with investment, commercial savings, loan service and insurance (Walter & Hiraki, 1993, Smith & Walter, 1997, and Chen & Kao, 2010). Modern universal banking system represents two basic financial models; one is capital market based financial model and second is bank based financial model. American and England banks are the best examples of capital market based financial model, while Japan and European banks have been heavily influenced by the bank based financial model (Padoan, Brenton, Boyd, 2003) and for decades universal bank have been the secret of their economic success (James, 2001).

4. RESEARCH ANALYSIS

The research analysis is divided into three parts and based on secondary data collected from extensive literature reviews as stated on section 3: 1) PESTEL analysis on external environment of banking, securities and insurance sector in order to understand the current situation within Mainland and further use for a guide into bank strategy and business models; 2) Universal bank strategy increases financial stability of banks while extending the scope of Choosing Entry Mode to Mainland China 85 activities that quickly respond to local market demand; and 3) Creating a bank based structural model equalizes power – and equalizes opportunities to successfully implement a strategy.

4.1 PESTEL analysis on external environment of banking, securities and insurance sector.

China market significantly high rates for foreign banks than domestic, indeed foreign banks have more advantages that promoting competitive products and services (Liping, 2004). However, from a different angle, the relative importance of foreign banks in China is only 10 percent (Claessens & Horen, 2009). Consequently, while Chinese financial market is being liberalized, the Taiwanese banks shall prepare its strategy and model to enter Mainland China.

Politic

The politics of the People's Republic of China based on a single-party socialist republic. State power is exercised through the Communist Party, the Central People's Government and local provincial counterparts (National People's Congress, 2010). Since early 1990s, worldwide political scientists have been working on guiding research for politics and globalization in Mainland China (Wei, 2007). Most academic literatures highlight the slow pace of democratization of Mainland, but beyond this slow political reform, Mainland building modern market economy. China banks are more political than business entities; even local governments of cities have huge influence

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over the city commercial banks and influence on client's decision making (Heijen, 2008). Before, the main problem for Chinese banks was nonperformed loans, but these days they fix the problem by allocating capital more efficiently and earn a sound return on investment.

In 2001, China entered to World Trade Organization (WTO) by was making banking reform that allow foreign banks to do local currency business in Mainland market and enjoy with as same right as domestic banks. Currently, foreign banks in Mainland able to lower corporate income tax up to 15 percent from 33 percent compared to domestic banks (Siackhachanh, 2006).

Additionally, all geographic and customer restrictions removed within five years from 2006 to 2011. The cross-border supply of services allows transferring financial information, financial data processing, and other auxiliary financial service by suppliers (International Trade Administration, 2001). The 9 main cities dominated by foreign banks are Shanghai, Shenzhen, Tianjin, Dalian, Guangzhou, Zhuhai, Qingdao, Nanjing and Wuhan.

Economy

The Chinese economy has been growing fast and becoming the second largest economy after United States of America. China's economy has moved from centrally planned to a market economy, at the same time an economic migration from rural to urban areas become one of the greatest challenges for local economies, quite different from Taiwan. Thus, economic stability in both sides is an essential condition for banking industry. In China, the banking system has been changing dramatically, undergoing an important transformation that would make its banking sector one of the most attractive

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financial targets in the world. Nowadays, many researchers study the relationship between bank development and economic growth of China, but no direct research has been done on the reactions (Chang, Jia & Wang, 2010). State ownership of the banks may be inefficient and ineffective, diminishing potential for economic growth (Chang, Jia & Wang, 2010) and Mainland China's financial liberalization has not completed yet.

In the first half of 2010, yuan deposits increased CNY7.63 trillion

(Ruan, 2010) and loans grew from 102% of GDP in 2008 to 127% in 2009 (The Economist, 2010). China has two stock exchanges, the Shanghai and Shenzhen Stock Exchange. The market capitalization of Shenzhen Stock exchange is 1 trillion USD as of October' 2010 (Shenzhen Stock Exchange, 2010) and market cap of Shanghai stock exchange is 2.4 trillion USD as of August' 2010 (Shanghai Stock Exchange, 2010), respectively. The yuan has risen about 3% against the dollar since June' 2010 to RMB 6.6239 and foreign currency reserve of China is \$2.65 trillion as more than double any other country.

Social-culture

The demographics of China identified by large population as 1.3 billion, unfortunately, the youth rate has begun to decline in part due to the one-child policy. 20,1% is between 0-14 years age, 71.9% is from 15 to 64 years and 8% is over 65 years age as of 2008. National average density is 137 people per km² as of 2007. 42,3% live in urban area and 57,7% live in rural area of China. By education, 15,6% of total population do not attend any school, 35,7% completed primary school, 45,1 % have secondary school education, and 3.6%

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have advanced education (World Bank, 2010). The rural area people and lowlevel groups of China do not know much about foreign banks and have never served. The research presented here raises the question, who is a customer of foreign bank in China and why they choice? Foreign bank branches shall not be focus only on traditional banking activities, alternatively, shall concentrate on niche market and private equity fund (Xu, 2010), because there are increasingly have wealthy customers, who are willing to consume.

Simultaneously, the wealth management grows in Taiwan that equity and bond fund amounts continue to grow in 2011 (Yu, 2010). Cross country study shows: 1) foreign banks have flexible matching needs and requirements of customers; 2) foreign banks can provide more innovative services and products; 3) foreign banks use state-of-art technology for their delivery channels and networks; and 4) foreign banks employ professional experienced staffs (Xian & Fuping, 2005).

Chinese culture started from 2000 BC. Personal relationship or “guanxi” is the most important concept in business network and is cultural characteristic of the mainland market (Heijes, 2008). Every business in Mainland requires building a good relationship with local government officials, consultants, agents and employees. The right relationship must develop before business starts and this can bring long-term and successful business in Mainland.

Another important thing is “mianzi” means face or considered as saving face, losing face and giving faces and a respect for nature (Gorrill, 2008). The common socio-cultural barriers in Mainland China are lack of corporate governance standards that the most banks are state owned as independent

directors have not yet completely become a part of the culture in the financial industry (Kodjo, 2007). One of the determinants of socio-cultural perspectives in banks is salary range that employees of domestic banks earn a lower salary compared to the employees, who work in foreign banks (Heijes, 2008), which have a direct effect on customer relationship satisfaction and commitment to work.

Technology

Scholars discovered that Chinese technology started from 600 AD. Nowadays, in order to meet the new challenges in the global economy, Ministry of Science and Technology of P. R. China decides to organize 12 mega-projects on 863 national key technologies R & D program. According to these projects, there is developing advanced technologies of construction, information and communication and other sectors to enhance innovation processes and to encourage the international cooperation. The Ministry of Science and Technology and China Banking Regulatory Commission cooperatively launched a one-year initiative to grant loan for small and medium tech business (Ministry of Science and Technology of R. P. China, 2010).

Foreign banks challenge domestic banks on internet banking or technology-oriented bank services. Hence, domestic banks need to make investment to modernize the information technology to compete with foreign entrants that allow the creation of new opportunities with increased competition. Mainland China banking technology will grow at 8.5 percent from 2008 to 2013 while banking business function will hold the highest growth opportunities level. Service innovation and technology innovation (Jana, 2007) will play a key role in banking business.

Environment of securities and insurance

China's securities market developed rapidly since the 1980s. As of the 2010, a total of 106 security companies operate in Mainland China, including 9 foreign-funded joint stock security companies. According to the procedures, a representative office of foreign securities institutions shall become a member of Chinese stock exchange, than a license will be issued on basis of prudential ratio. Foreign investment banks successfully enter the Mainland market and build up corporate image. The maximum foreign investment shall be up to 33 percent to establish joint venture and to conduct domestic securities investment fund management business (International Trade Administration, 2001) in Mainland China. Recent years, banks diversified their business to custody of securities and investment funds (Neftci & Xu, 2007). Mainland banks started to issue transfer-operate-transfers (TOT) option of private equity fund that almost 40 TOT products have been issued in Mainland as of 2010 (Baohua, Juan & Zhiyun, 2010). Moreover, many foreign banks have been changing their banking direction to the personal finance managing market, such as Citi

bank, HSBC and Standard Chartered who designed own personal financing brands. Capital market of Mainland started to impact on smooth functioning hierarchy and contributes on resource allocation (Canals, 2002) of financial institutions.

In Mainland China, the insurance industry develops so efficiently and effectively that in the first half of 2010, the insurance premiums rose by 34 percent or 800 billion yuan (USD 120 billion), according to data from China's insurance regulator. The foreign insurers are very keen to enter to mainland market, but the foreign insurance company should have 30 years of experience and at least two years operation in Mainland. The Chinese Insurance Regulatory Commission issues an insurance license basis on prudential criteria and total assets exceeding USD 500 million. Foreign non-life insurers need to formulate “master policy” insurance to insure large-scale commercial risks with no geographic restrictions to both foreign and domestic clients (International Trade Administration, 2001). In Mainland, the cooperation between insurer and banks rapidly strengthen that banks become a major distribution channel for life insurance. Moreover, in practice, since 1990, the term bank assurance has been used among public in consistent way, which is sales of insurance through bank’s distribution channel (Wang, 2010). Besides, Wang (2010) stated that near future, the insurance securitization will be popular in Mainland financial market with increased demand among community. Currently, foreign insurance companies find it quite difficult to run an insurance business due to policies and procedures. Still, Mainland China is expected to revise the insurance law, including risk prevention, insurance supervision and consumer interests.

Legal environment

China’s financial legal environment has not had an enough time to mature and develop like that of the industrialized countries (Berger, Hasan & Zhou, 2009). The bank permission issues by People’s Bank of China, than registers by the Administration for Industry and Commerce, thereafter banks permit to obtain a business license. The banking activities are regulated by the Commercial Banking Law, the organizational structure of banks by Company Law, and market risk management by the Guidelines on Market Risk Management of Commercial Banks of P.R.Chna, respectively. Also, foreign funded banks are administered by the Administration of Foreign-funded Banks and its regulations (China Banking Regulation Commission, 2010). The securities and insurance companies need to have an approval from the China Securities Regulatory Commission and China Insurance Regulatory Commission.

One thing to be mention is four big banks of Mainland China was expanded to universal banking involving trust, securities, and insurance

services in 1986, but terminated in 1993 (Fu & Heffernan, 2009). The reason of termination was the state council decided to do the second banking reform to create competitive commercial banking system. In 1995, the Commercial banking law passed and prohibited trust fund, stock business and investment to real estate. However, according to this law, commercial bank allows to conduct insurance business, issue financial bonds and act as an agent to underwrite government bonds (Commercial Banking Law of P.R.China, 1995) under official permission. Recently, China Banking Regulation Commission issued the “Notice” for regulation of wealth management between banks and trust companies that benefit all participants in order to satisfy the market demand (China Banking Regulation Commission, 2010). The main objective is to create a competitive commercial bank in domestic and international financial market.

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The main difficult issue for foreign banks in Mainland is regulatory and supervisory banking requirements by the CBRC. Fortunately, foreign banks are less influenced by local policies thus more efficiently respond to the market demand on timely manner (Heijes, 2008). Some literatures stressed that (Walter & Hiraki, 1993 and Irvine, 2003) the regulatory apparatus protects the shareholders rights and increases the responsibility toward to the efficient decision of management. Nevertheless, it is required to remove the barrier between bank and securities firm and insurance firm that furthermore will have positive implications to market behavior.

4.2 Universal bank strategy increases financial stability of banks while extending the scope of activities that quickly respond to local market demand.

Universal bank strategy is not only focusing on traditional banking services and products, but also takes a novel approach to security and insurance services on demand. At the current stage, the capital standards of banks have been negotiated between Taiwan and Mainland and will be ready shortly (Chen, 2009). The changing geographical location of financial services, banks of Taiwan need to change its core perspective to universal bank. As noted, a universal banking strategy diversifies customer portfolio by offering a wide range of financial services at a comparatively cheaper price and build stable customer relationship. This strategy had examined in Western European countries since 1980s and proven to be successful, especially in cross –border extension of banking operation. Since 1995, United States of America has been gradually transferred to universal banking operation (Smith, 1993 and Canals, 2002) and currently the most American banks are adopted a universal banking strategy. We considered that in a competitive market some actions have taken can be seen as a perfect in the short–term, but cause a failure in the market in the long run (Edwards, 2007). However, a universal banking strategy brings a

step toward future diversifying new market opportunities (Holland, Lockett & Blackman, 1998).

Foreign banks enter the mainland market through a foreign bank branch, wholly-owned by a foreign bank, joint-venture or acquisition. The first cross-border merger happened between Hong Kong and Shanghai bank (Smith, 1993), which reduced redundant overhead and increased the profit margin. Joint ventures are not considered an efficient method in the banking sector worldwide, as well as in Mainland China. Since 1980s, foreign banks started to establish joint venture in Mainland, but have not succeeded until now. Rather, a foreign bank branch has much faster growth in Mainland market. Because, a foreign bank branch easily adapts internal infrastructure and promotes a highly diversified strategy. Considering this point, Taiwan banks need to establish core branch in Mainland China. Currently, government owned -First Financial Holding, quasi-government owned - Hua Nan Commercial Bank, and private - Cathay, Fubon and China Trust opened its branches in Mainland, but they are very unlikely to invest in Mainland China banks or allow investments by Mainland banks (Chen, 2010). However, it is feasible that some small banks may have acquisition, for example, the most probable acquisition target is Chinfon Bank (Chen, 2010).

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Universal bank possess considerable freedom in financial market that held large equity portfolios, also enhances the degree of competition and risktaking

behavior of banks. Theory and evidence suggests that bank and insurance are more likely to be in quite different “strategy” category that raises serious doubts concerning whether universality is possible or not.

Fundamentally, bank and security firm have short-term outlook and insurance has long-term outlook. In spite of that universal banking does not mean to compete among an insurance company and bank nor between security firm and bank. Thus they do not need to see each other as competitors in their activities outside Taiwan, instead need to focus on penetration the target arena at mainland market. In Mainland China’s case, foreign banks sharply expanded their operation with a more exposed strategy while concentrating on corporate banking, treasury and trade finance, fund and wealth management (Liaw, 2007).

Figure 1. Timetable of branches in Mainland

Source: (Yu, 2010)

The representative office of Taiwan bank can upgrade its branch status after one year regular business operation that capable to lend RMB to Taiwanese corporations in Mainland China. After two years profitable

1 year 1 year

3-6 months

ECFA signed

June’ 2010

Taiwan FSC

approval
August' 2010
Mainland Regulator
Approval
September' 2010
Preparation
period
1-2 months
Apply for
opening
from
Mainland
regulators
Upgrade
branch
status in
Mainland
Upgrade
branch
status in
Mainland

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operation, it can upgrade again that able to lend RMB to Mainland companies. Figure 1 shows detailed time table of Taiwan banks to enter Mainland market.

4.3 Creating a bank based structural model equalizes power – and equalizes opportunities to successfully implement a strategy.

This part aims to design a model structuring for bank, securities and insurance firms to validate the strategy and to fully respond to the market demand. In the first two years, Taiwanese business people in Mainland will be major customers (Chen, 2010) of a representative office of Taiwan bank. According to the analyst review (Lo, 2009) Taiwanese banks shall wait up to two years to do transaction on Yuan (RMB) and no immediate rating implications for them, even thought, ECFA will allow to Taiwanese banks to tap in Mainland market (Moody's, 2010). Therefore, within this two year period, Taiwan bank requires to adjust a model to fit universal banking strategy and localize operational mechanism to reach local customers in mainland market. At the same time, the model reflects on prices and rates of products and services to take competitive advantage in the market.

Whether it requires incremental or radical changes, bank needs draw a unique product design and a product improvement on existing product lines. The paper proposes Diamond-Dybvig model (Diamond & Dybvig, 2000) to be an efficient technique applicable to the Taiwan banks. According to this model, first, if depositors are uncertain of the state of their deposits, banks can share their risks with future liquidity needs (Sargent, 2010) through deposit insurance.

Second, banks provide maturity and liquidity transformation to increase longterm investments through loans, deposits and fund management. Third, banks can mix illiquid assets (such as business or mortgage loans) and liquid liabilities. This model enables to have a power in the Mainland market and equalize opportunities to access financial resources by own capacities. The key player is a branch of commercial bank and security and insurance firm become legally separate subsidiaries of the bank. The main limitations of bank based structural model are erosion of the coherence of the financial system and excessive risk can be accumulated bank (Padoan, Brenton and Boyd, 2003).

Structural chart is shown at Figure 2.

Figure 2. Structural chart of the model

The strength and weakness of a model mapped on Table 1. The model provides better allocation of financial resources, exploits linkages among the business units, diversify sources of earnings and potential for risk substitution. The key success factors in Mainland shall be scale, a low cost and full set of unique products and services base on the latest technology. The combination of investment banking and insurance service with a big retail base are attractive (James, 2001) for the time being. In view of the uncertainty in the financial market, bank needs to maintain a more liquid balance with cost effective

Insurance firms

Branch of commercial Bank

Securities firms

Universal banking strategy

Bank based structural model

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functions. Moreover, from time to time as part of its product offerings, universal bank develops new corporate image focusing on comprehensive and quality to the mainland customers.

Table 1: Testing of strength and weakness

Universal banking strategy

Strength Weaknesses

Static

efficiency

Dynamic efficiency

Bank based structure

model

Too-big-to-fail

Customers offered onestop

financial shopping

More complex

Business

diversification makes

banks able to withstand

various shocks.

Requires high

controlled expense
management
Increased synergies Deregulation needed
Cost efficiency (Lin, 2010)
Technology changes Policy pressure

5. FURTHER ACTIONS AND DISCUSSION

Every model and every strategy carries own risk (Ineichen, 2007), especially a universal bank model has blurring of risks, such as effusion of risk on stability of operations and integrations, also too big to manage and synergies are not realized, hence risk validation shall be executed for further full capacity growth (Shafer, Smith and Linder, 2005). Thus, quantitative assessment of risks are a vital part of due diligence, when banks enter a new market and maintain a stable and accountable financial source (Walter & Hiraki, 1993).

All aspects of risk could have adverse effects on the achievement of Taiwanese banks when to enter Mainland market and risk management issues Choosing Entry Mode to Mainland China 99 will affect further efficiency, competitiveness and stability. As a universal bank, it will face long –term future uncertainties, which they intend to account for it. Mainland China banks are heavily investing on risk management system and cooperate with foreign banks on improvement of their technical skills and product offerings. Two principle approaches are mostly used for measurement of risks: scenario analysis and value at risk (VaR).

The starting point to estimate the exposing risks of universal bank is value at risk (VaR) (Dunis, Timmermann & Moody, 2001) that is effectively used to improve a bank's decision making process. Researchers concerns on measurement techniques, in actual practice, value at risk identify the solution on bank's coordination mechanisms and characteristics of individual business units (Bessis, 1998). Risk for different business lines within universal bank and risk transmission across product and service lines are essential for bank managers. VaR forecasts the minimum expected loss over given time interval and increasingly used by financial institutions. Daily profit and loss from securities activities, insurance services and retail functions are all associated with VaR forecast (Berkovitz & O'Brien, 2001). Furthermore, this paper proposes to conduct VaR analysis on bank and its subsidiary security and insurance firms, whether the strategy and model can be controlled by risk techniques.

6. SUMMARY OF RESEARCH OUTCOME AND IMPLICATION

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In principle, a bank is defined as one of the financial institutions gradually improving their market shares with new innovative banking services

and become highly competitive worldwide. We do not reject the monopolistic competition of banking market in Mainland China. However, there is still exists some discrimination between foreign owned and domestic banks, even between government owned and private-domestic banks in mainland market. Our approach ultimately is determined by actual situation in Mainland developing more radical new approach in consolidation of financial system and protection from any financial crisis. Many foreign banks are evaluating Mainland banking market as potential market entry, but the route to entry is still very complicated. Overall, the universal banking strategy and bank based structural model simultaneously suits the banks of Taiwan in order to obtain sustainable, efficient and competitive advantage in mainland market. However, it is intended to follow up the quality of banks to ensure the stabilization of their operation in the long run and supervise the internal control system for safe and sound operation of banks.

As a foreign bank, Taiwanese banks will play an important role for external financial market development of Mainland China and the universal banking strategy will bridge direct investment. The major advantage of proposing strategy and model is positive linkages between financial market and economic growth, besides Taiwan banks can influence by technology innovation and management techniques that have greater access to resources than domestic banks. As mentioned before Mainland China has large banking system, which their financial resources cannot allocate efficiently and

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effectively, moreover domestic banks are still unstable. On the other hand, Mainland has been forced to change their banking markets with investment and foreign skills.

Finally, it shall note that government of Mainland China shall amend some other regulations in order to move toward with banking market-oriented economy, such as reducing control of interest rate, promoting bank privatization and decreasing market entry barrier for foreign banks (Chan, Fung & Thapa, 2007). This paper gives positive implication for bank managers on structure of the bank that focusing on commercial banking services expended to the securities and insurance services. Nonetheless, increased flexibility of banks requires complex restructuring and wakes the banks to new directions. Everybody wins, nobody losses.

APPENDIX 1.

Capital investment limit in China and Taiwan

China regulation

(to foreign institutions)

Taiwan regulation

(to Chinese institutions)

Bank

Investment:

single $\leq 20\%$ single $\leq 5\%$

total <=25% total <=10%
Business: limited RMB
business

Insurance Investment: foreign <=50%

Listed single <=5%

total <=10%

Unlisted single <=10%

total <=15%

Securities Investment:

unlisted <=33% Listed single <=5%

listed <=20% total <=10%

total <=25% Unlisted single <=10%

Business: no A-share brokerage total <=15%

Source: *Yu, 2010*

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APPENDIX 2.

Summary statistics of Mainland banking sector

Items

Mainland Taiwan

2007 2008 2007 2008

Bank capital to assets ratio (%) 5.8 6.1 6.75% 6.43%

Bank non-performing loans to total gross loans (%) 6.2 2.4 1.36% 1.26%

Domestic credit provided by banking sector (% of
GDP)

132.0 126.2 44.23% 46.27%

Insurance penetration (% of GDP) 2.85 3.2 14.5 13

Market capitalization of listed companies (% of GDP) 177.09 61.6 171.57% 95.15%

Source: *Claessens & Horen, 2009 and Worldbank, 2010*

APPENDIX 3.

Types of banks and financial institutions in Mainland China

Type of banks and financial institution Number

Policy banks 3

State-owned commercial banks 4

Joint-stock commercial banks 13

City commercial banks 115

Rural commercial banks 57

Asset management companies 4

Trust and investment companies 59

Finance companies affiliated to business groups 74

Representative offices of 173 foreign banks from 40 countries
(in 23 cities of Mainland China)

238

Operational entities of 71 foreign banks from 20 countries
(in 23 cities of Mainland China)

238

Source: *China Banking Regulatory Commission, 2010*

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APPENDIX 3.

List of Taiwanese banks (34)

Name of Bank Private / Public /
State owned

Branch in Hong

Kong or

mainland China

Name of Bank Private /

Public / State

owned

Branch in Hong

Kong or

mainland China

Bank of Kaoshiung Private None Land Bank of
Taiwan

State owned

bank

None

Bank of Panshin private n/a **Hua Nan**

Commercial

Bank

Quasigovernment

Hong Kong and

Mainland China

Bank Sinopac Private Mainland China Hwatai Bank Private None

Bank of Taipei Private Mainland China Jih Sun

International

Commercial Bank

Private None

Bank of Taiwan State owned Mainland China

and Hong Kong

Industrial Bank of

Taiwan

Public Hong Kong

Cathay United

Bank

Private Hong Kong and

Shanghai

Mega International

Commercial Bank

Public (TSE:

2886)

Hong Kong

Chang Hwa Bank Public (TSE:

2801)

Hong Kong Shanghai

Commercial and

Savings Bank

Private bank Hong Kong

Chinatrust

Commercial Bank

Private Hong Kong Sunny Bank Private n/a

China

Development

Industrial Bank

Government
 owned
 None Tachong Bank Public n/a
 Chinfon Bank private None Taichung Bank Public
 (TSEC:2812)
 Cosmos bank private None **Taipei Fubon**
Bank
Public
(TWSE:2881)
Hong Kong
 COTA Commercial
 Bank
 Private None Taishin
 International Bank
 Private Hong Kong
 EnTie Commercial
 Bank
 Public None Taiwan Business
 Bank
 Private Hong Kong
 E.Sun Bank Private Hong Kong Taiwan
 Cooperative Bank
 Public:
 TSEC:5854
 None
 Far Eastern
 international Bank
 Public TSE:
 2849
 Hong Kong Taiwan Shin Kong
 Commercial Bank
 Private Hong Kong
First Financial
Holding
Government
owned
 Yuanta Bank Public Hong Kong
 King's Town Bank Public None Union Bank of
 Taiwan
 Private Hong Kong

Source: Wikipedia, 2010

Note: Bank with a representative office or branch in Mainland China stated in bold letters.

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