

# **Evaluating the Risks Associated with Taiwanese Banks' Westward Expansion in the Light of the Chinese Economy**

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Increasing Taiwanese banks' operations in China would incur the following risks:

## **1. Policy risks:**

In the past, private domestic banks had found it difficult to obtain the local media's attention to their overseas business openings. Take my own experience for example: During the course of my previous career in the banking sector, I had been involved in the establishment of more than 10 overseas branches, including a subsidiary, but these openings hardly got media attention. Whenever a domestic bank opened a branch abroad and sought publication in the press, it had to place advertisements in newspapers as well as sending a press release to these media outlets. Newspaper coverage of such news usually only occupied less than a quarter of a page and this style of reportage was considered as pretty normal in Taiwan.

In comparison to its neglect of private banks, the media have treated state-owned banks' business openings in China rather differently. Any slightest hints, hearsay or rumors about these banks' new operations in China could be splashed in headlines across all the leading newspapers; besides, President Ma Ying-jeou's opinions or aspirations concerning these operations would also receive detailed media coverage. Although opening businesses in China and in other countries are both parts of the process of the banking industry's internationalization, there has been a huge difference between the levels of attention the Taiwanese media has paid to businesses opened in China and those established in other countries. This is not only an abnormal phenomenon, but also reveals that the issue of Taiwanese banks' increasing operations in China has been interspersed with strong ideology. The media's skewed partiality will induce the government to make wrong policies and regulations. For instance, the 2008 global financial tsunami is a consequence of the modern academia and media's excessive eulogies of America's derivative products, which had misled the U.S. Federal Reserve to come to wrong judgments. Today, similar risks also confront Taiwanese banks opening businesses in China.

## **2. Domestic risks:**

State-owned and private banks have strived to increase capital recently, but the process has been anything but smooth. In fact, it is apparent that these banks' real reason for capital increase is to make preparations to establish operations in China.

Under the terms of the Chinese government's regulations, the minimum operating fund of a foreign bank's branch is 300 million yuan (about NT\$1.44 billion). After the branch is opened, it is required to increase its fund by 100 million yuan (about NT\$480 million) for each increase of 1.25 billion yuan in its business operations. From this it can be inferred that a foreign bank's head office has to bolster capital by at least NT\$14.4 billion in order to open 10 branches in China. The requirement of such an enormous amount of capital, however, would effectively deprive foreign banks of the strength to establish any subsidiary or to merge with other banks.

Why has the process of Taiwanese banks' capital increases been bumpy? It is because capital in the market that can be truly used for investments has appeared to be "overdrawn" over the past 10 years. This means that newly increased capital from normal economic activities has fallen behind with the capital "leaked out" of Taiwan every year. In other words, Taiwan has invested too much capital in China. This phenomenon has originated from the Ma administration's policy to turn Taiwan into an "Asia-Pacific capital-raising center." The policy proposed the Taiwan depositary receipt (TDR) model to encourage Taiwanese-controlled companies to come list shares in Taiwan and has withdrawn capital of no less than NT\$100 billion from Taiwan. Taiwan's stock market has begun to show signs of weakness after the Chen Shui-bain administration adopted the policy of "proactive liberalization" toward China. Its situation has further exacerbated since Ma's government launched the "complete liberalization" policy toward China. Over the past three years, the Taiwanese stock market has become the symbol of the sick cat of Asia.

The negative impact made on the domestic economy by Taiwanese banks' westward expansion is no less serious than that made by Taiwanese manufacturing companies' relocation to China. If the banks can neither acquire sufficient funds needed for their westward expansion from the domestic capital market nor downsize domestic credit operations to support the expansion of their businesses in China, then moving operations to China will become an option for all major Taiwanese financial holding companies (for the spreads between the interest rates for deposits and loans are low in Taiwan but high in China). The consequence is that domestic banks will tighten up lending conditions and small- and medium-sized enterprises (SMEs) will lose funding possibilities. If the wave of SME shutdowns spreads as a result, then what comes next will be a Taiwanese version of the financial tsunami and economic depression.

### **3. Operational risks:**

Because China has a 3% interest rate spread on loans (the interest rate spread on loans in Taiwan is less than 1%), state-owned banks in Taiwan have been in a rush to tap into the advantage. As to credit risks, although each bank has its own risk management mechanism and principles for lending, none of the banks can make right judgments when tempted by profits. As the saying goes, “A man would risk his head being cut off to pursue profitable business; though he is aware of the presence of lions in the lion’s den, he would still go ahead if he thinks profits are to be made there.” The banks would immediately lose clients if they fail to jump on the bandwagon, especially when all the other banks are doing the same thing. This is the tragedy of bank managers. In other words, bank managers’ reason and wisdom have limits in this environment dominated by the majority tendency, and this is why banks need the government’s regulation.

It is noticeable that China’s current financial development remains unpredictable. On the surface, the Chinese economy is still growing fast and China has been implementing its 12th Five-Year Plan at full speed. For that purpose, China has been beckoning Taiwanese companies and Taiwan’s state-owned banks. On the other hand, the Chinese economy has also been caught in the midst of domestic and international plights. In the face of house price bubbles and a high inflation rate, the Chinese government’s macroeconomic control policies, measures to suppress inflation, and house price strategies will engender many problems no matter whether these approaches are successful or not.

Besides, China’s stock market seems to be forecasting a soft landing for the Chinese economy. Although its economy continues to grow and its foreign exchange reserve keeps on accumulating, the Shanghai Composite Index had dropped from the 3,338 point of around two years ago (Nov. 23, 2009) to 2,324 points (Oct. 10, 2010), among which bank shares had fallen most steeply. Private estimation reported that bad debts involved in the private lending woes recently breaking out in Wenzhou may reach 150 billion yuan. This further attests the severity of China’s financial problems.

What’s more, China has to resist the pressure from western countries to appreciate the Renminbi. On October 11, the U.S. Senate voted 63-35 to pass the Currency Exchange Rate Oversight Reform Act, pressing China to quicken the appreciation of its currency. The global exchange rate wars seem to be on the verge of breaking out. Although there is still a long way to go for the proposed legislation to be made into law, the bill has at least demonstrated the American people’s unhappiness about China’s apparent manipulation of exchange rates. If the appreciation of the yuan picks

up pace as a result of the passing of the Act, Chinese manufacturers' (including China-based Taiwanese companies') overseas competitiveness will definitely be weakened.

Is now the right time for Taiwan's state-owned banks to launch all-out efforts to open operations in China to seek credit opportunities? That surely is a question for managers of each state-owned bank to decide based on their professional judgment. The president of an economic research institution has suggested that Taiwan's financial sector has several advantages in opening businesses in China. However, these advantages and the easy expansion of businesses in China are exactly what highlight the crisis of the state-owned banks' westward expansion and where the banks' operational risks lie.