Economic Modelling 31 (2013) 578–585

Contents lists available at SciVerse ScienceDirect

Economic Modelling

journal homepage: www.elsevier.com/locate/ecmod

# Bank ownership, performance, and the politics: Evidence from Taiwan

Pei-Fen Chen *, Ping-Chin Liu

*Department of International Business Studies, National Chi-Nan University, Taiwan*

ARTICLE INFO

*Article history:*
Accepted 11 December 2012

*JEL classification:*
G21
G23
G32
D21

*Keywords:*
Financial institutions
Election
Bank ownership
Bank performance

ABSTRACT

This paper investigates the effects of politics on the performances of financial institutions in Taiwan over the period from 1994 through 2009 using the two-stage generalized method of moments approach. We argue that politics and financial institutions are related and this relationship varies with the ownership of financial institutions. Our main findings are, firstly, during election years, the private financial institutions earned higher ROA and loan growth than the government- and foreign-owned. Secondly, government-owned institutions are not affected by current elections for all measures of performance, while foreign institutions significantly earned lower ROA, higher interest margin, and spent higher overhead costs. The finding that lendings of government-owned institutions are no longer subject to political pressures across time implies partial success of financial reforms in Taiwan.



## 1. Introduction

The interconnection between politics and the economy is strong in both transitional and newly developed countries. It is argued that the government can influence the activity of government-owned financial institutions in which these entities possess important flows of capital in financial markets. Because government-owned financial institutions play an important role in the financial sector, the extent of political influence on their performance is important from both political and regulatory points of view. The financial institutions with more and better financial resources are supposed to operate in a more profitable and efficient way, while government-owned institutions in Taiwan do not meet such expectation. One explanation is that government-owned banks might be directed by the ruling party, which then channels project funds for political purposes rather than for the public interest (Baum et al., 2009). Our argument herein is to reveal whether political forces play a critical role on the performance of different ownerships among financial institutions.

The purposes of this research are, firstly, to explore the relationship between financial institutions' ownership and their performance in Taiwan; and secondly, to examine whether political forces have significant impacts on the performance-ownership nexus.

Before the 1980s, Taiwan applied rigid administrative and manipulative policies over its financial sector, with bank assets directly controlled by the government authorities. Government-owned banks used to dominate the banking industry until the early 1990s, when Taiwan embarked on financial liberalization by granting new banking licenses and encouraging foreign banks to enter the domestic market. As a result of increasing competition and the government's privatization policy, 1991 is the turning point for a shift in market dominance from government-owned financial institutions to the private. Thus, what are the political effects on financial institutions' performance after the financial reform in Taiwan? This is indeed worth further exploration.

Privatization is intended to increase competition in the banking industry and therefore hopefully result in efficiency, which is crucial for the international competitiveness of financial institutions. However, traditional government-owned institutions before 1990s in Taiwan were notorious for their lack of efficiency. On the one hand, they controlled most of the financial resources, and on the other hand, they financed projects that would not pass scrutiny at private institutions. This phenomenon occurs more often in countries with higher corruption and more centralized governments (Ariff and Can, 2009; Braun and Raddatz, 2009; Kilinc and Neyapti, 2012; Lu, et al., 2012), which could have pertained to Taiwan before the 1990s. However, twice financial reforms create a sound environment for competition. Therefore, one of our purposes is to investigate if the strong links between politics and financial institutions, especially the government-owned, still remain.

We use presidential elections to represent political forces that benefit from bankers' actions, thereby influencing election outcomes. Imai and Shelton (2011) pointed that political parties favor specific sectors or firms in Taiwan. Their investigation showed that the presidential elections have substantial effects on the stock market performance of Taiwanese firms. Controversially, based on the dataset of Swiss banking sector, Bichsel (2006) argued that state-owned and

* Corresponding author. Tel.: +886 49 2910960x4643; fax: +886 49 2912595.
*E-mail address:* pfchen@ncnu.edu.tw (P.-F. Chen).

0264-9993/$ – see front matter © 2012 Elsevier B.V. All rights reserved.
http://dx.doi.org/10.1016/j.econmod.2012.12.006

privately owned banks might be driven by different objective functions. As a consequence, state-owned banks play an important role in enhancing competition.

Our unique dataset is composed of various types of financial institutions in Taiwan, including commercial banks, insurance companies, securities firms, holding companies, etc., rather than only commercial banks with different kinds of ownerships. The reason is that, aside from the privatization policy in the 1990s, financial authorities encouraged mergers among these institutions in order to produce larger-sized holding companies and to increase their international competitiveness. More specifically, we broadly investigate the relationship between the ownership of financial institutions and their performance and test whether politics plays an important role in this relationship. In addition, we used broad measure of performance, including returns on assets, interest margin, overhead costs, and loan growth in the empirical investigations.

Our investigation is motivated by the growing literature on the relationship between bank ownership and bank performance. Many studies were interested in the regional or global-wide evidence (Bongini et al., 2001; Dinç, 2005; Jackowicz, et al., 2011; Micco, et al., 2007; Shen and Lin, 2012). However, another strand of research focused on a single country. Chiu and Chen (2009) estimated bank efficiency scores for public and private banks in Taiwan. Chen (2012) analyzed banks' productivity by considering risk input for public and private banks respectively in Taiwan. Chen et al. (2009) theoretically analyzed the production efficiency among state-owned, private, and foreign banks in the Chinese banking sector. Barros et al. (2011) investigate the technical efficiency of Chinese banks by incorporating the influence of firm size and ownership. Baum et al. (2009) found that government-owned banks' behavior does not meaningfully differ from domestic private sector and foreign-owned banks, during or after elections in Turkey. Cole (2009) studied agricultural credit in India and gathered strong evidence of political interference in banks' activities. He discovered that the growth in agricultural credit was higher for state-owned banks during election years than during other stages of the electoral cycle. Imai and Shelton (2011) examined the partisan effects on the stock market in Taiwan. They find that the share prices of Taiwanese firms were greatly affected by electoral shocks in a two-party system. Lu et al. (2012) examined the political connections for state-owned and non-state-owned enterprises in China. They find that non-state-owned enterprises generally have fewer political connections and often experience loan discrimination for political reasons. However, our evidence herein includes government- and foreign-owned institutions versus the private. Most of all, we extend the research of existing literature from commercial banks to financial institutions. Furthermore, we provide the results for only commercial banks to help confirm our findings.

Our paper contributes to the existing literature in several ways. First, it extends the literature on the performance of banks by documenting some of the political factors that impact both government-owned and privately-owned institutions' abilities to operate in a small country. Second, the empirical results show that the performances for different types of financial institutions vary during election and pre-election years. Third, this study mainly focuses on the structural transformations of banking industry and transitioning of politics simultaneously from a single nation, Taiwan, to investigate the connection between financial institutions ownership and performance. Fourth, we used broad measurements for bank performance, including profitability (ROA and interest margin), efficiency (overhead costs), and income (loans) to investigate the political effects thoroughly. Finally, the empirical results show that political links to government-owned institutions are no longer strong, indicating substantial progress of financial reforms in Taiwan.

The rest of the paper is structured as follows. Section 2 describes political elections and financial institutions in Taiwan. Section 3 introduces the data and methodology. Section 4 provides empirical model and results, and Section 5 concludes.

## 2. Political elections and financial institutions in Taiwan

In this section, we first describe the background and democratic reforms of political elections in Taiwan. Second, we introduce developments in the financial environment and financial reforms.

### *2.1. The democratic reforms of political elections in Taiwan*

Taiwan has been ruled under the Republic of China (ROC) from 1945 until the present. A martial law order issued in 1949 over the island was finally rescinded in 1987. Since then, Taiwan has gradually and peacefully developed to be a free, open, democratic and constitutional economy.

Following the democratic political reforms, Taiwan has nine election categories. The two elections at the central government level are the President Election and Legislators Election. The other seven elections at the local level are Municipal Mayors, Municipal Councilmen, County Magistrates (City Mayors), County (City) Councilmen, Township Chiefs, Township Councilmen, and Village Heads. The terms of all elected officials are four years.

After the end of martial law, a new National Security Law allowed political parties to be formed. Some of the initial anti-Kuomintang (KMT) forces later became a significant foundation of the Democratic Progressive Party (DPP), established in September 1986. By the end of 2005, 116 political parties had registered. All political parties are free to nominate candidates to campaign in any election. The major parties are KMT, the People First Party (PFP), and the New Party (CNP) (which make up the Pan-Blue Coalition) and the DPP, the Taiwan Solidarity Union (TSU), and the minor Taiwan Independence Party (TAIP) (which make up the Pan-Green Coalition).

Almost as important was the lifting of martial law which led to the first constitutional amendments of May 1991, allowing Taiwanese to freely participate in politics from the local level to the central level of the government. For example, legislators in the Legislative Yuan and delegates of the National Assembly were previously elected in mainland China in 1947, but now the people of Taiwan directly elect them. As for the ROC Presidents, the delegates of the National Assembly elected them in the past, but since March 1996, Taiwan citizens have directly elected people to this office. After the first constitutional amendments of May 1991, legislator elections were held in 1992, 1995, 1998, 2001, 2004, and 2008. Meanwhile, presidents were directly elected by the people in 1996, 2000, 2004, and 2008.

### *2.2. Financial institutions and financial reforms in Taiwan*

Before the 1980s, Taiwan's financial sector was governed by rigid administrative and manipulative policies. After the 1980s, Taiwan started to carry out significant financial deregulation and internationalization under international pressure. In the early 1990s, Taiwan embarked on financial liberalization by granting new banking licenses and encouraging foreign banks to enter the domestic market. Since 1991, the local financial market has shifted in market dominance from government-owned institutions to the private, but the dramatic increase in new institutions led to the problem of overbanking, especially in dealing with the surge of non-performing loans (NPLs) during 1998–2002. Therefore, financial institutions had to devote substantial manpower to recovering bad loans, adversely affecting their normal operations. Loaded with past-due loans, they became more conservative and cautious in lending money to businesses, which further damped the chance of economic rebound. Thus, the weakening of financial institutions' asset quality led to a contraction of their lending and investment, squeezing their profitability and reducing their return on equity.

Two stages of financial reforms started in 2001 and 2004 respectively. In order to meet the global financial trend, the Taiwan government sets up an independent *Financial Supervisory Committee* in 2004 to help with revolutionizing the local supervision and management