MULTINATIONAL BANKS IN THE GLOBAL ECONOMY.

EVIDENCE FROM ITALIAN CASE.

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Competitive paper

ABSTRACT

The present paper aims at providing a coherent theoretical framework to develop hypotheses regarding the recent international expansion of MNBs, relying on the theory of the MNC. Prior studies have typically focused on the commitment level adopted by the banks upon foreign markets or on the choice between different organisational forms, while the present study moves beyond by focusing on a two-dimensional choice, i.e. internal vs. external, and high vs. low commitment level required. It is argued that the factors influencing a banks' international growth may be framed within the eclectic paradigm, i.e. they may be related to the whole set of ownership, internalisation and location advantages. Hypotheses were econometrically tested on data about the foreign presence of 78 multinational Italian banks, as in 1997.

Key words: multinational banks, internationalisation, internal and external growth

1. INTRODUCTION

Firms can internationalise in a number of ways, including through exports, licensing, and foreign direct investment (FDI). The latter, in particular, has increased dramatically over the last few decades, both in relative and absolute terms, mainly due to a series of technological, economic and political changes ranging from the diffusion of ICTs to globalisation of markets, liberalisation and privatisation processes. The world FDI flows almost reached 1,200 billions $ in year 2000, thanks to an average annual growth rate of 13% from the beginning of the 1980s (the same rate is below 5% and 7% for GDP and exports, respectively), thus reaching an incidence of 19% on the world gross product (UNCTAD, 2001). In this context, tertiary sectors played a pivotal role (accounting for 54.7 per cent of the total at the end of the '90s against the 41.8 per cent recorded at the end of the '80s) and, particularly, this is truer for financial and banking sectors (accounting for 27.3 per cent of the total of services at the end of the '90s against the 19.8 per cent recorded at the end of the '80s).

Numerous studies on the internationalisation of banking and financial services have then flourished. Most of the existing literature refers to the US (*e.g.* Grubel, 1977; Goldberg and Saunders, 1981a, 1981b; Gray and Gray, 1981; Yannopoulos, 1983; Aliber, 1984; Nigh *et al.*, 1986; Hultman and McGee, 1989; Goldberg and Johnson, 1990; Goldberg and Grosse, 1994; Miller and Parkhe, 1998; Berger and DeYoung, 2001). Some studies have been put forward for the UK (Jones, 1992), Germany (Moshirian and Van der Laan, 1998; Buch, 1999), Japan (Aggarwal, 1993; Yamori, 1998), Italy (Nieri, 1994; Crecchia, 1996; Di Quirico, 1999), and the Nordic European countries (Jacobsen and Tschoegl, 1999; Engwall and Wallenstål, 1998).

Therefore, both the theoretical and the empirical debate about the international corporate strategies of MNBs is lively and some of the most relevant issues refer to: (a) the entry mode choice of banks on foreign markets and the bank's motivation to adopt different organisational forms (Ball and Tschoegl, 1982; Heinkel and Levi, 1992; Ursaki and Vertinsky, 1992; Gabrowski *et al.*, 1993); (b) the survival of MNBs in foreign and unfamiliar contexts (e.g. Zaheer and Mosakowski, 1997), and; (c) the impact of multinationality on banks' productivity and performance (Berger *et al.*, 2000; Berger and DeYoung, 2001). However, very few studies (e.g. Ball and Tschoegl, 1982) investigate both internal and external growth (i.e greenfield vs. acquisitions) in multinational banking, mainly focusing upon the former. Nonetheless, as cross-border M&As are getting more and more importance in the most recent times (UNCTAD, 2000), we believe the twos are well worth investigating together.

Our study aims at providing a coherent theoretical framework to develop hypotheses regarding the recent international expansion of MNBs (through both internal and external growth), relying on the theory of the MNC. It is argued that MNCs' choice is driven by the need of reducing uncertainty and risk due to the unfamiliarity with the foreign environment. Therefore, companies going abroad need to be properly equipped and advantaged to face such difficulties, and these advantages increase the propensity towards ventures requiring higher level of commitment. Additionally, MNBs' international expansion tends to follow customers' growth upon foreign markets; however, the organizational form adopted and the relevant commitment level strongly depend on the features of the target country.

Hypotheses were tested on data about the Italian banks' presence abroad over a period in which important phenomena (such as the upsurge of M&As and equity agreements among banks in the European Union; and the advances in the liberalisation and privatisation processes in Central and Eastern Europe countries, which opened new opportunities for international growth) have changed the competitive scenario and thus influenced the internationalisation strategies of banks themselves. Specifically, the sample refers to the foreign presence of 78 multinational Italian banks, as in 1997.

2. BACKGROUND

The international banking literature relates geographic expansion of banks to the possibility to move towards a more efficient structure thanks to efficiency improvements, which may accrue in the form of lower costs or higher revenues (De Young and Nolle, 1996). Indeed, geographic expansion allows banks to grow upon new markets when domestic growth is limited (Aggarwal, 1993); to diversify the risks in different regional economic environments thus reducing the variation in the organisations' earnings (Aggarwal and Durnford, 1989; Berger and DeYoung, 2001); to exploit internationally high domestic market to book ratios (Aliber, 1984) as the easy availability of capital seems to provide bankers with a significant competitive edge in global markets (Marr *et al.*, 1989).

A bank's motivation for its presence abroad links with the organisational form it adopts, at least when host country regulations do not constrain the choice (Heinkel and Levi, 1992; Tschoegl, 2001). The organisational form that foreign banks adopt in foreign markets reflects the product market they are entering. In his pioneering article, Grubel (1977) distinguished three markets: the wholesale, the corporate and the retail.

When banks wish to operate in the wholesale and corporate markets they typically adopt the branch or agency (representative office) form of representation. Because branches and representative offices are integral parts of the parent, they trade on the basis of the parent's capital and reputation. Specifically, the intent to operate in the wholesale markets leads banks to the major world financial centres, while the intent to serve corporate clients, either domestic clients moving abroad or host country firms either seeking or open to dealing with foreign banks, leads banks to locate in national financial centres, i.e. where the domestic banking sector is wide and well developed. On the contrary, banks wishing to operate in retail market in a foreign country tend to operate via local subsidiaries, which trade on the basis of their own capital and reputation. In fact, foreign banks eager to apply their management skills to the retail sector in the host country frequently believe that it is more cost-effective to improve a larger, local acquisition than to build up a *ex novo* operation (Tschoegl, 2001).

Specifically, when a firm expands into a foreign market by establishing a local unit, it has to decide whether to start a new venture or acquiring an existing local company. Foreign startups (or greenfield investment) entail building an entirely new organisation in a foreign country from scratch. In the case of an acquisition, the expanding firm buys at least part of the equity of an existing firm in a foreign country.

The acquisition may have various benefits compared to greenfield, or newly formed branches of a firm. Acquisitions allow indeed firms to achieve a greater market power, to overcome barriers to entry, to enter new markets quickly, and to acquire new knowledge and resources. However, acquisitions also imply additional costs to the acquiring organization for integration, rationalization, coordination and implementation processes.

Previous studies in this tradition (e.g. Barkema and Vermeulen, 1998; Vermeulen and Barkema, 2001) have examined the influence of a variety of factors (for instance, firm size, multinational experience, cultural distance and host country specific determinants) on this strategic choice but none with specific reference to multinational banks. As far as multinational banks are concerned, internal growth, i.e. greenfield initiatives might take the form of representative offices or branches. The former is the cheapest overseas banking organizational forms, and it usually consists of a small commercial office designed for helping the parent bank and its customers in their financial and commercial activities. A foreign branch constitutes instead a higher level of commitment with the market, as it actively participates in the host country banking system. Concerning external growth, i.e. the acquisition of a foreign bank, the degree of commitment is proportionally related to the acquired share in the existing local bank. Therefore, *ceteris paribus*, it is lower when considering affiliates (i.e. when the parent bank acquires only a minority share of the target company), while on the contrary it increases for control-owned subsidiaries.

Existing research investigating the entry mode choice of banks on foreign markets (Ball and Tschoegl, 1982; Heinkel and Levi, 1992; Ursaki and Vertinsky, 1992; Gabrowski *et al.*, 1993) normally focus on the motivations underlying the commitment level implied by the chosen organisational form (Miller and Parkhe, 1998).

The present study relies on the theory of the multinational enterprise (MNE), and namely upon the eclectic paradigm approach (Dunning, 1977), to develop hypotheses regarding banks' decision to expand abroad through direct investment, and namely through internal and/or external growth[1]. The eclectic paradigm has been the leading explanation for the growth of multinational activity over the past decades. Its broad appeal has made it a mainstay in explaining various sectors and types of activities; its simplicity and general nature makes it compatible with a number of schools of economic and managerial thought. According with such a paradigm, FDI decision stems from a combination of:

(1) *ownership advantages*, i.e. the competitive advantages which firms of one nationality possess over those of another nationality in supplying any particular market or set of markets;

(2) *internalisation advantages*, related to the extent to which firms perceive it to be in their best interests to internalise the markets for the generation and/or the use of their competitive assets;

(3) *location advantages*, related to the extent to which firms choose to locate activities outside their national boundaries.

Ownership advantages are crucial as they allow the foreign bank to overcome the advantages possessed by both the domestic banks and other multinational banks already present in the foreign market, and to compete effectively with them. Entry in foreign markets generally involves greater uncertainty and risk than domestic investments as it requires facing a complex environment where the firm has to deal with many unfamiliar factors. Since the antidote to uncertainty is the acquisition of information (Arrow 1972), it follows that firms wishing to grow internationally have to commit in the costly exercise of gathering, collecting and monitoring information (Casson, 1994). Ownership competitive advantages arise then

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[1] Other Authors have put forward preliminary applications of the eclectic paradigm to the investigation of the bank's decision to invest abroad but mainly focusing on internal growth (e.g. Gray and Gray, 1981; Cho, 1985; Sagari, 1992; Williams, 1997).

essentially from the availability of financial and human resources, the possession of superior and unique managerial techniques, extensive experience, skilled personnel, organisational skills, and a large domestic capital and deposit base (Lees, 1974; Yannopoulos, 1983; Aliber, 1984; Cho, 1985).

Internalisation advantages explain why multinational firms offer cross border transaction services via a direct presence rather than by using some other form of international involvement (e.g. licensing to produce the service in a foreign country). As a broad generalisation, the transaction costs of using the market, compared with the hierarchical route of exchanging intermediate services, are likely to be higher than in case of goods. Indeed, most services contain a larger element of customer tailoring than do goods and, as information or knowledge related to service activities may be inexpensive to replicate, the possibility of abuse or dissipation of that knowledge is a real threat to the firm possessing it. Additionally, many services are impossible or difficult to trade over space, thus explaining the rapid growth of hierarchical forms in this sector (Dunning, 1993).

Location advantages are regarded as another necessary condition for internationalisation. Many of the factors affecting the location of goods producing activities (i.e. the market size or the availability of resources) help explain the location of services but two additional variables seem to be particularly relevant in the siting of the production of services: (a) the first is the extent to which the service is tradable. Many services are, in fact, location bound, thus requiring face to face contacts between buyers and sellers. Such services can be provided to consumers either by a foreign firm via FDI or by indigenous firm under license to the foreign producer; (b) the second factor, especially relevant to the location of services, is the regulatory environment of host countries.

3. HYPOTHESES

The theory in the background section suggests that a set of *advantages* has to be considered to describe the firm's propensity to both set up a new venture in a foreign country and to acquire an existing local company. Below, we develop the hypotheses on how the OLI advantages affect the bank's attitude towards internal vs. external growth choice, as well as the level of commitment involved.

Ownership advantages

International growth exposes a bank to a rich array of environments, which leads to higher competition as well as uncertainty and risk. Therefore, a bank wishing to expand internationally should in principle be able to sustain costly activities to collect, synthesize and circulate the needed information to differentiate their products, in order to compete effectively with local counterparts, and to reduce uncertainty and risk related to the unknown unfamiliar environment.

For these reasons, larger banks, which enjoy more financial and managerial resources are more likely to grow internationally. In fact, constraints and the lack of complementary assets afflicting small-sized firms leave them with fewer means of reducing uncertainty and induce them to favor entry modes requiring less commitment. Smaller firms find more suitable to attempt tentative moves on foreign markets, often gambling on emerging opportunities, thus reducing both the actual costs and the potential sunk costs. Therefore, smaller banks would orient their internationalization strategies towards prudent arrangements (representative offices and/or affiliates), which allow both set up costs and the risks involved in FDI to be reduced. Conversely, the majority of studies indicate that larger firms are likely to prefer high levels of equity ownership and commitment (Gomes-Casseres, 1985; Miller and Parkhe, 1998). Thus, according with the "schumpeterian" relationship between size, the endowment of skills and capabilities, and the abilities to innovate and differentiate products, we propose to test:

Hypothesis 1. Dimensional scale increases the bank's propensity to grow upon foreign market (by both internal and external growth), and to set up foreign units requiring higher level of commitment.

Entry in foreign markets and the related uncertainty is also crucial for international neophytes which lack experience in managing foreign operations. The internationalizing company must face many unfamiliar factors that cannot always be managed on the basis of experience gained in the country of origin. The lack of international experience may cause the novice investor setting up *ex novo* activities to take inappropriate decisions on matters such as the location in the foreign country, adaptation of products and services to local market requirements, management of relations with workforce, suppliers, customers, other banks, local authorities. On the contrary, a lighter and quicker involvement may constitute an efficient solution to the problem, since it allows the novice foreign investor to exploit the positive externalities deriving from having a local partner, which can represent a precious accumulation point for information on the local economy and environment.

Once the first experience of FDI has been gained, the firm sets in motion a cumulative evolutionary learning process in "going abroad". The perception of uncertainty decreases and the firm acquires increasing capabilities and knowledge about how to manage foreign operations and to correctly assess the risks and the expected economic returns of FDI. This is particularly evident when the parent company already manages other subsidiaries in the target country or if it has entered before other countries which are culturally similar to it. On this concept strongly related to path-dependency and the importance of the past history, Johanson and Vahlne (1977) explain the phenomenon of "incremental internationalisation", *i.e.* a step-by-step increase of the firm's involvement in a foreign market. More generally, the capability of the firm to capture the gains from an internationally integrated structure depends positively upon its degree of multinationality (Cantwell and Sanna Randaccio, 1993) and the cumulative and incremental learning experience which determines the set of opportunities for growth. As a result, the propensity to augment the ownership level in foreign units tends to increase while experience in dealing with international operations is accumulated (Anderson and Gatignon, 1986). Set-up costs decrease if the firm has already acquired experience in managing foreign operations, and particularly if this experience is potentially useful for the target country: for instance, if the firm has already undertaken FDI in that country, or has entered other environments similar to that of the being entered (Johanson and Vahlne, 1977). The empirical evidence confirms that earlier operations in the target country by the parent company increase the probability of choosing a wholly owned subsidiary (Kogut and Singh, 1988).[2] Our hypothesis is therefore:

Hypothesis 2. Rising level of international experience increases the propensity to grow upon foreign market (by resorting to both internal and external growth), and to set up foreign units requiring higher level of commitment.

Empirical evidence provided in the literature tends in the main to support these two hypotheses with reference to FDI undertaken in manufacturing (Gomes-Casseres, 1985; Kogut and Singh, 1988), in the banking sector (Ball and Tschoegl, 1982; Ursacky and Vertinsky, 1992), and in other service sectors as well (see for example Contractor and Kundu, 1998, with reference to the hotel sector). Specifically, the dimensional scale and the relevant endowment of resources, the international experience, knowledge and information about foreign market have been shown to be important factors in explaining banks' international growth (Enderwick, 1989). Likewise, Ball and Tschoegl (1982) found that foreign direct investment in banking is significantly influenced by the size of the bank as well as by its multinational experience. More recently, Ursacki and Vertinsky (1992), investigating foreign banking expansion in Japan and Korea, confirmed that the size of the bank and its experience operating in a multinational environment constitute significant determinants of the banks'

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[2] Some Authors proposed different hypotheses. For example, analyzing the behavior of 151 United States-based service firms, Erramilli (1991) departed from traditional linear conceptualization and hypothesized and tested a U-shaped relationship between experience and integrated entry modes.

expansion through branches.

Additionally, as Autio *et al.* (2000) pointed out, acquiring foreign experiential knowledge involves new ways of thinking in the face of strong inertial forces to continue in the old patterns. Specifically, the adoption of new knowledge involves not merely the learning of the new, but the unlearning of the old (Nonaka, 1994; Bettis and Prahalad, 1995). Therefore, the company's age should affect how quickly it will gain new foreign knowledge, as the needed unlearning becomes more difficult as firms get older. Nonetheless, as the older companies are often the larger (see Hypothesis 1), we do not have a priori expectations on the impact of the bank's age at entry.

Internalisation advantages

Internalisation discussed in the case of multinational banking relates to the product and factor market imperfections and to the economies of internal operations (Gray and Gray, 1981). Specifically, internalisation is largely sourced from the role of information, which has a crucial role in banking (Yannopoulos, 1983; Tschoegl, 1987). The bank-client relationship consists primarily of flows of information and information inputs are difficult to obtain at arm length due to the failure in the market for information. Dunning (1981) refers to this as cognitive imperfection, which arises whenever information about a product or service is not readily available or is costly to acquire. Information capital provides opportunities for multinational banks to internalise a firm-specific advantage (Miller and Parkhe, 1998). Indeed, as observed by Casson (1990), personal contact constitutes one of the main advantages for banks. Preserving established accounts by opening foreign offices become a means for protecting knowledge and information networks, thus achieving internalisation advantages. This idea, originally associated to that of a defensive strategy[3], is also and better

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[3] Brimmer and Dahl (1975) defined "defensive expansion" the reaction of US banks to specific regulations which forced them to expand offshore. Banks respond to the expansion of their clients abroad to defend their client-bank relationship. In fact, if the banks do not accompany their client abroad, their client will establish a banking relationship that could expand to supplant any domestic banking relationship.

known as the “follow the customer” approach (Kindleberger, 1983). Formally:

Hypothesis 3. The international expansion of a bank towards a foreign country is positively related to foreign initiatives already undertaken by national firms in that country. As far as the organisational forms, when following their customers abroad banks typically adopt internal forms (i.e. branch and/or representative office), which act on the basis of the parent’s capital and reputation, and are therefore closer to the customers themselves. The commitment level adopted is higher when the local market is economically more promising.

Empirical evidence to the hypothesis has already been provided by both trends followed by FDI in the ‘60s and ‘70s (UNCTC, 1989), and research studies about multinational banks’ activities. In particular, Nigh *et al.* (1986), Goldberg and Johnson (1990), and Miller and Parkhe (1998) found a positive correlation between US banks’ foreign activities and manufacturing activities set abroad by US firms in the periods 1976–1982, 1972–1995, and 1987–1995, respectively. Similarly, Goldberg and Saunders (1981a, 1981b), Hultman and McGee (1989) and Goldberg and Grosse (1994) confirmed the same result with reference to the foreign participation in the US market in the period 1973–1986. Yamori (1998) corroborated the evidence with a study on Japanese banks in the first years of the 90s assessing that Japanese banks can exploit their superior knowledge of and contacts with their home-based multinational corporations. Interestingly, a study by Seth *et al.* (1998) using data on the financial sources of affiliates of foreign firms in the US as well as data on the activities of foreign banks in the US, found a strong evidence that banks from Japan and the UK did not follow their customers there, while the reverse was true for banks from other countries.

The establishment of any initiative by firms in a foreign country implies flows of goods and services across national borders. These flows require converting the currency of importing country into the currency of the exporting country, which is facilitated by the presence of banking operations *in loco* (Gray and Gray, 1981), also due to the intangibility and inseparability of banking and financial services, which limit the possibility of trading them across boundaries (Dunning, 1993). Accordingly, empirical studies suggest a positive relationship between the presence of banks in a foreign country and the extent of commercial relationships between the two countries involved (Goldberg and Johnson, 1990; Miller and Parkhe, 1998; Yamori, 1998; Buch, 1999), as a further evidence for the "follow the customer" hypothesis. Furthermore, because of the self-reinforcing complementarity between FDI and trade, as they increasingly seem to support one another (UNCTAD, 1996), we propose to test:

Hypothesis 4. The presence of overseas units of banks in a country will be positively associated to commercial relationships with that country. Accordingly to Hypothesis 3, banks are more likely to undertake branches and/ or representative offices in the country considered and the commitment level adopted is higher when the local market is economically more promising.

This hypothesis has been confirmed by Goldberg and Johnson (1990), and Grosse and Goldberg (1991) which found that bilateral trade contributes to the expansion of foreign banks in the US. Likewise, Miller and Parkhe (1998) and Yamori (1998) found that bilateral trade influenced the behaviour abroad of the US and the Japanese banks, respectively; Buch (1999) reached a similar conclusion for German banks' internationalisation choices.

Location advantages

The choice of the bank's entry mode can not be appreciated without jointly considering the characteristics of the target country. With specific reference to multinational banking, location advantages encompass a wide variety of factors including differences in regulatory structures, the desire of investors to separate currency from political risk, the entry into growing markets, and the access to a skilled pool of labour. Indeed, banks are found to be attracted to foreign markets to exploit favourable (or less restrictive) foreign banking environment and/or to take advantage of local banking opportunities in foreign countries[4] (Brimmer and Dahl, 1975;

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[4] It is worth observing that the same hypotheses have been tested and confirmed for domestic new entrants in local banking markets, which are attracted by high profits, market size and market growth (Amel and Liang, 1997).

Khouri, 1979; Goldberg and Saunders, 1981a,b; Gray and Gray, 1981; Yannopoulos, 1983; Aliber, 1984; Cho, 1985; Nigh *et al.* 1986).

However, the existence of locational advantages in a given country exploitable even by foreign banks are reflected in the characteristics of the local banking market in terms of size, development and efficiency (Amel and Liang, 1997; Miller and Parkhe, 1998; Buch, 1999). Therefore:

Hypothesis 5. Banks' FDI requiring higher level of commitment is more likely to be directed towards larger and well developed financial markets, where business opportunities in the financial sector are higher, and where risk is lower, once allowed for regulatory restrictions.

Several studies have already shown that multinational banks' locational choices are strongly attracted by important international financial centres (Brealey and Kaplanis, 1996; Buch, 1999), where indeed they can exploit relevant positive externalities and agglomeration economies. As locating in such a centre can provide the banks with the access to new competitive advantages, they would prefer to get there a significant presence. Therefore, according to Tschoegl (2000, 2001) the hypothesis is:

Hypothesis 6. Banks' foreign activities in a country hosting an important international financial centre are more likely to originate from internal growth strategies.

An important empirical insight of the last two decades is that acquisitions are often associated with implementation problems and unsatisfactory post acquisition performance. An important reason for disappointing performance is the problems associated with the integration of acquisitions (Haspeslagh and Jemison, 1991). Such problems are avoided in the case of greenfields. Indeed, several studies have found that greenfield usually perform better than acquisitions (Li and Guisinger, 1991; Nitsch *et al.*, 1996). The integration of an acquired company into a parent firm is complicated by the differences between the organisations involved and the differences in organisational culture and management style (Chatterjee *et al.*, 1992)[5]. Being acquired by a firm with a different culture may cause tensions and hostility. Many studies have found that cultural differences increase the probability that acquisitions will fail (Kogut and Singh, 1988; Barkema and Vermeulen, 1998). Therefore:

Hypothesis 7. Cultural distance decreases the propensity of a bank to get heavily involved in the foreign country through acquisitions of local companies.

4. METHODS

Sample and Analysis

The data set concerns the universe of Italian banks possessing at least an operation unit abroad, as in 1997. The data set collects data on foreign initiatives undertaken through both internal growth (representative offices and branches), and external growth (affiliates and subsidiaries). The former have been gathered from the information provided by the Association of the Italian Banks (ABI); the latter have instead been collected from Bankscope 1998 (a database developed and commercialised by Bureau van Dijck-Fitch). Cross-checks have also been run using the annual reports and the web sites of the major Italian banks.

Table 1 reports the situation of Italian multinational banks' direct presence abroad as in 1997. It is worth observing that the number of Italian banks with a foreign unit (78) is less than the 10 percent of the total number of banks. The favoured forms adopted by Italian banks abroad are branches and representative offices (90 and 208, respectively), i.e. internal growth modes, while foreign units established by minority and majority acquisitions are both above 50 (61 and 54, respectively).

As far as the geographical breakdown is concerned, Table 2 shows that the direct presence of Italian banks is mainly focused in Western Europe where they locate both through setting up *ex novo* units and acquisition of existing companies. As far as Eastern Europe is concerned,

[5] Nonetheless, it is worth reminding that differences between acquired firms and acquiring companies is not necessarily detrimental as they might create, if they are not too large, opportunities for synergies and learning (e.g. Krishnan *et al.*, 1997).

Italian banks took the recent chances by locating there mainly through lower commitment forms (22 representative offices and 19 affiliates). The same behaviour has been adopted in Africa although at a lower extent (6 representative offices and 11 affiliates). Interestingly, the presence in the Far and Middle East is attained exclusively through internal greenfield initiatives.

In order to corroborate the interpretative framework based on the eclectic paradigm and to validate the relevant hypotheses advanced, we developed an econometric model. Specifically, the model refers to the 78 Italian banks with at least a presence abroad in the year 1997. The observation unit is the extent of the presence of bank i in country j, and the model specification is the following:

$$FOR\_PRESENCE_{ij} = a + bOWNER_{i} + cINTERNAL_{ij} + dLOCAT_{j} + \varepsilon_{ij}$$

i = 1, … , 78 Italian banks j = 1, …, 65 countries

The dependent variable $FOR\_PRESENCE_{ij}$ assumes four distinct specifications according to each organisational form adopted abroad. Therefore:

a) $FOR\_PRESENCE_{ij} = BRANCHES_{ij}$, that is the total number of the bank's i branches in country j;

b) $FOR\_PRESENCE_{ij} = OFFICES_{ij}$, that is the total number of the bank's i representative offices in country j.

c) $FOR\_PRESENCE_{ij} = SUBSID_{ij}$, that is the total number of the bank's i subsidiaries in country j;

d) $FOR\_PRESENCE_{ij} = AFFILIAT_{ij}$, that is the total number of the bank's i affiliates in country j;

As the dependent variables are limited count variables, a simple ordinary least squares regression analysis would yield biased results. For this reason, the equation has been estimated through negative binomial regression models, which are the most appropriate for count data[6].

Independent variables

According to the hypotheses previously developed, to the variables suggested by the international literature and to the availability of data, the independent variables relate to ownership-, internalisation- and location-specific advantages, as follow. Characteristics of the variables considered are reported in Table 3.

Ownership advantages ($OWNER_i$)

- *Dimensional scale.* The ability of a bank to differentiate products and services, as well as the availability of “exclusive” resources has been proxied by its dimensional scale, in line with the traditional “schumpeterian” hypothesis on the positive relationship between size, resources and innovativeness. Specifically, the size of the Italian bank has been measured by the bank’s deposits (SIZE1), by the total assets (SIZE2), and by the number of the parent’s domestic employees (SIZE3)[7].
- *International experience.* Variables relating to the parent company’s experience in managing operations abroad aim to capture both the geographical aspect - the variable INT_EXP1 is the number of foreign countries where the bank is already operating at time t -, and the cumulative dimension, that is the bank’s international experience related to the accumulation of experience in different countries: INT_EXP2 is the number of years the parent company had been present in that country;
- *Age at entry.* The age at entry (AGE) of an Italian bank was measured as the time, in years, between the bank’s founding and the year considered (1997).

Internalisation advantages ($INTERNAL_{ij}$)

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[6] The other possible model normally used for count data, the Poisson model, presents a major drawback related to the fact that the conditional mean is assumed to be equal to the conditional variance, so that any cross-sectional heterogeneity is ruled out. The negative binomial model provides a generalisation that permits to solve the problem, by introducing an individual unobserved effect into the conditional mean (Greene, 1997).

[7] It is worth observing that these variables related to dimensional aspects of the Italian banks have been also calculated as logarithm but the significance in the estimates has been sistematically lower. The source of data is Mediobanca.

Internalisation advantages mainly relate to the “follow the customer” hypothesis. Therefore, the proxy considered measures the extent of foreign direct investment by Italian firms in the same host country (in the previous year, i.e. in 1996). Specifically, the presence in foreign countries has been measured by the actual number of plants or employees, which allows a rather precise estimate of the phenomenon[8]. The variable FDI is the number of manufacturing affiliates of Italian firms in each country in 1996. However, the variable FDI_EMP, measured by the total number of employees in the mentioned manufacturing affiliates, allows for the dimensional scale of these foreign initiatives by Italian firms. Although considering only manufacturing affiliates could be constraining as it excludes commercial affiliates of manufacturing firms and affiliates of services firms, nonetheless the problem is smoothed by the two following facts: (i) FDI in service sectors are often pulled by manufacturing MNEs (which indeed generate the demand for services); and (ii) the presence of commercial activities is partly captured by the proxy (*see infra*) used for commercial relationship between the countries involved (see infra). Data are obtained from the database Reprint, which censuses outward and inward foreign direct investment in Italy from 1986. The database has been developed at Politecnico di Milano in co-operation with the National Council for Economics and Labour (CNEL)[9].

However, in order to take into account the extent of commercial relationships between the two countries involved (suggested as a further side of the "follow the customer" hypothesis), the variable TRADE is the sum of exports and imports of goods between Italy and each country considered (normalised through GDP). Data come from the Italian Institute for the

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[8] Traditionally instead, FDI has been measured by FDI flows and stocks, as recorded in the balance of payments. Nonetheless, we are convinced that they might present some limits and biases which undermine their significance for detailed analyses at country and industry level. First, they follow a *first country, first sector* criterium. For instance, if an Italian parent firm sets up a financial holding in the Netherlands which acquires a manufacturing firm in the US, the Italian balance of payments records an Italian FDI in the Netherlands in the financial sector, and does not record any FDI in the US. Moreover, only part of the capital invested abroad by multinational enterprises is financed though movements recorded in the balance of payments. Finally, further problems relate to the fact that FDI are recorded at their historical value.

[9] For further details, see Cominotti *et al.* (1999).

International Trade (ICE).

Location advantages ($LOCAT_J$)

- *Wealth and size of the local market.* The wealth of the foreign market has been measured by GDP and the GDP_PC, which are the national GDP and GDP *per capita* in the year considered. Data come from the International Monetary Fund.
- *Characteristics of the local banking market.* As far as the characteristics of the local banking market (Demirgüç–Kunt and Levine, 1996; Miller and Parkhe, 1998), we considered: MKT_SIZE (measured by the total deposits to the national GDP) as a proxy for the size of the banking market; MKT_DEV (measured as the ratio of the total claims of deposit money banks to the national GDP) as a proxy for the development of the banking system; and MKT_EFF (measured by the difference between bank lending and borrowing rate) as a proxy for the banking efficiency. The source for all these variables is International Monetary Fund.
- *Country political and economic risk*. Some of the empirical studies so far proposed in the literature suggested that FDI by banks can be negatively influenced by the target country's risk (e.g. Hultman e McGee, 1989; Yamori, 1998). Accordingly, we included the variable RISK, obtained from IPSOA for each country where the foreign operations of Italian banks are located. The index allows for the economic and political structure of the country. Specifically, it goes from 0, indicating the highest risk, 100 for the lower risk.
- *Regulatory environment.* The variables relating to the regulatory environment come from a new and comprehensive database based upon a survey sent to national bank regulatory and supervisory authorities. Such data enable us to identify the existing regulation and supervision of banks in 107 countries at all levels of income and in all parts of the world[10].

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[10] Data are available at the World's Bank website for financial sector research (http:///www.worldbank.org/research/interest/intrstweb.htm). However, we are particularly grateful to G. Caprio and R. Levine for having supplied us with the relevant data not available on the website.

Specifically, we considered the variable REG_ENTRY defined as a dummy assuming value 1 whether the country presents entry barriers to potential foreign entrants, and zero otherwise. Likewise, we also considered the dummy variable REG_OWN that equals 1 when the constraints in the country concern the ownership of local banks by foreign companies, and zero otherwise.

- *Presence of an international financial centre*. According with Brealey and Kaplanis (1996), and Buch (1999), the variable FIN_CEN is a dummy which equals one for the following countries: Bahamas, Cayman Islands, Hong Kong, Indonesia, Japan, Luxemburg, Singapore, Switzerland, United Kingdom, USA.
- *Cultural distance.* The literature is unanimous in recognising that the higher the socio-cultural distance between home and host countries, the lower the degree of control demanded by foreign investors. The proxy of socio-cultural distance (CULT_DIS) was evaluated by applying to Italy the formula proposed by Kogut and Singh (1988), based on the four indicators proposed by Hofstede (1980), which has already been used in empirical studies concerning the entry mode choice (e.g. Erramilli 1991).

5. EMPIRICAL FINDINGS

Table 3 presents summary statistics and correlation among the variables and reveal several interesting aspects about the structure of the Italian international banking as in 1997. First of all, correlation coefficients show that larger banks are the most internationally experienced (coefficients are always greater than 0.7), while age is positively (although not seriously) correlated with both the dimensional scale and the international experience. As expected, the commercial relationships and the amount of FDI undertaken by Italian firms in the same country are highly correlated, thus showing that both stimulate the subsequent entry of Italian banks in the foreign country considered. In fact, the two phenomena may be seen as complementary. On the one hand, the presence of Italian MNEs in a foreign country stimulates trade between the home and the host countries; on the other, countries enjoying high commercial flows with Italy are more likely to host FDI by those Italian firms wishing to reach insider presence in the country (thus evolving from commercial internationalisation to foreign direct investment). That, in turn, breeds further commercial flows, thus giving rise to a virtuous circle among FDI, trade between the countries and presence of foreign banks. It is worth observing that while many banks initially followed their clients (mostly goods producing companies) to the countries in which they set up their factories, today is the ability of banks to offer global services which appeals to their clients, who, themselves are global corporations (Dunning, 1993).

Results of the econometric estimates for the four organisational modes (both the most general models in which the whole set of independent variables are estimated – Models a –, and the best specifications of the model, in which only the variables significant at least at $p<0.10$ are left – Models b and c –) are reported in Tables 4 (internal growth) and 5 (external growth).

The pattern of results obtained generally provides strong support to the hypotheses developed about the international growth patterns followed by Italian banks, and their level of services and commitment undertaken on foreign countries, as at the end of the '90s.

O*wnership advantages*

Hypotheses 1 and 2 received strong support. Indeed, the bank's dimensional scale as well as its international experience, show a positive and significant coefficient in the whole set of Models, i.e. they are crucially important for a bank wishing to expand abroad through both internal and external growth. Specifically, SIZE1[11] is significant at $p<.01$ in the whole set of Models, while EXP_INT2 (i.e. the cumulative dimension of experience within a given foreign country) is significant at $p<.01$ for the organisational forms requiring higher level of commitment (branches and subsidiaries), and EXP_INT1 (the geographical dimension) for the lighter forms (representative offices and affiliates).

Interestingly, the two effects (size and international experience) work together in Models 1 and 3 (i.e. branches and subsidiaries), thus confirming that larger and more internationally experienced firms are more likely to adopt higher levels of commitments.

The estimated coefficients for the bank's age at entry are always positive although they do not come out significant, perhaps because the spurious correlation with the bank's dimensional scale.

Internalisation advantages

Empirical findings confirm also the *follow the customer* hypothesis, i.e. that Italian banks tend to save their pre-existing relationships with their clients, following them into foreign countries. Nonetheless, while the variable FDI shows a positive and significant sign (at p<.01) for the whole set of organisational forms considered, the proxy for commercial relationships (TRADE) is positive and significant only in Models 1 and 2 (i.e. only to explain branches and representative offices). This reveals that when following their existing customers, Italian banks prefer to do it directly, thus confirming Hypotheses 3 and 4. As intuitively expected, they adopt greater level of commitment when the local market is greater and more promising (MKT_SIZE positive and significant in Models 1 and 3).

Location advantages

According with Hypothesis 5, banks' FDI requiring higher level of commitment is more likely to be directed towards larger and well developed financial markets. Indeed, MKT_SIZE is positive and significant (at p<.01) in Models 1 and 3, i.e. for branches and subsidiaries. Conversely, where the business opportunities in the local financial sector are lower, the bank prefer to set there only (exploratory) representative offices. Likewise, the results show that when wishing to operate in the wholesale markets, then resorting to internal organisational forms, Italian banks address their efforts towards the major world financial centres. FIN_CEN is positive and significant at p<.01 for branches and representative offices; positive and

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[11] Estimated coefficients for SIZE2 and SIZE3 are positive and significant as well. Nonetheless, we report only

significant at p<.05 for subsidiaries while it becomes negative for affiliates, thus revealing that banks set only minority interests in minor international financial centres.

As obviously expected, regulatory constraints act as a control effect and impact on the banks' decisions. Indeed, Italian banks set up only representative offices in countries with relevant constraints (REG_ENTRY and REG_OWN show positive and significant coefficients in Models 2).

Finally, Hypothesis 7 is strongly confirmed as Italian banks do not seem to be keen to undertake relevant acquisitions of local companies in countries culturally distant (CULT_DIS is indeed negative and significant at p<.05 only in Models 3) as the integration of an acquired company is very much likely to be complicated by differences in organisational culture and management style.

6. DISCUSSION

The evidence in this study highlights that banks expand abroad both through internal expansion or through acquisitive growth even in the same country. Firms undertake acquisitions in order to enter a market quickly, to overcome barriers to entry or to imitate other firms that make acquisitions. However, acquisition may also revitalise a firm and enhance its ability to react adequately to changing circumstances. Acquisitions may lead to cultural clashes and tensions when they are implemented (Haspeslagh and Jemison, 1991), which may cause immediate problems and unsatisfactory performance, but they may also enrich the knowledge bases and break the rigidities of acquiring firms. Conversely, greenfield initiatives are more likely when the firm wish to replicate and exploit existing competencies, but they may lead to rigidity and simplicity (Vermeulen and Barkema, 2001).

In this study we advanced and tested the idea that the factors influencing a bank's international growth may be framed within the eclectic paradigm, i.e. they may be related to

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estimates for SIZE1, that performs better throughout the models.

the whole set of ownership, internalisation and location advantages. Prior studies have typically focused on the commitment level adopted by the banks upon foreign markets (Miller and Parkhe, 1998) or on the choice between different organisational forms (Ball and Tschoegl, 1982). We moved beyond by focusing on a two-dimensional choice, i.e. internal vs. external, and high vs. low commitment level required. We argued and econometrically tested that:

(i) stronger ownership advantages (larger size and higher level of international experience) increase the propensity to grow upon foreign market (by resorting to both internal and external growth), and to set up foreign units requiring higher level of commitment;

(ii) the international expansion of a bank towards a foreign country is positively related to foreign initiatives already undertaken by national firms in that country, in order to save their pre-existing relationships. Indeed, personal contact constitutes one of the main advantages for banks and preserving established accounts by opening foreign offices become a means for protecting knowledge and information networks, thus achieving internalisation advantages. As far as the organisational forms, when following their customers abroad banks typically adopt internal forms (i.e. branch and/or representative office), which act on the basis of the parent's capital and reputation, and are therefore closer to the customers themselves; however, higher commitment levels are chosen mainly in mode promising target countries;

(iii) banks' FDI requiring higher level of commitment is more likely to be directed towards larger and well developed financial markets, where business opportunities in the financial sector are higher, and where risk is lower, once allowed for regulatory restrictions. Additionally, banks' foreign activities in a country hosting an important international financial centre are more likely to originate from internal growth strategies; and finally

(iv) cultural distance decreases the propensity of a bank to get heavily involved in the foreign country through acquisitions of local companies.

These findings seem to offer some support to the evidence about the recent MNEs' attitude to source key competitive advantages from abroad. Namely, MNEs' are increasingly undertaking foreign direct investment not only as a means of exploiting the existing ownership specific or competitive advantages, but also as a vehicles to augment them or source them from a foreign location (see McKaig-Berliner and Dunning, 2001).

In fact, it seems to emerge a complementarity between the MNBs' ownership advantages and its ability to consolidate and extend these advantages through the international network placed both where existing customers have already extended their activities, and where they can enjoy (industry-specific) spillovers and (specialisation) externalities.

7. LIMITATIONS AND FUTURE DIRECTIONS

The research focuses on the distinction between acquisition and greenfield investments, with reference to the choice undertaken by banks. Previous studies (Vermeulen and Barkema, 2001) underlined that expansion through greenfields, i.e. through the exploitation of existing knowledge resources, may lead companies to ossification and simplicity. Indeed, when a firm sets up a greenfield initiative, it will be inclined to implement its habitual ways of organising and managing, and that may make the organisation's culture stronger but may also lead to oppressive conformity, blindness and intolerance. Acquisitions have instead different effects. Acquiring and absorbing an existing organisation may be difficult as acquired companies have idiosyncratic sets of routines and their integration often leads to clashes and tensions, owing to the confrontation of different cultures, structures and systems. However, these differences bay also break rigidities in acquiring firms, counter simplicity and foster learning. Experience with acquisitions thus make firms more flexible and more able to adapt to varying circumstances, while on the contrary, experience with greenfields make them more rigid and less likely to undertake successful new ventures.

Therefore, an interesting extension of the present research would be a survival analysis for each initiative undertaken by the bank. That would require enlarging the temporal window in order to investigate how greenfields and acquisitions affect the viability of a firm's later expansions.

However, the characteristics of the target firm may be included. It seems likely, for instance, that a firm will learn more by acquiring a highly profitable target firm, rather than by taking over a poorly performing firm that happens to be a bargain (Vermeulen and Barkema, 2001). Future studies would then benefit from the inclusion of these information.

Our research focused exclusively on equity modes adopted by banks in their international expansion. However, non-equity modes, defined as modes that do not entail equity investment by a foreign entrant, are becoming increasingly popular among financial service firms for organising overseas ventures/operations (see for example Jacobsen and Tschoegl (1999), which investigate Nordic banks' international alliances, cooperative agreements and consortia). Hierarchical control and full internalisation is no longer always a first-best option to MNEs. A series of events over the last two decades has led scholars to suggest that the world is moving to embrace a new process of globalisation and the associate advent of alliance capitalism (Dunning, 1995). That has ushered changes also in the way MNBs undertake cross-border activities, shifting away the emphasis from hierarchies towards a richer variety of organisational models. In fact, external growth and non-equity alliances are becoming more important forms of international economic involvement. These strategies may enable firms to maintain their ability to react adequately to changing external conditions and, consequently, to survive in the long run (Vermeulen and Barkema, 2001). Future studies that consider a wider range of strategic options, will supplement the present study.

Our findings may have been influenced by idiosyncratic features of our sample. The banks in our sample were based in a single country, Italy. Till recently, the relatively small dimension of Italian banks and the low concentration rate of the national banking system, differentiated the Italian situation from the other main European countries, and only in the very latest few years it is reaching an internationally adequate dimension. A comparison with banks from other European countries could provide further insights into the phenomenon as far as banks' locational preferences, organisational forms and growth strategies are concerned.

The methodology of this study implied looking at internationalising organisations; we studied banks that decided to grow upon foreign markets. When looking at the actual choices that these firms made, we found that they conformed to the patterns implied by our theoretical expectations. In future studies, it may be worth adopting a complementary methodology by ex ante selecting a cohort of banks and examining whether they internationalised or not, and if so, how they decided among different organisational forms.

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