An overview of the Taiwanese qualified foreign institutional investor system

Karen Lu

1. Introduction

This paper details, at high level, JPMorgan's global custody and local custody experience of the Taiwanese qualified foreign institutional investor (QFII) model. The paper focuses on foreign exchange and quota monitoring systems in relation to the equity market from a foreign investors' perspective. Furthermore the paper also provides background market information; information on liberalisation initiatives which have modernised the QFII's investment opportunities; and details of market standards and mechanics, as well as adopted best practices, in relation to foreign exchange.

2. Background

The Taiwan Stock Exchange commenced operations in February 1962 with foreign investors admitted in 1982, pursuant to the Introduction of Foreign Investment Plan approved by the Executive Yuan (the administration). The Introduction of Foreign Investment Plan was a three-phase policy and was adopted as follows:

Phase 1: Direct investment through buying beneficiary certificates of securities investment trust funds;

Phase 2: Direct investment in securities by approved foreign investment institutions (QFIIs); and

Phase 3: Direct investment in securities by non-resident individuals of Taiwanese origin or otherwise (generalised foreign individual investors or GFIIs).

On 28 December 1990, in accordance with the amended Regulations Governing Securities Investment by Overseas Chinese and Foreign Investors and Remittance Procedures promulgated by the Executive Yuan, foreign institutional investors were permitted to invest directly in local securities with the approval of the securities authority. To cope with the internationalisation and liberalisation of the securities market, the Regulation was amended again on 8 November 1993, 5 July 1995 and 3 January 1996, to relax some investment restrictions on a step-by-step basis (see Section 5). Since inception, foreign institutional investors have assumed an important role in introducing professional investment techniques as well as providing the securities authority with the opportunity to experience the management of such investors. As a result of this experience, the Regulations were further revised and promulgated on 1 March 1996 to allow non-resident individuals of Taiwanese origin or otherwise to invest directly in local securities.

The Taiwan market has undergone much liberalisation in relation to exchange rates, capital flow, interest rates, financial institution development and securities market enhancements (see Section 6). Through various market directives, which resulted in amended rules and regulations, enhancements have helped modernise the market, encouraging greater foreign investment whilst maintaining adequate control, monitoring and supervision. The key laws applicable to the securities market are the Banking Law, the Securities and Exchange Law and the Insurance Law.

3. Policy framework in relation to QFIIs

Liberalisation of the market for foreign investors will continue with a three-step plan through the period 2002-4. The Statute for Investment by Foreign Nationals ("The Statute"), introduced in 1954 and amended in 1997, provides the main framework for QFIIs and foreign investors.

Article 7 of the Statute prohibits investment in certain industries, while Article 8 requests the foreign investor to submit an investment application along with an investment plan and relevant documents to the competent authority.

Three other areas which may influence QFIIs, if indirectly, are foreign exchange, choice of financial institution, and the Securities and Exchange Law.

Foreign exchange regulation

In 1949 Taiwan promulgated the Statute Governing Foreign Exchange, which was subsequently amended in 1970 with the introduction of fixed exchange rates, whereby the Central Bank managed the foreign exchange system countrywide through authorised foreign exchange banks. A shift to a flexible exchange rate system (floating rate) was adopted in 1978, with rates influenced by the Central Bank through effective control. 1989 saw the central exchange rate move to a floating exchange rate mechanism albeit with reference rates limiting fluctuations to +/– USD 0.1. In 1990 reference exchange rates were abolished, which provided banks with full discretion to negotiate foreign exchange rates, based on cost of capital, supply and demand, and the bank's position.

Liberalisation of the establishment of financial institutions

For a number of decades, Taiwan adopted a restrictive policy on financial institutions with a view to creating stability; however, this policy restricted improvements, as well as quality of service. The government then took steps to liberalise, allowing establishment of new financial institutions. In 1988 the government permitted the establishment of securities firms, which led to a sixfold increase in securities brokerage firms, securities dealers and underwriters during the next 10 years.

Securities and Exchange Law

Under Article 14-1. public companies, securities exchanges, securities firms and enterprises shall establish financial and operational internal control systems. The competent authority may prescribe rules governing internal control systems of companies or enterprises, providing a framework for corporate governance.

4. Market considerations for QFIIs

Operationally, foreign investors have four key areas for consideration when investing in the market:

(a) Application process

(b) Investment quota

(c) Settlement mechanics

(d) Reporting process

In order to supervise, monitor and administer the market, the authorities introduced reporting controls at market entry, foreign exchange execution, and at the point of trading and settlement. Originally foreign investors found it difficult to meet the QFII qualification criteria, resulting in limited investment applications (1991). The Taiwanese authorities gradually relaxed the application criteria, resulting in an increase of QFII accounts and inward remittance (1993). Further increases were witnessed as the market broadened the eligibility criteria to include pension funds (1995) and mutual funds (1996). As supervisory experience was gained through the development of the QFII and GFII systems, further steps were taken to relax the market entry criteria (2001). This has resulted in the current QFII investment position, which to date tallies at 656 QFII accounts and investment of inward remittances of USD 36 billion.

Table 1
History of QFII market developments

Year	High-level QFII market developments
1982	Executive Yuan approved three-phase policy *Phase 1*: Indirect Investment through buying of beneficiary certificates of securities investments trust funds. *Phase 2*: Direct investment in securities by Qualified Foreign Institutional Investors (QFIIs). *Phase 3*: Direct investment in securities by non-resident individuals of Taiwanese origin or otherwise (GFIIs).
1991	QFII programme introduced.
1992	55 foreign investors applied and obtained approval (QFIIs).
1993	Authorities commence relaxation of QFII qualification criteria.
1995	Foreign investor QFII eligibility extended to include pension funds.
1996	Introduction of non-resident individuals of Taiwanese origin or otherwise (GFIIs), foreign investor QFII eligibility extended to include mutual funds.
2001	Relaxation of Taiwan securities market in line with preparation to enter the WTO.

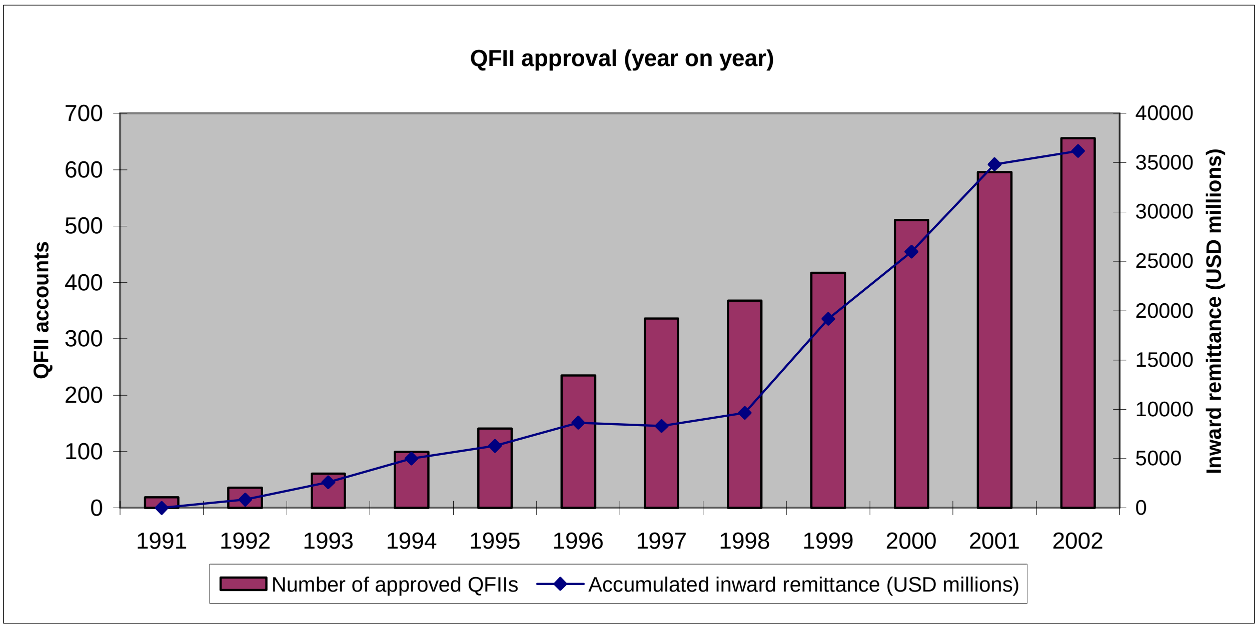
Table 2
Market shares for different types of investors, June 2002

Local institutional investors	Foreign institutional investors	Local individual investors
10.5%	6.1%	83.4%

QFII approval compared to USD investment year on year (1991-2002)

The following graph provides a comparison between the liberalisation of investor eligibility criteria, and therefore application approval, and the corresponding US dollars remitted into the Taiwan market.

Graph 1
QFII approvals and inward remittance



5. Overview of QFII liberalisation

Since the inception of foreign institutional investors (QFIIs) in 1991, the Taiwan market has gradually liberalised entry criteria to an almost uniform "total assets exceeding USD 200 million", across all investor types:

Table 3

QFII eligibility and entry criteria

Investor type	1991	1993	1995	1996	2001
Bank	– Top 500 banks. – Total securities > USD 0.3bn.	Top 1,000 banks.	No change.	No change.	– Total securities > USD 0.2bn. – Established for 1 year. – Securities custody and management experience. – International finance or trust experience.
Insurance company	– 10 years' experience – Total securities > USD 0.5bn.	– 5 years' experience.	– 3 years' experience – Total securities > USD 0.3bn	No change.	– Total securities > USD 0.2bn. – 1 year of insurance experience.
Fund manager	– Incorporated for 5 years. – Total securities > USD 0.5bn.	– Incorporated for 3 years. – Total securities > USD 0.3bn.	– Total securities > USD 0.2bn	No change.	– Assets > USD 0.2bn. – Incorporated for 1 year.
Mutual fund/unit trust	n/a	n/a	n/a	– Incorporated for 3 years. – Total securities > USD 0.2bn.	– Assets > USD 0.2bn. – Incorporated for 1 year.
Securities house	n/a	– Intl experience in securities. – Total assets > USD 0.150bn.	No change	No change.	No change.
Foreign government	n/a	n/a	– Foreign governments permitted.	No change.	No change.
Pension fund	n/a	n/a	– Incorporated for 2 years.	No change.	No change.
Other investors	n/a	n/a	– Other investors to be approved by the Securities and Futures Commission.	No change.	– Total securities > USD 0.2bn. – Established for 1 year.

6. Overview of market liberalisation

The liberalisation of the market can be evidenced in five main areas: exchange rate, capital flow, interest rates, financial institutions and securities markets. The table below provides a timeline for liberalisation of these areas.

Table 4

Summary of financial market liberalisation

Year	Exchange rate liberalisation	Capital flow liberalisation	Interest rate liberalisation	Financial institution liberalisation	Securities market liberalisation
1976				Money market established.	
1978	Flexible exchange rate system established.				
1979		Foreign exchange market opened.			
1980			Banks permitted to set interest rates on negotiable certificates of deposit and debentures and bill discounts.		
1983					Securities investment trust system established.
1984		Offshore banking units (OBUs) opened.		Rules governing establishment of branches by domestic banks relaxed.	
1985			Banks permitted to set their own interest rates.		
1986				Foreign banks permitted to establish branches outside Taipei.	– Banks permitted to invest in foreign securities through specific trust funds. – Private and state enterprises permitted to issue bonds.

Table 4 (cont)

Summary of financial market liberalisation

Year	Exchange rate liberalisation	Capital flow liberalisation	Interest rate liberalisation	Financial institution liberalisation	Securities market liberalisation
1987		Foreign exchange control on trade-related transactions abolished. Relaxation on repatriation without permission, USD 5m. Inward remittance USD 50,000 per person.			
1988				Securities houses permitted in the market.	– Revision to the securities transaction law. – Foreign institutional investors permitted to invest in the market.
1989	Central exchange rate system replaced by negotiable exchange rate system.	Foreign exchange interbank call loan market established.	Interest rates liberalised.		– Foreign brokerage firms permitted to open branches. – Over-the-counter market opened.
1990	TWD exchange rate free floating and determined by market forces.				
1991		Forward foreign exchange market established.			– Permission given for Taiwan Depository Receipts. – QFII programme introduced. – Foreign ownership level (FOL) 10%.
1992		Repatriation and remittance increased to USD 5m per person.			– Insurance market opened to foreign insurance companies. – Domestic companies permitted to issue global depository receipts.

Table 4 (cont)

Summary of financial market liberalisation

Year	Exchange rate liberalisation	Capital flow liberalisation	Interest rate liberalisation	Financial institution liberalisation	Securities market liberalisation
1993		– QFII investment limit raised from USD 100m to USD 200m. – QFIIs permitted to return repatriated funds to the market within a three-month period from the point of repatriation.		Establishment of commercial banks permitted.	
1995		QFII investment quota raised from USD 200m to USD 400m.			– QFIIs permitted to trade non-deliverable forwards. – Securities traded on the TSE become scripless. – Liberalisation of QFII entry criteria. – FOL 15%.
1996					– FOL 25%. – GFII introduced.
1998		QFII investment quota raised from USD 400m to USD 600m.			– Taiwan Futures Exchange established. – FOL 30% (96-97 FOL 25%).
1999		QFII investment quota raised from USD 600m to USD 1.2bn.			FOL 50%.
2000		QFII investment quota raised from USD 1.2bn to USD 2bn.			FOL removed for the majority of market securities.
2001		QFII investment quota raised from USD 2bn to USD 3bn.			Liberalisation of entry criteria for QFII investors.

7. QFII funding

Taiwan's QFII funding can be described under three main headings:

– Investment quota

– Foreign exchange

– Reporting

7.1 Investment quota

The securities authority determines a maximum investment quota for each QFII after consulting with the foreign exchange authority. The investment quota is calculated and monitored in US dollars. The investment quota remitted into Taiwan must be converted into New Taiwan dollars within the prescribed period set by the securities authority. The portion of the quota which is not remitted and converted within the prescribed period loses its eligibility to be remitted and converted and is effectively forfeited.

Over a period of time step-by-step liberalisation has been adopted. The investment quota system, the mechanism of which covers the ceiling, quota remittance period and FX conversion procedure, has been altered, providing more opportunities to the foreign investor. The table below provides an overview of the market as it has developed.

Table 5

Overview of quota development

Year	Country quota ceiling (in US dollars)	Quota ceiling for each QFII (in US dollars)	Quota remit period	Quota revolving period	Repatriation restriction	
					Principal	Gain
1991	2.5bn	50m	3 months	nil	3 months	annually
1993	**5.0bn**	**200m**	**6 months**	**3 months**	3 months	annually
1994	**7.5bn**	200m	6 months	3 months	3 months	annually
1995	**lifted**	**400m**	6 months	3 months	3 months	annually
1996	lifted	**600m**	6 months	**6 months**	**lifted**	**lifted**
1997	lifted	600m	**1 year**	**1 year**	lifted	lifted
1998	lifted	600m	1 year	1 year	lifted	lifted
1999	lifted	**1.2bn**	1 year	1 year	lifted	lifted
2000	lifted	**2.0bn**	1 year	1 year	lifted	lifted
2001	lifted	**3.0bn**	**2 years**	**lifted**	lifted	lifted

7.2 Funding foreign exchange

During the period 1991-95, the foreign exchange authority controlled FX conversion execution. FX conversion for each inward remittance under the investment quota was subject to prior approval from the authority that determined the conversion execution date upon receipt of the conversion request from the QFII through its custodian bank. In consideration of the restriction on execution of FX conversion, QFIIs were required to fund their accounts by way of capital injection.

Starting from January 1996 when phase 3, which allowed direct investment in securities by non-resident individuals of Taiwanese origin or otherwise, was introduced, prior approval for conversion execution was lifted. This change allowed investment capital to be freely remitted into Taiwan as long as the remitted amount was within the quota ceiling for each QFII. This enhancement enabled QFIIs to change their funding practices and fund their accounts in line with their securities trade settlement.

The outward remittance of invested capital, gains and income has been liberalised on a step-by-step basis. From 1991 to 1995, the remitted capital could be repatriated after three months of capital injection, while gains could be repatriated annually. Since 1996, the remitted capital and its gains can be freely repatriated, although gain repatriation is subject to the submission of evidence of appointment of a tax guarantor or tax clearance certificate.

7.3 Reporting

Investment quota utilisation is tracked on a daily basis by the local custodians, and notified to the authorities through a number of reporting mechanisms.

Under the Taiwan regulations, the local custodian is required to establish an exclusive account for posting of daily transactions comprising investment activities for each QFII. These reports are normally submitted to the authority within 10 days after each month-end. The necessary reports are prepared and submitted to the authorities by the local custodian. The reports comprise securities and foreign exchange details, a statement of securities transactions, securities information and remittance report for the preceding month. Two months after the calendar year-end, local custodian banks prepare an annual financial statement in respect of the QFII's investment activities on its Taiwan portfolio. These reports are audited and certified by a CPA, prior to submission to the securities and foreign exchange authorities, who use these for record purposes.

8. Taiwan QFII settlement mechanics

The settlement mechanics of the Taiwan market exposes the QFII to settlement risk: securities and cash are settled separately, with a time lag on the funding.

For a purchase transaction good title is received on T+2 via Taiwan Securities Central Depository, with no interim exposure; however, for a sales transaction good funds are received on T+2 via FIS (interbank money transfer system) whilst securities are delivered on T+1. This results in interim exposure for the QFII, until funds are received, from the clearing banks and selling broker.

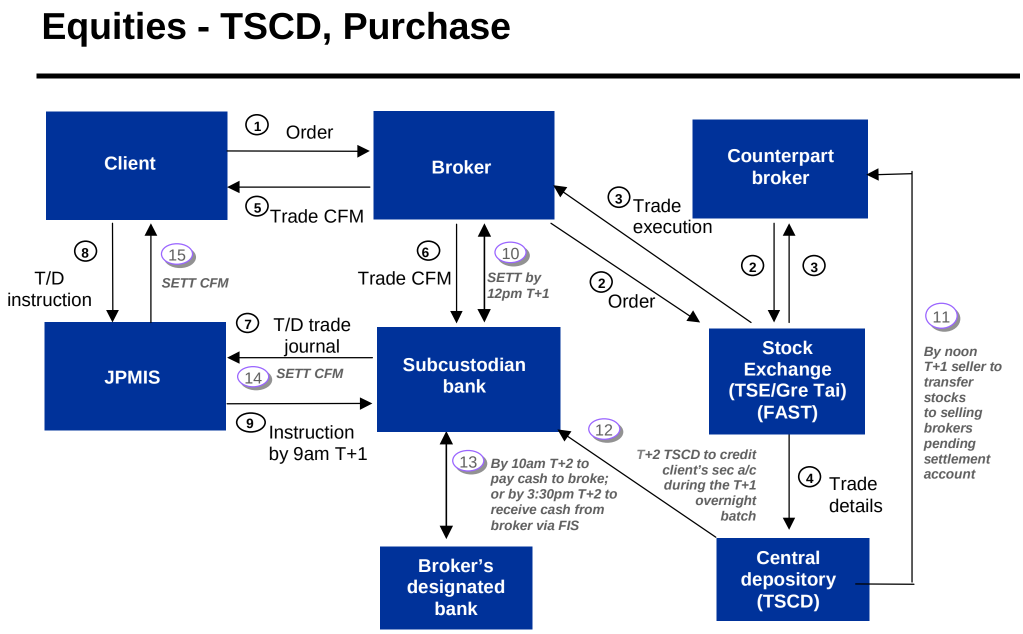
Foreign investors have greater confidence when investing in markets which posses true DVP (delivery versus payment) or RTGS (real-time gross settlement). Markets which do not provide these risk mitigating features may be viewed as less attractive to overseas investors, due to associated risks.

9. Settlement considerations for QFIIs

The authorities currently have a T+2 settlement timeframe for DVP; stock moves on T+1, with cash moving on the morning of T+2. The market has evolved with a stringent failure penalty; that is, suspension for three years should a trade fail. Although these deterrents are in place to help buoy the market, the implications of failure place tremendous pressure on the local participants, giving little room to manoeuvre should problems arise. Furthermore, there is no buy-in procedure in the market to avoid penalties should settlement failure occur. In December 2001 the market did, however, introduce Investor Error Trade Reporting. This system provides investors with the opportunity to declare an "error trade" before settlement providing an option to unwind a trade which may fail. Error trade reporting is an indication of the liberal steps the market is taking to align with markets which have sophisticated settlement failure and buy-in systems.

Graph 2

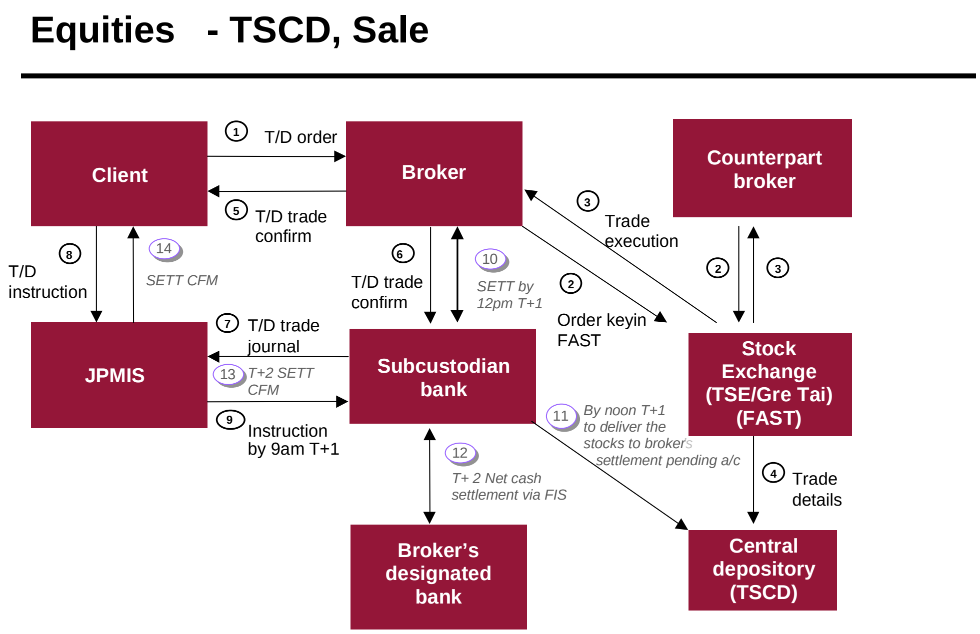
Purchase transaction equity flow



Buy side: good title will be received on T+2 via TSCD before payment is made.

Graph 3

Sale transaction equity flow



Sell side: good funds are received on T+2 via FIS while the shares have been delivered on T+1.

References

Chan, Vei-Lin and Sheng-Cheng Hu (2000): *Financial liberalization in Taiwan*, Academia Sinica, Taipei.

Ministry of Finance (2002): *The modernization of the Taiwan market*, Taipei.