Big two-way investment flows
Taiwan has long been a popular destination for international investors. Foreign institutional investors (known as FINIs in Taiwan) own more than 30% of all Taiwanese equities and account for between 18 and 28% of daily trading volumes. Structural changes now underway will, in the main, make the over-USD700-billion Taiwanese equity market more welcoming still.

In a mirror image of those flows, Taiwanese investors have caught the bug for investing internationally. Since 2009, sums invested in offshore funds have outweighed domestic fund assets. The gap between the two has progressively grown. As of 30 June 2012, offshore funds had more than USD81 billion in assets under management compared with USD61 billion in onshore funds.

In view of the local demand for foreign investment products, the regulators have been encouraging foreign asset managers to establish an onshore presence. As a result, most of the leading international firms prominent in the marketplace have established a local presence by acquiring a Taiwanese firm or set up a branch entity in Taiwan.

Key structural changes in the local market
The investment landscape is witnessing change on a number of fronts.

Major progress in improving corporate governance
Foreign investors have more than USD220 billion of holdings in Taiwan equities, and corporate governance is a key issue for many of them. The Asia Corporate Governance Association (ACGA) has been observing the Taiwanese corporate governance practice for years. In the ACGA White Paper on Corporate Governance in Taiwan, issued in February 2011, the association made recommendations in three key areas: shareholder meetings and voting, board effectiveness and shareholder rights.

The Financial Supervisory Commission (FSC), the competent authority in Taiwan, responded positively to the recommendations by changing the relevant regulations. With effect from the beginning of 2012, listed companies can only adopt a cumulative voting mechanism for company director elections. Previously they could use a block-voting (winner-takes-all) system, simply by incorporating the mechanism in their articles.

Are there still opportunities in Taiwan?

Big changes are afoot in Taiwan. Several are aimed at increasing the market’s attractions for foreign investors. At the same time, Taiwanese investors are increasingly buying foreign funds – making Taiwan a key market for international fund managers. Citi is actively engaged in a number of key initiatives.
The Taiwanese government has been advocating e-voting in the past few years in order to solve the issue of over-clustered AGMs. This year, it amended the related regulations to make e-voting compulsory to companies that meet certain criteria. “Although not all the companies are requested to adopt e-voting and the current procedure may not be perfect, it does represent progress,” says Hsiao-chi Wang, Director, Taiwan Securities Country Manager at Citi Transaction Services.

Importantly, fund managers and other intermediaries such as broker-dealers can now split the votes attaching to their clients’ holdings. “Previously a foreign fund manager had a single FINI ID, it could only cast its votes in one direction. Now, the introduction of split voting means votes can be cast to reflect the wishes of different underlying holders. This is a major step forward,” says Ms Wang.

**The imposition of capital gains tax**
Capital gains tax is at the top of the government’s tax reform agenda this year. On 25 July 2012, the Legislative Yuan passed the third reading of a bill to levy capital gains tax on securities trading. This will be implemented at the start of January 2013. However, the government acknowledged the importance of foreign investors to the Taiwanese equity market. In line with international practice, FINIs without a permanent establishment in Taiwan will continue to be exempt from the tax.

“Numerous studies from industry bodies and academics have come to the conclusion that short selling has no sustained impact on share prices.”

**Securities lending market**
Taiwan has a buoyant stock-lending market in Asia, with outstanding balances of around USD6.4 billion at the end of June 2012. While the authorities have taken steps to strengthen the rules in recent months, it remains one of the most attractive lending markets in Asia.

Concerned at the potential impact of short selling on the market, the authorities have tightened up on what they perceive as “naked” short positions. “Stock lending trades are done on a T+1 basis,” says Martin Corrall, Director, Asia-Pacific Head of Securities Lending, Citi Transaction Services. “Given that it is difficult in Asia to collateralise a loan on the same day, some borrowers were selling once they had agreed the loan – on trade date. That made it appear that the total of shorts exceeded the total borrowed.”

Now a broker must have input and matched the borrow trade in the TSE system before a borrower can sell in the market. Says Mr Corrall: “Borrowers are concerned of additional funding costs. They get collateralised in the US or Europe late in the day on trade date, but the trade cannot be input into the system until the following day once that collateral has been received by the borrower.” Only then can they short the shares.

Demand, however, remains strong, he says: “From a lender’s point of view, rates are very attractive. There are a number of special factors that restrict liquidity while demand for borrowing is high.” One source of that demand is from investors keen to swap their holdings into ETFs, where there is no tax on dividends.

Mr Corrall expects the Taiwanese stock-borrowing market to remain buoyant. “Numerous studies from industry bodies and academics have come to the conclusion that short selling has no sustained impact on share prices. The TSE has always been very approachable and has worked to accommodate offshore lenders. The onshore bid/offer market is the more prominent market but the level of FINIs' balances has consistently grown – and we expect them to go on doing so.” Citi is by some measure the leading agency lender in Taiwan.

**The development of an offshore RMB market**
In August 2012, Taiwan and China signed a memorandum of understanding covering currency clearing. It included a provision to appoint an RMB settlement bank for Taiwan, which is expected to become the next offshore RMB clearing centre. Once implemented, the clearing mechanism will allow Taiwanese banks to accept RMB deposits and extend RMB loans locally. Offshore deposits of RMB will be denoted as CNT, as opposed to CNH in Hong Kong.

Taiwan’s vast trade ties with China give it a major advantage in the development of an offshore RMB centre. Taiwan has the world’s largest trade surplus with China, and foreign direct investment by Taiwanese companies rose 11% to USD13 billion in 2011, according to official data. With the potential for RMB trade settlement flows of up to USD12 billion a year, CNT deposits are expected to build up very quickly.

Given the example of Hong Kong, it is expected that Taiwan’s CNT market will introduce RMB-denominated investment products in the near future. The FSC recently deregulated to allow local asset managers to launch RMB-denominated funds and further deregulation is expected to permit companies to issue RMB-denominated bonds in the local market.

At the present time, it is not clear what arrangements will be made to link the offshore RMB markets in Taiwan and Hong Kong, but the CNT market might well generate arbitrage opportunities.
International fund managers moving onshore
Taiwan continues to be a fertile market for offshore mutual fund sales. In what is a retail-driven market, local investors have been big buyers of regional equity funds – typically investing in Asia-Pacific ex-Japan, Latin America or Greater China – and fixed income and other high-yield bonds. The latter now account for around 47% of offshore fund holdings.

Offshore funds face a variety of restrictions, and these have been tightened in the past two years. Since March 2011, all commissions awarded to distributors have had to be disclosed. Capital gains on offshore funds exceeding TWD1 million (USD33,000) is now taxable. By contrast, gains on the overseas component of locally domiciled funds are non-taxable. And the restriction on the proportion of any offshore fund Taiwanese investors can own in aggregate – down from 90 to 70% – has led some firms to suspend fund sales.

It is not surprising then that leading international firms have been establishing a local presence. In the past two years, the likes of BlackRock, Mirae Asset Management, BNP Paribas and Schroders have all entered the local market by acquiring a Taiwanese firm. Alliance Bernstein has taken full control of its local joint venture.

Having acquired local investment expertise, some of these managers would like to use it in the management of their UCITS funds. However, appointing the local operation as a manager of Luxembourg- or Dublin-based funds is proving problematic. “As a Taiwan asset management business, the local operation needs to follow local regulatory requirements,” says Ms Wang, “but these conflict with the rules relating to FINIs.”

Citi is actively engaged in discussions with the regulators aimed at resolving this impasse and allowing a leading international fund manager to appoint its Taiwanese operation as the discretionary fund manager.

Citi’s key role in inward and outward flows
The largest foreign-owned bank and the top-rated custodian in Taiwan, Citi has the largest assets under custody locally and is the only foreign bank licensed to clear government securities.

Offering a full range of securities services, Citi was the first custodian bank to offer agency lending in Taiwan – in 2005 – and remained the only provider until last year. It continues to work on behalf of international investors to advocate market developments.

Citi works with international fund managers, helping them establish and manage local distribution channels and providing all the operational services they need to make a success of their offshore fund marketing.

Through its Citi Collective Investment Services (CIS) platform, Citi also provides all the tools distributors need to sell not only mutual funds but many other products. Serving both originators and distributors gives Citi a unique insight into the funds marketplace – and the ability to provide consultative and advisory services that add real value to its clients.

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