

The choice of the form of representation in multinational banking: Evidence from Spain.

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1. Introduction

The important increase in foreign banking activity during the last decades has motivated a growing interest about the causes that have led to this process. H. Grubel (1977) posed a main question in this subject: Which are the sources of advantage that allow some banks to enter into foreign markets, and to compete successfully with domestic firms, more familiar with the environment? Since then, numerous researchers have attempted to answer this question from different approaches. However, whereas most papers have dealt with this issue at an aggregate level, focusing on the determinants of banking activity in a foreign country (usually the U.S.) that are country specific, only a few papers have undertaken a micro approach investigating the banks' motivations for entering the foreign markets.

When a bank decides to enter a foreign location, a question that immediately arises is the election of the form of representation. The following organizational forms are generally available for the bank: representative office, agency, branch and subsidiary.

The representative office is the most economical of overseas banking organizational forms. Usually it consists in a small commercial office designed for helping the parent bank and its customers in their financial and commercial activities in foreign markets. Since these offices are not allowed to participate in the typical banking activities, the main motivation for establishing a representative office is to allow the parent bank to engage in international merchant banking activities (Heinkel and Levi, 1992). Agencies constitute a second organizational level for carrying out overseas operations. Because a higher investment is required, agencies imply a stronger commitment with the host country. However, as representative offices, they can not participate in the host country banking system. Banks usually establish agencies in locations where a sufficient scale of operations exists that justify the higher investment required.

A foreign branch constitutes a higher level of commitment with the market than representative offices and agencies. Unlike them, foreign branches actively participate in the host country banking system. In addition, they involve a higher investment for the parent bank. Nevertheless, to establish a foreign branch can be justified when the bank is interested in playing an active role in the local banking sector.

Finally, foreign subsidiaries are incorporated to the host country banking system. This feature constitutes the main difference with the previous forms, and is specially important because this makes foreign subsidiaries to be subjected only to the same limitations that domestic banks for carrying out their activities. Thus, the subsidiary is the form of representation that allows the parent bank to develop a wider activity in the foreign location.

Since, as we have discussed, representative offices, agencies, branches and subsidiaries involve different levels of investment, as well as they allow to offer a different range of

banking services, the issue of the form of the entry needs to be taken into account in the investigation of banking expansion in foreign countries.

In this paper a prognostic model of the entry in Spain by foreign banks has been proposed. Unlike most of the studies investigating this issue, the form of representation chosen by the bank for entering the foreign markets has been considered. Dunning's eclectic paradigm constitutes the theoretical framework in the investigation. The main interest of this paper is to evaluate the importance of OLI advantages as the determinants of the form of representation in foreign locations. Only Ursacki and Vertinsky (1992) investigating the entry in Japan and Korea by foreign banks has previously addressed this issue. They use a multinomial logistic model to examine foreign entry through representative offices and branches. Unlike them, we have used an ordinal logistic model. In addition, foreign banking entry through representative offices, branches and subsidiaries has been investigated. The structure of the paper is as follows: the next section reviews the literature about foreign direct investment in the banking sector. The proposed model is discussed in section 3. Data and variables are showed in section 4. Last, we present the empirical results of the investigation, as well as the conclusions that arise from them.

2. Review of the literature

Papers investigating international banking activity from a theoretical approach, have developed hypotheses about the motivations that would influence banking entities to establish offices in foreign locations. Authors as Grubel (1977), and Gray and Gray (1981) apply the theory of the multinational firm to the banking sector. As many other researchers they adopt Dunning's eclectic paradigm as the theoretical framework for the investigation of the firm's decision to invest abroad. Accordingly, ownership specific advantages are crucial as it is the possession of these advantages that allow the foreign bank to overcome the advantages of domestic banks due to incumbency (Williams, 1997). They suggest a following-the-client behavior to explain banking internationalization. The reason of such a behavior lies in the advantages in terms of information costs for banks working with the foreign subsidiaries of their home country clients. Therefore, the internalization of this advantage should constitute a main motivation in the bank's decision to be present in foreign locations. Cho (1985 and 1986) emphasizes the importance of the bank's experience in multinational operations as well as the differentiation of banking products as important sources of ownership advantages. Other papers have attempted to test the importance of these advantages. Most of them have focused on the US' case, investigating either foreign banking expansion in the US (Hultman and McGee, 1989, Grosse and Goldberg, 1991 and Heinkel and Levi, 1992),

or foreign expansion by banks from the US (Fieleke, 1977, Nigh, Cho and Krishnan, 1986, Sabi, 1988 and Goldberg and Johnson, 1990). These studies have shown the importance of commercial ties with the host country as well as the existing regulation towards foreign banking entry, as the main determinants of foreign banking activity. However, since they make use of aggregate data, it is not possible to know the importance of the firm's specific advantages in its decision to offer banking services abroad. Only a few papers have overcome this limitation carrying out the analysis with individual data. Ball and Tschoegl (1982) were the pioneers in modeling the bank's decision to invest abroad through variables that are, for the most part, internal to the bank. However, they do not take into account the form of representation chosen by the bank in foreign markets. Their results show that foreign direct investment in banking is determined by the size of the bank, its multinational experience, and the distance between the bank's country of origin and the host country. More recently Ursacki and Vertinsky (1992) investigated, using a multinomial logistic model, foreign banking expansion in Japan and Korea through branches and representative offices. The authors adopt Dunning's eclectic paradigm as the theoretical framework. Their results show the importance of ownership advantages, as the size of the bank and its experience operating in a multinational environment, as well as the bank's country-specific technology, as the determinants of foreign banking expansion through branches. Surprisingly, only the experience of the bank operating in a multinational environment reveals as an important factor in explaining foreign banking expansion through representative offices. As an unexpected result, direct trade and investment ties to a home country are unrelated to the entry, either through representative offices or branches. Since foreign subsidiaries were not allowed neither in Japan nor in Korea, the authors do not include this form of overseas offices in their investigation.

3. Methodology

As it has been previously discussed, due to differences in their scope of activity as well as on the amount of investment required, representative offices, agencies, branches and subsidiaries imply different levels of foreign involvement. Within the eclectic paradigm, whereas firm's OSAs are considered to be pre-requisites for the existence of foreign direct investment, locations advantages will dictate the site of the investment. Previous research has shown the importance of these advantages as the determinants of the bank's entry in foreign locations. However, with the only exception of Ursacki and Vertinsky (1992), these papers have not tackled the issue of the form of the entry. In this paper the bank's decision to be present in a foreign location is examined from a wider approach, by considering the form of representation chosen by the bank in its multinational expansion.

3.1. Model

In order to test the importance of OLI advantages as the determinants of banking entry in foreign markets, an ordinal logistic model has been proposed. Unlike Ursacki and Vertinsky (1992) who use a non-ordinal model we have chosen an ordinal model. This decision is based on the inherent ordination of the dependent variable: representative offices, agencies, branches and subsidiaries represent a growing level of foreign involvement for the bank. When this is the case, according to Greene (1993), although the outcome is discrete the multinomial logit or probit models would fail to account for the ordinal nature of the dependent variable. In such a situation the use of an ordinal model would allow to overcome this limitation.

The dependent variable will be 0 for banks which are not present in Spain in the base year of the investigation. It will be 1 for those banks whose form of presence is the representative office, 2 for banks with branches, and 3 for banks which are established through subsidiaries.

The formulation of the model will be as follows:

$$\Pr ob(y = 0) = F(-b' x)$$

$$\Pr ob(y = 1) = F(m_1 - b' x) - F(-b' x)$$

$$\Pr ob(y = 2) = F(m_2 - b' x) - F(m_1 - b' x)$$

$$\Pr ob(y = 3) = 1 - F(m_2 - b' x)$$

where, m_1 and m_2 are the intercepts, and $F(\cdot)$ is the accumulated distribution function for the logistic model, given by the expression:

$$F(\cdot) = \frac{e^{(\cdot)}}{1 + e^{(\cdot)}}$$

3.2. Hypotheses

The election of the variables introduced in the model as the determinants of the form of representation in multinational banking is discussed next.

Size

Firms need a minimum size in order to be able to develop an international activity and compete successfully in foreign markets with local entities. Important resources are needed for absorbing the high costs of marketing and taking advantage of the economies of scale, when they exist. According to Buckley and Casson (1976), and Kumar (1984), the size of the firm will reflect its ability for absorbing these costs. In banking, economies of scale have not been regarded as an important advantage, as they appear to be exhausted at relatively low levels. However, the importance of size can be due to the possibilities of product differentiation that they provide to the bank, for example in terms of prestige. Ball and Tschoegl (1982) find that the size of the bank has been a main determinant of multinational banking expansion in California and Japan. Ursacki and Vertinsky (1992) obtain that whereas the size of the bank positively affects the setting up of foreign branches, it does not affect the establishment of representative offices abroad. This result could illustrate the fact that whereas multinational banking through branches and subsidiaries involves important amounts of resources for the parent bank, the representative office constitutes a more economical way for expanding activities abroad.

Soundness

Product differentiation is usually considered as an example of ownership advantage. Neven (1990) emphasizes that because banking services show a high degree of simplicity, the scope for differentiation is quite small. He points up, however, bank's soundness as a way of product differentiation. Following this line of argument, since holding a deposit in a bank implies a level of risk for the depositor, those clients with a higher degree of risk aversion will pay more attention to the degree of security associated to the bank they are dealing with. Since the capitalization ratio constitutes an indicator of the bank's soundness we would expect that entities with a higher capitalization ratio will enjoy signaling-related advantages for competing abroad because the strong commitment of their own funds.

Multinational experience

The experience of the bank operating in a multinational environment is expected to constitute an advantage in encouraging its expansion abroad. According to Agarwall and Ramaswami (1992), firms with an important multinational experience will enjoy a larger ability for adapting their operations in different environments at a low cost. In addition, for the banking sector, as Ursacki and Vertinsky (1992) suggest, banks with a large and geographically diverse customer base will be able to reduce transaction costs by bringing

together customers with offsetting needs. When the form of representation is introduced in the analysis, we expect that multinational experience will favor higher levels of involvement in the host country. The reason is that banks without an important experience operating abroad will hardly assume the risk associated with an important investment in a foreign market, as the acquisition of a foreign bank, or the establishment of a branch involve. On the contrary, these entities are expected to start their multinational activity through organizational forms that imply relatively small levels of commitment with the host country.

Foreign direct investment

According to Grubel (1977) and Gray and Gray (1981), banks following their clients in their multinational expansion, has constituted a main motivation in multinational banking. Some authors have justified this behavior as a defensive strategy since, if the bank does not follow their clients abroad, they could establish a new banking relationship in the host country that eventually could supplant the existing domestic banking relationship. The rationale of the following the client behavior is based on the imperfections in the factors markets, that caused banks have an unique client knowledge and leads to a situation of information asymmetries, in relation with local banks. This fact is particularly important since information is, jointly with capital, the most important input in the banking activity. Therefore, information costs could be reduced if the bank that has relations with the parent company also deals with its subsidiaries abroad. In consequence, the presence in a foreign location of home country clients subsidiaries should encourage the bank to undertake a higher level of involvement in the host country, given the lower risk of its investment abroad, comparing with those banks without these multinational clients.

Country-specific advantages

Many authors have emphasized the importance of country-specific advantages in multinational banking. Nevertheless some difficulties arise in order to test their importance. In Ball and Tschoegl (1982) the origin of these advantages remains unspecified. They introduce as a proxy the number of banks from the home country that have a branch or subsidiary in a foreign location. Ursacki and Vertinsky (1992) propose the percentage of home labor force in the finance sector as a proxy of these advantages. They consider that it would indicate the degree of sophistication of the domestic banking sector. However, important shortcomings can be pointed to this assumption. One of the most obvious is that it does not take into account the productivity of the home labor force. In our model, country-specific advantages have been introduced through the

degree of competitiveness in the domestic banking sector. Although it has been widely suggested in the literature that banks proceeding from more competitive banking systems will be better able to compete abroad, empirical evidence is lacking.

Distance

Distance is usually considered in the eclectic paradigm as a main locational specific advantage. The reason is that the costs of monitoring an investment grow with distance. Therefore, since the cost of monitoring clients will be higher in distant markets, distance should constitute a barrier of entry in international banking, making banks less willing to invest in distant locations. However, authors as Terpstra and Yu [1988] while accepting this behavior for industrial firms, disagree about the effect of distance for service firms. They discuss that since for these firms the proximity with the client is essential, whereas clients from the closest locations could be served from the company headquarters, a foreign presence will be needed for servicing clients in distant markets. Therefore, a higher distance to a foreign location should favor the bank's physical presence. Although empirical evidence in the banking sector supports, for the most part, distance as an entry barrier, a general agreement does not exist, as proved by the results obtained by Grosse and Goldberg (1991) confirming the behavior proposed by Terpstra and Yu (1988).

4. Data and variables

The analysis of the entry in Spain by foreign banks, relates the bank's advantages in 1988 with its form of representation in Spain in 1992. This is the latest year for which information about the variables in the model was available. The gap of four years is considered necessary for the bank in order to evaluate the attractiveness of a foreign location, as well as, for obtaining the pertinent license from the host country banking authority.

Four categories of entities have been considered: Banks which are not present in Spain, banks which have established representative offices, banks with branches, and finally banks which operate through subsidiaries. Agencies have not been included in the investigation because they are not considered by the Spanish law.

The sample used in the analysis is formed by the foreign banks included in "The Banker's top 300" of each year since 1988 to 1992. This latest restriction has been incorporated in order to eliminate minor banks present in the sample because foreign exchange fluctuations. Information was available for 192 of the 244 entities that complied with this condition. After removing those banks whose main dedication was not commercial

banking, as development banks and investment banks, we have ended up with 173 entities.

The variables introduced in the model as the determinants of the form of the entry are the following:

AS: bank's total assets, in millions of US\$ as a measure of the size of the bank. Source: The Banker.

CAP: capital/asset ratio as a measure of bank's soundness. Source: The Banker.

FOE: number of countries where the bank has established offices as a measure of its multinational experience.

Source: The Banker's Almanac.

FDI: foreign direct investment in Spain in millions' pts from the bank's country of origin. Source: Boletín Económico de Información Comercial Española.

IM: interest margin as a percentage of total assets in the bank's country of origin, as an indicator of the degree of banking competitiveness. Source: Bank Profitability.

D: distance between Madrid and the foreign location where the bank is registered.

Table 1 reports some descriptive statistics about these variables.

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The expected signs for the regressors, according to the discussion in the previous section are shown in table 2.

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5. Empirical Results

Empirical results, reported in table 3, show the significance of the proposed model at the required levels. In addition, almost a 90% of the cases are correctly predicted.

Table 4 illustrates an interesting point: no entry has been predicted through representative offices. All the banks that have entered into Spain through this organizational form -except one-, have been classified by the model within the group of banks without any representation at all. Thus, it would imply that from the point of view of the proposed variables those banks would be closer to the banks which were not established in Spain. This result supports Ursacki and Vertinsky (1992) findings that ownership specific advantages do not result statistically significant for explaining foreign banking expansion through representative offices.

The size of the bank as well as its experience operating in a multinational environment positively affect, as expected, the bank's commitment with the host country. In both cases the associated coefficient is positive and statistically significant at a 0,01 level.

Neither the bank's capital/asset ratio nor the foreign direct investment in the host country from the bank's country of origin, affect significantly the form of the entry. In the first case it would indicate that bank's soundness has not constituted an advantage in explaining the bank's foreign involvement. This would agree with the results of Ursacki and Vertinsky (1992) for the Japanese case. The non significance of the associated coefficient to foreign direct investment could be explained by the extraordinary high rates of return which prevailed in the Spanish banking system when the entry of foreign banks was allowed. This could make that the attractiveness of the entry was independent of the presence in Spain of home country clients multinationals.

No evidence has been obtained about the importance of country-specific advantages as a determinant of foreign banking activity. Surprisingly, the variable introduced as a proxy of these advantages, shows a negative sign, although it is only significant at a 0.05 level. This would indicate that the more a bank proceeds from a less competitive banking systems the more committed with the Spanish system. This unexpected result, however, has to be taken with caution due to the limitations of the chosen proxy for international comparisons. For example, the structure of gross interest margins varies significantly from country to country, as a function of the different dedication to retail activities by the domestic banking sector, or to the existence of cross-subsidization among different types of operations.

Distance to a home country, negatively affects the level of the bank's involvement in the foreign location. As expected, this variable shows an associated coefficient with a negative sign and statistically significant at a 0.01 level. This result supports most of the existing evidence showing the importance of distance as an entry barrier in multinational banking.

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6. Conclusions

Papers investigating foreign direct investment in the banking sector do not usually take into account the different forms of establishing operations in foreign markets. They just consider two groups of entities: banks with offices abroad, and banks without offices abroad. However, the important differences existing among the different types of foreign offices would justify to take into account the form of representation chosen by the bank in its multinational expansion. In this paper we have investigated the importance of OLI advantages as the determinants of the form of the entry in foreign locations. Although there are several methodological differences between the two papers, our results greatly support Ursacki and Vertinsky (1992) findings, investigating foreign banking entry in Japan and Korea. Therefore, a stronger evidence has been achieved about the determinants of foreign banking activity. It has been obtained that whereas the proposed model is globally significant, it fails in explaining foreign banking expansion through representative offices. This could reflect the special kind of activities of this form of representation, that can not actively participate in the host country banking system. In addition, we have shown that the size of the bank as well as its multinational experience favor a stronger commitment with the host country. On the contrary, distance constitutes a barrier of entry. This last point is especially important since a general agreement about the effect of distance in the multinational expansion by service firms does not exist.

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Table 1. Descriptive statistics

Variable	Mean	Stand. Dev.	Min.	Max.
AS	92,90	99,89	9,00	352,53
CAP	4,80	1,61	0,75	11,13
FOE	8,29	10,54	1,00	61,00
FDI	297096,1	328849,81	31,00	1773728,00
IM	2,87	1,04	1,30	4,90
D	5963,41	4310,84	550,00	17320,00

Table 2. Expected signs for the regressors

<u>Variable</u>	<u>Expected sign</u>
AS	+
CAP	+
FOE	+
FDI	+
IM	-
D	-

Table 3. Empirical Results

	Coefficient (t-statistic)
Constant	-1.8230
AS	0.00102 (3.788)
CAP	-0.1487 (-1.012)
FOE	0.0886 (6.290)
FDI	-0.2865 (-1.432)
IM	0.3856 (2.083)
D	-0.0002 (-3.025)
m_1	0.3912 (2.735)
m_2	3.5990 (6.081)
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N	173
Log-Likelihood	-58.94694
Chi-Squared	160.86000
Significance Level	0.00000

Table 4. Classification Accuracy

Actual	Predicted				Total
	0	1	2	3	
0	120	0	6	0	126
1	7	0	1	0	8
2	5	0	27	1	33
3	0	0	1	5	6
Total	132	0	35	6	173